The Development of the Mortgage Market and Prudential Supervision in Russia

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Foreword

This report seeks to provide a broad, high level overview of the regulatory structure and institutional arrangements for mortgage finance in Russia.

The general approach has been to set out best practice for mortgage supervision and then, as far as possible, to apply these to the Russian context. The report is based on a study of relevant literature, both on supervision of mortgage lending generally and on the particular circumstances of Russia, and a series of meetings held during a two day visit to Moscow on 26 and 27 May 2003.

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Executive Summary

The importance of housing finance in emerging markets

An efficient housing finance market can facilitate a significant improvement in the availability of and access to housing through making available loans to finance house purchase at reasonable rates of interest. An efficient housing finance market also contributes to the objective of strengthening financial markets generally.

Principles for prudential supervision of mortgage lending

Mortgage lending is a form of bank lending and should be regulated as such. There is a recognition that well secured loans to purchasers of residential property are less risky than other forms of lending and accordingly carry a 50% risk weighting in the international standards. Regulators also need to examine the overall risk profile of a mortgage lender's loan book and the way that any maturity mismatch is handled.

Where a bank has an interest in a non-bank a consolidated approach to supervision should be adopted. State owned mortgage banks should be subject to the same requirements as private sector banks.

Supervision in the Russian context

Russia has a tiny mortgage market for a variety of reasons including legislation which makes it difficult for mortgage lenders to realise their security and a general distrust of banking institutions. The regulatory regime needs to safeguard the soundness of financial institutions and, at the same time, not stifle the development of the mortgage market that Russia needs. The Central Bank is right to require a 100% risk weighting for mortgage loans.

Supervision and secondary market activity

The secondary market activity can broaden the sources of funds available to the mortgage market and help mortgage lenders manage their balance sheets. However, an efficient secondary market will not work unless the building blocks are in place in respect of the primary market. There are rather too high hopes of what secondary market activity can achieve in Russia.

Banks should be able to issues mortgage related securities in the same way as non-banking institutions. Banks should be required to main capital backing for loans unless they transfer all of the risk when they securitise loans.

The Central Bank and the securities regulator must adopt a co-ordinated approach to supervisory secondary market activity so as to avoid regulatory arbitrage and distorting competition.

Protection of the borrower

There is a trade off between protecting the borrower and the development of the housing finance market. It is important that borrowers are fully aware of the nature of the loan they are taking out, but beyond this attempts to protect borrowers often have the effect of stifling the market.

Supervision of deposit taking

The development of the mortgage market must go hand in hand with the development of the retails savings market. There is distrust in financial institutions. A deposit protection scheme might help to address this issue but needs to be carefully structured otherwise there is a danger of the State bearing too much of the risk.

There are plans to introduce mortgage savings contracts on the lines of those operating in Germany. While such schemes can play a part in developing a mortgage market, again there is a danger of expectations being raised which will not be capable of being met. Such schemes can provide only a small part of the loan finance that people need and tend to work only if there is a government subsidy and also if new savers are continually attracted.

Issues and recommendations

- There needs to be an overall plan for the development of the mortgage market and someone must have ownership for this plan. .
- There must be clear arrangements by which a mortgage lender can realise its security should the borrower default.
- Consideration should be given to a mortgage insurance scheme.
- Currently, residential mortgage loans should have a 100% risk weighting.
- The Central Bank should develop a framework for monitoring the quality of a bank's mortgage loan portfolio and interest rate risk.
- Provisioning requirements should be based on actual loss experience and the whole loan portfolio rather than detailed estimates for each loan.
- There should be a consolidated approach to supervision where a bank has a significant interest in a non-bank mortgage lending institution.
- State housing banks should be subject to the same supervisory requirements as banks.
- Policy towards mortgage market development should not be centred on securitisation.
- Banks should be able issue mortgage bonds and mortgage backed securities in the same way as non-banks.
- Mortgage loans that are sold or securitised should require no capital backing only if the issuing bank carries no risk.
- The Securities Commission and the Central Bank should adopt a co-ordinated approach to regulating mortgage backed securities.
- Protection of the borrower should be through ensuring that they have the necessary information.
- Banks must be able to demonstrate that they can meet any commitments under mortgage savings schemes.

Chapter 1

The importance of mortgage finance in emerging markets

In any economy, the cost of housing is high in relation to incomes. People can afford to build or purchase housing only if they are able to obtain funds from another source. Among the sources commonly used in emerging markets are family and friends and those responsible for building housing. Formal financial institutions are used by only a minority of house buyers.

In an efficient mortgage market, the rate of interest on loans to finance house purchase is well below other rates of interest payable by individuals. This is because loans are secured effectively on the income of the borrower but also on the property, that is, in the event of the borrower defaulting on his loan, the lender can take possession of the property, sell it with vacant possession and thereby recover their debt.

Because the security is so good and rates of interest much lower than other rates of interest, it follows that more people are able to purchase housing where there is an effective formal housing finance mechanism. A thriving mortgage market can also help deepen and broaden financial market generally. People may be reluctant to save money with financial institutions or indeed to have anything to do with them. However, if they are able to obtain the assistance of a financial institution to finance the purchase of their house then they will be more inclined to deal with it more generally.

The conditions for a successful mortgage market

Over the last twenty or so years, a substantial body of knowledge has emerged about the conditions needed to enable a mortgage market to develop successful in emerging markets. Much of the work is being done under the auspices of the World Bank and other international agencies.

A successful mortgage system needs conditions to be right in three different or related areas.

Firstly, there must be the right institutional framework in terms of laws and professional people for the market. The legal framework needs to cover the key issues of land ownership and the rights and obligations of lenders and borrowers. In particular, it needs to be recognised that the better secured the lender, the lower the spread between the cost of funds and the rate charged to borrowers. It is also important that valuations are based on sound principles which, in turn, require a body of appropriately qualified people.

The second set of conditions is concerned with the institutions that make housing finance loans. Emerging markets cannot afford to subsidise loans to help people purchase housing, particularly as such people tend to be among the richer sections of the community. Mortgage loans therefore need to be at a commercial rate of interest. This must be determined by the market and not by administrative means. The regulation of mortgage lending needs to be sufficiently rigorous to ensure soundness of financial institutions but not so restrictive as to prevent lenders operating in a commercial way.

There is a debate as to whether loans to finance house purchase are best provided by commercial banks or by specialist institutions. There is no one right answer to this. In most countries, commercial banks account for the majority of mortgage lending. Where, however, a market is being developed, a specialist institution may have some advantages, in particular because there is a need for special expertise and for a clear focus on the housing finance function.

The third set of conditions is to do with the economy and the financial markets generally. It is very difficult, if not impossible, for a mortgage market to operate in an unstable economic environment or one where rates of inflation are very high. It is equally important that people have confidence in financial institutions.

There is an additional feature relevant to all of these issues, that is the need for stability. The right environment must be put in place and lenders and other participants in the market must have certainty that it will not be changed mortgage finance market, given the long term nature of the lending. If lenders believe that there is a possibility that interest rates will be controlled retrospectively or that some other conditions of the terms on which they make loans can be altered by legislation then this will deter them from participating in the market.

Chapter 2

Principles for prudential supervision of mortgage lending

House purchase loans can be made by banks or by non-banking institutions. The regulatory regime for the two types of institution can legitimately differ but they need to be constructed in a harmonious way so that there is no opportunity for regulatory arbitrage. This chapter concentrates on supervision of banking institutions and then draws some implications for the supervision of non-banking institutions.

The Basle principles

In most countries there is now a well established framework for the supervision of mortgage lending by banking institutions based on guidelines produced by the Basle Committee of Banking Supervisors.

Supervision of bank lending for house purchase should be regulated as part of the normal prudential supervision of banks. This assigns risk weights to various categories of assets. Loans generally carry a 100% risk weighting for which an 8% capital requirement is considered the minimum. Government securities carry a much lower risk weighting reflecting the security they offer. Because loans secured on residential property are more secure than bank lending generally, under the current Basle rules loans to house purchasers carry a 50% risk weighting.

This lower risk weighting than for normal loans is justified on both theoretical and empirical grounds. The theoretical grounds are that –

- Unlike most commercial loans the income earned to repay the loan does not derive from the investment financed by the loan. Loans are repaid out of income earned by borrowers and borrowers prioritise loan repayments because failure to do so might mean them losing their home.
- If borrowers lose their income then other means may be available to repay the loan, including income from other family members, savings, income from renting out part of the property, social security payments and in some countries the proceeds of insurance policies.
- If borrowers are unable to repay their loans the lender still does not lose any money because he can possess the property with vacant possession and sell it. The lender is likely to be able to recover the loan from the proceeds because the security is readily marketable (unlike the security for many commercial loans), the loan will have been for no more than 80% of the value of the property, the chances are that house prices have risen since the loan was taken out and insurance may cover any loss that the lender may make.

Empirical evidence also shows that residential mortgage lending is safer than other forms of bank lending. This is demonstrated not only by the loss experience but also by the willingness of lenders to make residential mortgage loans at a narrow spread over the cost of funds. In developed economies this is typically under two percentage points.

It is important to note that the 50% risk weighting follows from the theoretical points in this section, backed up by empirical evidence on the loss ratio. If this supporting evidence is not available in an economy the 50% risk weighting cannot be justified.

Supervision of the quality of a mortgage lender's portfolio

Banking regulators also need to consider the quality of a bank's overall portfolio of mortgage loans to assess whether the capital it holds is adequate. If a portfolio is relatively risky then the regulator can legitimately require a higher capital requirement. The following factors are all relevant to the security offered by individual mortgage loans and to the quality of the mortgage loan portfolio of a bank –

- The loan to value (LTV) ratio. Empirical evidence shows that this is a particularly significant factor in determining the likelihood of mortgage defaults and resultant losses. The rating agency, Fitch ICBA, has established the following relationship between LTV and expected loss from the experience of six countries (Australia, Germany, Holland, Spain, the UK and the US).

LTV range	Expected losses relative to LTV of 75.01%-80%
50.00% and below	0.00
50.01% - 60.00%	0.09
60.01% - 65.00%	0.25
65.01% - 70.00%	0.46
70.01% - 75.00%	0.70
75.01% - 80.00%	1.00
80.01% - 85.00%	1.39
85.01% - 90.00%	1.92
90.01% - 95.00%	2.67
95.01% - 98.00%	3.40
98.01% - 100.00%	4.14

  It will be seen that a loan with an LTV of 75-80% has a four times greater expected loss than one with an LTV of between 60-65% and a loan with a LTV of 95-98% has an expected loss 3.4 times higher than a loan with an LTV of 75-80%. Because the LTV ratio is so significant lenders (and regulators) may put a ceiling on the ratio, typically 75 – 80%. A market has also developed for mortgage insurance (see below) which insures the top slice of the loan and, in a mature market, may allow a loan to exceed the maximum ratio.
- Loan to income ratio. Other things being equal, the higher the loan to income ratio, the greater the risk of default. A regulator may wish to see a maximum loan to income ratio and may look at the average loan to income ratio for a bank in comparison with other banks. However, this does assume that the income figure is meaningful, which does not always apply in emerging markets.
- This spread of risk, for example large exposures, the geographical spread of lending and the spread of lending between types of home buyer.
- Insider lender, in particular lending to purchasers of properties the construction of which the bank has financed or which the bank itself owns, for example have taken them into possession.

- Appropriate credit checks on the borrower.
- Any guarantors, for example a relative or an employer. In developed systems these are unusual and pose their own problems. In transitional economies they may be necessary to compensate for weaknesses in the security, but there should be a medium term objective to reduce reliance on such guarantees.
- Mortgage insurance. In many countries there are arrangements by which lenders can insure the "top slice" of a loan. Such arrangements might, for example, provide that in exchange for a premium an insurance company will meet any shortfall up to, say, 20% of the value of the loan in the event of the borrow defaulting, the lender repossessing the property and selling it but being unable to recover its debt. There are a number of other types of mortgage insurance. The institutions which can provide such insurance include commercial insurance companies and governmental agencies. Mortgage insurance schemes can also be a means by which other lending requirements can be enforced. For example, mortgage insurance might be available only if loans meet certain requirements, such as a maximum LTV ratio, a maximum size and a maximum loan to income ratio.

Supervision of the interest rate risk

The prudential supervision and capital requirements for banks also need to recognise any interest rate risk that the lender takes. In theory, a bank can take no interest rate risk either by –

- Making fixed rate loans funded by fixed rate liabilities of the same maturity. For example, 25 year loans would be funded by 25 year bonds, five year loans by five year bonds or deposits, etc.
- Making variable rate loans funded by variable rate deposits, that is the rate of interest on loans can be increased at any time in line with the increase in the cost of deposits. In some systems, the lender has discretion as to when, and by how much, to change interest rates with the market providing the necessary protection to borrowers while, in other systems, interest rates must be tied to some cost of funds index.

In practice, however, a lender cannot entirely eliminate interest rate risk whichever system it uses. Fixed rate loans present a risk when interest rates fall. If the borrower has the right to redeem the loan at any time without penalty or with a penalty that does not reflect the loss that the lender could incur then the lender carries a very substantial risk. Even if the borrower cannot redeem there is an increased default risk if interest rates fall as borrowers may refuse to continue paying what they see as an above market interest rate. This particular risk is reduced the more stable the general level of interest rates. The lender can also reduce the risk by limiting the period for which a loan is fixed. For example, a loan can be for a fixed rate for five years, the borrower then having the option of rolling over the loan into another fixed rate loan or a variable rate loan. However, the lender may suffer the risk as the variable rate lender if interest rates rise rapidly over this five year period.

With variable rate loans the risk of default is increased if interest rates rise rapidly as borrowers may be unable or unwilling to meet the higher repayments. To a limited extent, lenders can mitigate the effects of higher interest rates by extending the loan term. Again, in a stable economy with relatively stable interest rates this risk is reduced.

Generally, long term lending of any form is risky in an economy where interest rates are unstable. Short of government guarantees (for example compensating lenders when borrowers prepay long term loans in response to an interest rate fall) there is no means of isolating totally lending institutions from interest rate risks in respect of long term residential mortgage lending. Beyond the obvious points (such as not allowing long term loans to be made without long term liabilities to back them) banks and regulators must look to the stability of interest rates generally. In an unstable environment, particularly one characterised by a high rate of inflation and correspondingly high interest rates banks (and their supervisors) may decide that it is simply imprudent to make any loan with a maturity of more than three or five years. In these circumstances to the extent that banks finance house purchase at all they do so through a succession of short term loans, although the borrower can never be certain that the next loan will be forthcoming.

Loan loss provision

There is scope for alternative practices in respect of loan loss provision, much depending on the state of development of the mortgage market. In a mature market a bank may be permitted to establish its own loss provision based on its actual record. Typically a bank will review the whole of its lending portfolio and make a bulk provision, rather than a bottom-up approach based on individual loans. However, a supervisor should permit this approach only if it is confident that the bank is being realistic and that its track record is reliable in respect of forecasting actual losses. In a developing market a supervisory should take a more interventionist approach with some broad requirements, generally relating to loans that are so many days in arrears and properties in possession. It is important that these rules do not become too detailed and restrictive such as to deter banks from making residential mortgage loans or restructuring those loans subsequently. For example, it is inappropriate to require provisions (even if zero) to be made for every single loan given that the loans can be categorised into broad groups quite sufficient for the purposes of provisioning.

The supervisor’s main objective must be to ensure that there are systems in place so that banks know the status of all their loans and make reasonable provisions. The role of auditing is important here.

Supervision of lending by non-banks

The purpose of the supervisory mechanism outlined in the previous section is to protect bank depositors by ensuring that banks are well capitalised for the nature of their business. The purpose of international harmonisation of the rules is to prevent regulatory arbitrage, that is banks locating their business in territories with a favourable regulatory regime and thereby being able to compete unfairly in markets where the domestically based institutions are subject to more stringent regulation.

Should non-bank mortgage lenders be subject to the same prudential requirements as banks? (This is a quite separate issue from any requirements to protect the borrower, for example in respect of the information they must be given and the arrangements under which possession may be taken. These requirements should apply to all mortgage loans. This point is discussed in Chapter 5.) The answer depends on the nature of the lender.

If the non-bank lender is a private institution in which banks do not have an interest there is no case for prudential regulations applying because there are no depositors to protect. However, such non-banks must obtain their funding from somewhere. If that funding is from bank loans then those loans should be treated like any other bank loans and carry a 100% risk weighting and be subject to rules in respect of large exposures, concentration of risk etc. If the funding is through the securities market then the institution must comply with the requirements of the securities regulator. In practice few such private organisations exist anywhere. Where they do they are generally engaged in secondary market activity (covered in Chapter 4). Their funders, whoever they might be are likely to require them to match some of banking regulator's requirements, for example in respect to LTV ratio, loan to income ratio and concentration of risk. Where mortgage insurance exists then the insurer will have the same requirements for loans regardless of whether they are made by a bank or a non-bank.

Where a non-bank lender is owned by a bank or a group of banks the activities of the lender should be consolidated with the parent bank so that the same supervisory requirements apply. There may be sound business reasons why a bank may prefer to undertake some or all of its residential mortgage lending through a subsidiary which is not itself a deposit-taker; avoiding regulatory requirements does not count as a sound business reason. The rules on consolidation must prevent such arbitrage. For example, not requiring consolidation unless the bank's holding as at least 40% of the total equity of the non-bank gives obvious scope for arbitrage.

Supervision of mortgage lending by non-banks is most crucial in respect of state owned mortgage banks. These have been created in many emerging markets, without almost universal adverse effects. The banks exist only because of a state guarantee and generally they have access to funds from the state budget. Such banks invariable lend to the middle classes and are often inefficient in the way that they operate. They compete unfairly with private institutions and thereby hinder the development of a private and sustainable mortgage market.

There is a case for state mortgage banks to help develop a mortgage market where none previously existed, and in any event policy cannot wish away those banks that already exist. The longer term objective must be to abolish or privatise such banks. In the meantime the supervisory regime applying to commercial banks should be applied equally to them. This prevents unfair competition with private banks and is justifiable in its own right through helping to secure more effective and transparent management of the banks. It also helps the banks put themselves into a position that will enable them to operate effectively when cut off from state support if that is feasible.

Chapter 3

Supervision in the Russian context

The previous chapter set out best practice in respect of supervision of house purchase lending which is applicable to any country and at any time. In implementing the principles, it is necessary to take account of the particular circumstances of the country. In the case of Russia, there are a number of such circumstances.

Trust and stability
In the crisis of 1997 and 1998, a number of banks collapsed and people lost their savings. There is therefore a considerable distrust of the banking system. If people wish to save they are more inclined to do so in the form of cash or, in the case of better off Russians, through foreign currency deposits. There is therefore a low level of formal saving through the financial institutions and equally a very small amount of personal lending.

Allied to this point, the Russian economy has not been stable, and inflation and nominal interest rates remain at a high level. The consumer price index is currently rising at an annual rate of about 13.5% although the general view is that the rate will gradually reduce to perhaps half this level within ten years. The higher the nominal rate of interest, the more difficult it is for house purchase loans to be affordable in the early years although the real value of repayments does reduce rapidly.

Informal activity
The Russian economy is characterised by a great deal of informal activity which is not captured in the official statistics and records. While this may mean that the economy is more developed and incomes are higher than the official statistics suggest, it does present problems in other directions. If income levels cannot easily be verified then it is more difficult for lending institutions to assess people's ability to repay loans. Furthermore, people may be reluctant to reveal their real income in order to obtain a loan of the size they want and can afford because they fear that some official body might enquire as to the source of the income.

The quality of mortgage security
Most importantly, in Russia, residential property does not represent good security for mortgage lenders. The arrangements for land ownership and titling are less than ideal, which means that lenders cannot be certain of the security on which they are lending. Foreclosure arrangements are unsatisfactory. The general position is that, under the constitution, Russians have a right to housing. This is interpreted in a way that means that lenders may be able to take possession but are unable to evict, particularly if children are present. In practice, this means that lenders therefore do not have the security of residential property and accordingly the rate of interest on the loans they make cannot reflect this security.

The resultant primitive mortgage market
The effect of the particular circumstances of the Russian market is that the housing finance system is both very primitive and has to use a number of work-arounds to deal with the problems outlined above.

A few statistics are sufficient to indicate the minute size of the formal housing finance mechanism. The mortgage stock is estimated at roughly 0.1% of GDP or RUR29 billion. This is a very low percentage compared with developed economies, such as the European Union, where the average is 53%, or emerging markets, such as Colombia at 12% and Korea at 14%. The bulk of mortgage loans are made by regional public mortgage agencies and a high proportion are in Moscow. Outstanding bank loans are estimated in just RUR6 billion.

To the extent that the banks make mortgage loans then they have to compensate for the inadequate security. The maximum maturity for loans made by commercial banks is 15 years and the maximum loan to value ratio is 70%. Interest rates seem well above those which would apply in a developed economy with an efficient housing finance mechanism. RUR denominated loans carry a fixed rate of interest of between 21 and 23% and US dollar loans a rate of interest between 12% and 15%.

For new housing, developer finance is the most common form of financing. The purchaser pays a significant down payment and then instalments over a period of between five and seven years. Title does not pass until the final instalment is paid. The effective rate of interest on these loans is probably very high if a comparison could be made with the terms that would be available for a cash purchaser. The developer is exceptionally well protected as title does not change hands until the final instalment is paid. It should be noted that the absence of efficient foreclosure mechanisms is one reason for the small size of the formal housing finance market and, as a result of this, purchasers of new houses have far lesser protection as they are not deemed to own the house until the final instalment is paid.

It is understood that a number of other work-arounds apply in practice –

- Employers or others may give guarantees both to provide additional security generally and to compensate for the absence of hard information about income levels.
- Lenders may go to significant devices to avoid the current foreclosure regime, for example, setting up a company which technically becomes the owner of a home which is then leased to the “house buyer” who officially has another address. This therefore makes eviction possible should the need arise.
- Local authorities have a significant role to play because they determine whether rehousing is available and therefore whether a lender is able in practice to take possession of a property. A lender may be able to make an arrangement with a local authority that will give it the necessary security. In practice, the public lending agencies are able to use this tactic.

Supervisory treatment of residential mortgage loans
It is clear that mortgage lending in Russia is little more secure for the banks than unsecured lending. The banks accordingly have little interest in the mortgage market. Properly, the Central Bank does not allow mortgage loans to have a 50% risk rating, but rather they carry the same risk weighting as other bank loans. This approach by the Central Bank is undoubtedly correct. If the various matters outlined in this section can be addressed, and given some experience with defaults, the Central Bank properly should consider a reduction in the risk weighting to 50% but this must follow, not anticipate, developments which improve the quality of the collateral.

This study has not looked at the regional mortgage agencies and can do no more than note that they appear to be subject to no supervisory requirements. This is unsatisfactory for all of the reasons noted in the final section of the previous chapter. The agencies should be subject to the same prudential requirements as banks. This should improve the transparency of their operations and help ensure that adequate disciplines are in place to ensure that public money is being efficiently used.

Chapter 4

Supervision and secondary market activity

It is widely believed that mortgage securitisation can play a significant role in the development of the Russian mortgage market. Securitisation may have an important role to play but it cannot compensate fully for the deficiencies of a primary market. It is important that the regulatory aspects of securitisation are fully thought through otherwise there is a danger of regulatory arbitrage between the primary and secondary markets.

The concept of secondary markets

There are a number of different types of secondary market activity and considerable scope for argument as to what constitutes secondary market activity and what constitutes securitisation.

The basic principle behind secondary market activity is that it allows some institutions to specialise in the origination and servicing of mortgage loans and others in their funding. In this way, the funds available for the mortgage market are increased and those institutions able to originate and service loans are able to build up business without the need to also hold those loans. The home buyer benefits through a more competitive mortgage market, driving down the cost of funds.

For the banks that sell into the secondary market, the main benefit is more effective management of their balance sheet, either in respect of funding, use of capital or both.

Types of secondary market activity

There are a number of different types of secondary mortgage market activity.

The simplest is where an institution able to originate and service loans does so directly on to the balance sheet of an institution able to hold them. This is not true secondary market activity in that ownership of the loan and the beneficial interest in it does not change at any time. However, the effect can be similar to an institution originating a loan and then immediately selling it. This technique is particularly useful for investing institutions that wish to hold mortgage loans but do not have the capability either to originate them or to service them. The investing institution would determine the criteria that the originating institution must meet in respect of the mortgage loans, for example loan to value ratio, maximum size of loan, spread of loans and any insurance. The servicing institution would collect the regular payments of principal and interest, passing them straight through to the lender and would otherwise deal with all aspects of the administration of the loan. The agreement between the two parties would have to specify in detail how the loan portfolio is to be managed, particularly with respect to potential bad debts.

A variation from this arrangement is where an institution originates loans, holds them on its balance sheet and then transfers the loan portfolio, either with or without the servicing, to an investing institution. There are a number of circumstances in which a bank may want to sell a loan portfolio. It may wish to pull out of the mortgage lending business and thereby dispose of its portfolio to a lender still in the business. It may have a capacity to originate and service loans and earn income from so doing in excess of its capacity to hold loans. To the investing institution buying an existing loan portfolio can be more attractive than having loans originated on to its balance sheet in that there is just one transaction rather than a number and the investing institution can also require that the loans are "seasoned", that is that they have run without difficulty for a given period of time and that, therefore, there is already reasonable evidence that the default rate will be low.

A third type of secondary market activity is issuing mortgage bonds, also known as covered bonds. A mortgage bond is an on-balance sheet obligation of the issuing institution. In addition, they are backed by rights to the underlying mortgage collateral in the event of the bank itself being unable to meet its obligations. The pool of loans used to back mortgage bonds must be high quality particularly in respect of the maximum LTV ratio which is set at between 60% and 80%. The bonds may also be over-collateralised, that is the pool of loans and the interest payable have a great value that do the corresponding variables on the bonds. Mortgage bonds are used particularly in Germany (under the name Pfandbriefe) and Denmark.

Mortgage bonds do not really represent securitisation as there is no transfer of ownership of the mortgage loan or of securities backed by the mortgage loan but rather are a means of raising additional funds for lending institutions. The mortgage loans themselves are not removed from the balance sheet of the issuing institution and therefore continue to require capital backing.

The final type of securitisation is the issue of mortgage backed securities. The normal way in which this is done is for a special purpose vehicle (SPV) to be created. Loans that meet acceptable quality standards, particularly in respect of the LTV ratio are transferred from the lending institution to the special purpose vehicle. The SPV then issues securities backed by the loans.

In other words, the investors are purchasing the beneficial right to the interest and principal repayments on the loan without any form of guarantee from the issuing bank. In practice, purchasers of mortgage backed securities require some form of additional security. In practice, a number of layers of insurance provide that additional security –

- Individual properties in the pool must be insured.
- The individual borrowers must have life insurance.
- Where the loan exceeds a specified loan to value ratio then the top slice of the loan must be covered by insurance.
- The entire portfolio is insured.

In developed countries mortgage backed securities must have a credit rating from one of the major rating agencies. The combination of the requirements of the rating agency and the requirements of an insurance company providing a guarantee determine the underwriting criteria for loans that qualify for securitisation.

In some countries, the mortgage backed securities market works without any intervention from the government. This is true, for example, in the United Kingdom. In the United States, however, the government has played a major part in the development of the market. Government agencies are the principle purchasers of mortgage loans and the securities that they issue carry an implicit government guarantee. This means that the securities carry a lower risk weighting when held by banking institutions than mortgage backed securities without such a guarantee. However, providing this form of guarantee can potentially be very expensive and have very major implications for the primary mortgage market, which need to be fully thought through. In an emerging market, some form of government guarantee can help get a secondary market off the ground but in doing so it is important to enhance the quality of the primary market rather than to supplant it.

The limits of securitisation

It is important for policy makers to understand what mortgage securitisation can and cannot achieve. It is a useful technique which can provide an additional channel for institutional investors to fund mortgage loans and also a means by which the banks can, more efficiently, manage their balance sheets. But securitisation is not in itself an additional source of funds.

To some extent, a secondary market can compensate for an inefficient primary market. Indeed, this is the lesson of the United States. The secondary market originally developed in America to compensate for the absence of a nationwide banking system and also usury laws in some States. Subsequently, government agencies were created to help stimulate the housing market and those government agencies enabled the banks to manage the risk of making long term loans funded by short term deposits.

However, providing government backing for a secondary market has huge implications. It is more sensible to seek to structure the primary market in such a way that a secondary market is not needed to compensate for its deficiencies. However, some see securitisation as being desirable in its own right.

Where the primary market is not satisfactorily functioning, for example because mortgage collateral cannot be realised, then a secondary market cannot compensate for this effectively without government intervention which would, in effect, turn mortgage backed securities into government backed securities with massive implications.

For there to be an effective secondary mortgage market without government guarantees, the following conditions need to be met –

- The availability of insurance to enhance the security.
- A track record, sufficient to satisfy investors of the security and also to provide the information that insurers need to underwrite the loans.
- A critical mass, because the fixed costs are very high and the market needs volume if the sureties are to readily marketable.

The problem of course is that the starting point does not allow these conditions to be met, particularly in emerging market economies. For this reason, some government pump priming, for example insurance, is necessary.

Finally, it is necessary to ensure that the nature of mortgage backed securities is fully understood. The market would be severely damaged if investors purchased mortgage backed securities believing that they had certain characteristics, in particular in respect of security, which in practice turned out not to be the case. The market would then suffer a severe setback from which it could take many years to recover. It is therefore important that the regulator governing securities issues ensures that there is proper disclosure of the information about mortgage backed securities and, to some extent, that this is properly understood in the market place.

Regulatory issues for banks

In most countries where there is secondary market activity banks originate the loans that are sold or used as the basis for securities. In the case of mortgage bonds the securities are simply a method of funding. The loans stay on the balance sheet of the banks and require capital backing. Where mortgage have effectively been removed from the balance sheet of a bank such that it carries no risk then it is reasonable that the bank should not be required to hold any capital against these assets. However, regulators need to ensure that the bank really does retain no risk and therefore that the securities are structured appropriately. However, an issuing bank will retain some risk if it continues to service loans. For example, if a bank fails to service loans correctly, the likelihood of default will be increased and the holders of the securities will suffer losses. If it can be determined that this is the fault of the bank for the way that it serviced loans then it will be liable for any such losses under the terms of the servicing agreement between the bank and the SPV.

Mortgage backed securities may be held on the balance sheet of banks as well as being means by which loans are removed from bank balance sheets. A mortgage backed security would have a 50% risk weighting provided the SPV is properly structured; that the loans themselves qualify for a 50% rating; that the loans are not in default at the time at which they are transferred to the SPV; that the notes do not absorb more than their pro rata share of losses in the event of arrears and default, and that the documentation contains provision which would ultimately enable note holders to acquire the legal title to the security and to realise the security in the event of a default by the mortgagor. In practice any institutional investor would have these requirements.

In a number of western countries, the secondary mortgage market has become very sophisticated with multi-class securities being issued with differing risk profiles. However, the broad principles remain that the capital requirements must reflect the risk. For example, it might seem superficially attractive for a bank to sell 90% of a loan portfolio, retaining just 10% but absorbing the first 10% of any losses. Here, the regulator would properly require full capital backing as in practice the bank retains all of the risk.

It is also important to ensure that there is no scope for regulatory arbitrage, particularly as the issuing of securities is likely to be regulated by a different institution from the bank regulator.

Regulation of the securities market

Mortgage backed securities should be regulated by the capital markets regulator in the same way as other securities.

There needs to be adequate co-ordination between the banking regulator and the securities regulator if regulatory arbitrage is to be avoided and mortgage backed securities are to be an efficient part of the overall mortgage market mechanism. This co-ordination is achieved in some countries (for example the UK) by the two regulators being combined – although one should not under-estimate the difficulties of co-ordination within large regulatory bodies. Generally, the securities regulator should not "second guess" the banking regulator in respect of matters relating to the quality of mortgage loans. For example, the securities regulator should not specify that loans that may be securitised should have a maximum LTV ratio of 90% while the banking regulator imposes a maximum of 80%. The best approach is for the securities regulator to adopt where necessary all the requirements of the banking regulator.

In some countries the capital markets regulator becomes, in fact or in law, the regulator of non-bank mortgage lenders as those lenders have to raise their funds through the securities market. To avoid the possibility of regulatory arbitrage the capital markets regulator should delegate this function to the banking regulator.

Regulation of securitisation in the Russian context

There are high hopes of securitisation in Russia. Public policy seems to be concentrating on the establishment of a market for mortgage backed securities, perhaps at the expense of address in the weaknesses that have been identified in the primary market. Regardless of the merits of securitisation as a policy there are a number of features specific to the Russian context that need to be noted.

Russian law provides that in the event of the bankruptcy of a bank individual depositors have preference over institutional holders of the bank's securities. This would seem to preclude the banks from issuing mortgage bonds. This is unfortunate as mortgage bonds are a simpler and cheaper means for mortgage lenders to tap institutional markets than complex and costly mortgage backed securities.

There is a major policy issue as to whether banks should be allowed to issues mortgage backed securities. There have been two issues of quasi-mortgage backed securities, one by the Moscow Mortgage agency but with the securities guaranteed by the Bank of Moscow, and the other by the Home Mortgage Lending Agency, but with the securities backed by the Ministry of Finance. In effect these are not mortgage backed securities but rather public sector securities. However, a precedent has been set which may well cause problems in the future. Some policy makers argue that banks should not be able to issue mortgage backed securities – because of the point about priority in bankruptcy. There is therefore a preference for securities to be issued by special purpose vehicles. This can be justified as a means of getting round an unreasonable legal requirement if it allows banks to securitise their loan portfolios. There is also an issue about whether banks should be able to service loans that they have sold. It make no sense to prevent them doing so; banks must be able to exploit their ability to service loan agreements. It is understand that the law on securitisation will be reasonably liberal in respect of what the banks are permitted to do.

Another issue is the respective responsibilities of the Central Bank and the Securities Commission. It is important that they adopt a co-ordinated approach to the issue of securitisation so as to avoid the dangers of regulatory arbitrage and competitive distortions. For example, the Securities Commission should not permit an arrangement whereby non-banks are able to make loans on terms which are denied to the banks. And banks should not be allowed to avoid Central Bank regulation by operating through non-consolidated affiliates subject to less stringent regulation through the securities Commission. The Central Bank and the Securities Commission should be seen to be acting as a seamless regulator working within a common framework. The securities Commission must also ensure that to the extent that it regulates non-banks it should do so in a way that is compatible with bank regulation.

Chapter 5

Protection of the borrower

Prudential supervisors are concerned with the soundness of financial institutions and not the way that the institutions do business except to the extent that this impinges of financial soundness.

In most developed countries there has been a gradual evolution of regulation aimed to protect the borrower. Some of this protection is general, applying to all goods and services, and some is specific to the mortgage market. Such protection typically embraces some of the following –

- Regulation of the arrangements by which lenders can realise their security in the event of the borrower defaulting – already covered in this paper.
- Regulation of the way in which mortgage rates must be advertised, particular where variable rates are used or where a low introductory rate is offered. Regulation typically specifies the manner in which an "annual percentage rate" must be calculated and the prominence that must be given to this rate in relation to the "headline" rate.
- Regulation of the information that must be given to home buyers, in particular in respect of the nature of their mortgage loan. It is important that borrowers understand the basis on which the rate of interest may be varied and what will happen if they default on their loan repayments.
- Regulation of selling practices.
- Regulation of other professionals in the market, particularly valuers.

In some countries regulation extends to the detail of the mortgage contract, specifying for example the type of loan instrument (fixed or variable rate), the frequency with which payments must be made and the procedures to be followed when a loan is made or extended.

In an emerging market someone has to have overall responsibility for regulation in these areas to ensure that the objective of stimulated the mortgage market is not frustrated, that the regulations are in harmony with each other and that the consumer is not over-burdened with information.

As a general rule regulators should not try to prescribe either loan instruments or details of the how the relationship between borrowers and lenders should be conducted. A competitive marketplace is the best protection that the consumer can have in this respect. Rather regulation should ensure that the home buyer has the information he needs to make an informed decision.

Chapter 6

Supervision of deposit taking

It is not the purpose of this report to cover the supervision of deposit taking institutions as such. However, because mortgage loans can be funded by retail deposits the general question of protection of depositors needs a brief mention and there is also a need to cover in detail the regulatory aspects of savings schemes linked to mortgage loans.

Deposit insurance

Deposit insurance is a useful tool to protect small depositors. A typical arrangement is for deposits up to a limited amount, say $30,000, to have 100% protection with either no protection above this amount or limited protection. Some schemes provide no more than 90% protection to any depositor. Such schemes can help give individuals confidence to put their savings in a bank.

However, such schemes must go hand in hand with effective supervision and they should never provide 100% protection above a relatively small amount, otherwise they simply become a means of the State underwriting the banks with huge costs that cannot be easily met when a bank fails.

The Government is planning to introduce such a scheme which seems to be on the right lines. The scheme will provide 100% protection for deposits up to RUR20, 000 and 75% protection for amounts of between RUR20, 000 and RUR120, 000.

Mortgage savings schemes

It is understood that Russia is considering introducing a mortgage savings scheme on the lines of the German bausparkasse arrangement. This section briefly covers the prudential implications of operating such schemes.

The principle behind mortgage savings schemes is that people who wish to borrow for house purchase should contribute a significant part of those funds through prior saving. Typically, under such a scheme, people contract to save a certain amount over a certain period. At the end of that period, they are entitled to a loan. In its purest sense, the system is closed with savers and borrowers being the same people. It follows that interest rates need not be at a market level and indeed can be at any level provided that the interest rate on the loans carries the necessary margin over the interest rate paid on savings and that, in the short term, the interest rate on savings can be paid for by the liquid funds that the institution holds. In practice, this means that the whole operation must be conducted at below market interest rates.

An obvious advantage of such an arrangement is that it provides funds to be available for financing house purchase that might otherwise not be available. It is well established that people may well save in one form or another if this helps to finance house purchase, whereas otherwise they would not save at all. Arguably, the system has another benefit in that it helps to demonstrate a strong savings record and therefore an ability and willingness to make repayments on a loan. This is particularly important in economies with a high degree of informal activity where real incomes are difficult to verify.

However, the schemes also have their limitations. In practice, the savings of potential house buyers can never be sufficient to meet the funding needs of those same people. In very simple terms, people may expect to save, say, 20 or 25% of the purchase price of a house over five years and then expect to borrow 75% over 20 years. In practice, therefore, the system has to be used in conjunction with other systems and the loan that comes out of the scheme covers only a small proportion of the purchase price. In Germany, where the system is most firmly entrenched, the loan from the bausparkasse is likely to provide little more than 20% of the total funds needed to purchase the property. In practice, bausparkasse loans are used in conjunction with other loans. In fact, a bausparkasse contract may be taken out, not to help raise the funds to buy a house, but rather to obtain the funds to pay off a loan taken out to buy a house.

More generally, because contractual loans of this type can provide only a small proportion of the purchase price of a house, the institutions running such schemes tend to offer other loans on more normal terms, either directly or from connections with other financial institutions. They may also be tempted to borrow money in order to increase the amount of money they can make available to investors who have reached the end of the contractual savings period. In this way, building savings schemes actually turn into permanent savings bank type arrangements. The building societies in Britain made this transition from closed terminating societies to permanent societies in the nineteenth century.

The question then arises as to why people should use the contract savings system at all. The answer is that it tends to work only when there is a significant government subsidy to savers. The scheme is therefore rather more of a subsidised savings scheme than a scheme to finance house purchase loans.

There are two other important limitations of the scheme. The first is that if the period of saving before a loan can be obtained is long, people will not use the system. Accordingly, in practice, an ever increasing number of savers need to be recruited in order to meet the loan commitments to borrowers. This can become akin to a pyramid selling operation. Secondly, in an inflationary environment, in which the rate of inflation is significantly above the rate of interest paid on savings, the system cannot make a significant contribution towards helping people purchase a house because the savings will increase less rapidly than the price of the dwelling they wish to buy.

Finally, it is worth questioning the argument that the system demonstrates a willingness and ability to meet loan repayments and can compensate for the lack of easily verifiable income. The system demonstrates a willingness and ability to contribute to a savings scheme which earns an above market rate of interest because of a government subsidy. It says little about people's income or their willingness to meet loan repayments.

The relevance of the building savings scheme in the Russian market
It is not the purpose of this report to comment on the appropriateness of such a scheme in the Russian mortgage market. However, before considering the regulatory implications, it is worth just mentioning some key points –

- Russia has a rate of inflation now and projected forwards that is likely to be above the rate of interest available on savings deposits, which make such a savings arrangement not very attractive.
- A government subsidy would seem inappropriate, bearing in mind that those most likely to take advantage of it are higher income people.
- The system operates effectively in Germany and Austria, where it is well entrenched and benefits from significant government subsidy. There are almost no examples of its operating effectively elsewhere. .
- While mortgage savings schemes have their merits, the potential benefits of such a scheme to the Russian housing finance system at the present time seem marginal compared with the many other policy initiatives that are essential.

Regulatory requirements for mortgage savings schemes
If a financial institution offers a mortgage savings scheme then this should be a proper subject for supervisory interest. It is of course open to any bank to offer such a scheme on its own accord without special government arrangements or subsidies. The regulatory implications are the same whether schemes are offered on this basis or whether there is an official scheme.

It is important that investors are not misled. If they are contractually committing themselves to save money, particularly if it is at a below market rate of interest for an extended period of time, then they are entitled to know precisely when they will be able to obtain a loan and the terms of that loan. It cannot simply be left to the discretion of the bank.

In turn, where the bank does make such a commitment, then the regulator should ensure that it is capable of meeting that commitment. For example, if the bank commits itself to making loans to people who have completed the contractual period of the savings scheme at a below market rate of interest, then the banking regulator should ask where the funds are coming from to make those loans and if they are likely to incur the bank in making a loss then this should be recognised at the time the contracts are entered into not when the contracts crystallise. The regulator should not assume that there will be a steady stream of new savers willing to provide low interest deposits to fund loan commitments already incurred by previous members of the scheme.

This is not an area where the regulator need necessarily be prescriptive. Rather, if a bank is offering such a scheme, the regulator should put the onus on the bank to show precisely how the scheme is to be financed and, using conservative assumptions, that the necessary funds will be available to meet loan commitments and there is adequate capital backing for any risk that the bank might be taking.

Chapter 7

Issues and recommendations

This chapter sets out some regulatory issues that need to be addressed if the Russian mortgage market is to meet the requirements of the Russian economy, that is to provide a means by which people are able to borrow money at reasonable rates of interest to purchase homes and also to help wider and deepen financial markets generally.

Wider issues

It needs to be recognised that there are wider issues that militate against mortgage market activity in Russia, all of which need to be addressed in their own right. While the economy has improved considerably there is a fear of economic instability and still a considerable distrust of the banking system. A high proportion of activity in the Russian economy is informal and again this makes it difficult for formal institutions to develop, particularly those wishing to engage in longer term transactions.

A mortgage market needs a number of different building blocks to be in place, which are the responsibility of different government departments and agencies. **There needs to be an overall plan for the development of the mortgage market and someone must have ownership for this plan**. The Ministry of Economic Affairs, the Housing Ministry, the Central Bank and the Federal Commission for the Russian Securities Market all have a significant role to play in ensuring that the necessary arrangements are in place that will enable a market to develop.

Mortgage security

A prerequisite for an efficient mortgage market is that **there must be clear arrangements by which a lender can realise its security should the borrower default**. This can be achieved by a combination of legislation and administrative practices.

Consideration should be given to a mortgage insurance scheme to provided added security to lenders. To the extent that Government support to the mortgage market is available it can best be used in this way. of interest.

Regulation of banks

The Central Bank's stance, that is that **currently residential mortgage loans should have a 100% risk weighting**, is correct given the points noted above. The Bank should indicate its willingness to consider reducing this weighting to 50% where the security issues have been addressed and there is evidence that mortgage loans are safer than other forms of lending.

The Central Bank should develop a framework for monitoring the quality of a bank's mortgage loan portfolio and interest rate risk. This should draw on international best practice and should deal with the loan to value ration, the loan to income multiple, risk concentration and interest rate risk in particular.

Provisioning requirements should be based on actual loss experience and the whole loan portfolio. It is inappropriate for banks to be asked to treat residential mortgage loans in the same way as commercial loans for provision purposes. It is particularly important that the provisioning requirements are not so onerous or complicated as to deter banks from making mortgage loans or to distort they way that they manage their lending business.

There should be a **consolidated approach to supervision where a bank has a significant interest in a non-bank mortgage lending institution.** This is essential to avoid regulatory arbitrage.

Regulation of non-banks
State housing banks should be subject to the same supervisory requirements as banks. This will facilitate transparency and discipline in the activities of the banks and prevent them competing unfairly with private sector banks. In the longer terms mortgage lending should not be an activity of State owned organisations.

Any private sector non-bank mortgage lenders with no bank ownership do not need supervision other than any normal requirements applying to their fund raising activities.

Securitisation
There are high hopes of securitisation that can never be realised. **Policy towards mortgage market development should not be centred on securitisation.**

Banks should be able issue mortgage bonds and mortgage backed securities in the same way as non banks. Because of the law in relation to bankruptcy this may need to be through special purpose vehicles. **Mortgage loans that are sold or securitised should require no capital backing only if the issuing bank carries no risk.**

The Securities Commission is responsible for regulating the issuing of any securities. **The Securities Commission and the Central Bank should adopt a co-ordinated approach to regulating mortgage backed securities.** It is important to avoid regulatory arbitrage or distorting competition.

Protection of the borrower
There needs to a co-ordinated approach to the ay that borrowers should be protection. **Protection should be through ensuring that mortgage borrowers have the necessary information** rather than through details regulations covering loan instruments and the relationship between the borrower and the lender.

Mortgage savings schemes
At first sight a contractual mortgage savings scheme is of little relevant to the development of the Russian mortgage market in present circumstances. To the extent that such schemes exist, whether or not Government sponsored, the Central Bank should ensure that **banks must be able to meet any commitments under mortgage savings**

schemes. It is important that savers should not be misled about when they will be able to obtain their loan and that banks do not run undue risks in meeting their obligations.