

# Mortgage lending as a financial management tool

## Préstamos hipotecarios como herramienta de gestión financiera

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### Content

- [1. Introduction](#)
- [2. Methodology](#)
- [3. Results](#)
- [4. Discussion](#)
- [5. Conclusions](#)

[Bibliographic references](#)

#### ABSTRACT:

This article considers the current state of mortgage lending in Russian Federation, as well as the possibilities for its reforming. We have used a number of interrelated research methods: abstract-logical, economic-statistical, as well as the RF legal framework analysis. Results section provides recommendations for increasing public availability of mortgage loans. The focus is brought on the need for a system of risk-sharing among market participants.

**Keywords:** mortgage loan, mortgage lending, asset securitization, securities, risk sharing.

#### RESUMEN:

Este artículo considera el estado actual de los préstamos hipotecarios en la Federación de Rusia, así como las posibilidades de su reforma. Hemos utilizado una serie de métodos de investigación interrelacionados: abstracto-lógico, económico-estadístico, así como el análisis del marco legal RF. La sección de resultados ofrece recomendaciones para aumentar la disponibilidad pública de préstamos hipotecarios. Se hace hincapié en la necesidad de un sistema de reparto de riesgos entre los participantes en el mercado.

**Palabras claves:** préstamos hipotecarios, préstamos hipotecarios, titulización de activos, valores, participación en el riesgo.

## 1. Introduction

The study of world experience in mortgage lending is important for Russia, as its mortgage lending development is at the stage of transition from a budget system to an arm's length organization (Savinova et al., 2016; Kirpichnikov et al., 2016; yarovikova, 2016).

In this regard, let us dwell on the characteristics of a mortgage lending mechanism in Russian practice. Currently, only three models known in foreign practice are typical in Russia: universal banking model (Dagher&Kazimov, 2015; Scharfstein&Sunderam, 2014), contract savings model

(Beyer et al., 2016; Vojtech et al., 2016) and the securitization model (Bohle, 2014; Basset&Driscoll, 2015). There is no model based on specialized banks. The contract savings model is developing spontaneously and without an appropriate legal framework. The universal bank model and a model based on asset securitization are the most developed.

Federal Agency for Housing Mortgage Lending (hereinafter, the Agency) is the central link in the mortgage refinance system of Russia (Krutskikh, 2007; Kireeva, 2010). Its activity is based on mortgage repayment at the expense raised after placing securities on the Russian stock market. According to the Agency's concept, mortgage lending mechanism can be broken down into several stages (Andronovich, 2016; Poptsova, 2016; Fedorova, 2016).

At the first stage, commercial banks issue mortgage loans to individual borrowers for house purchase. The borrower becomes the owner of real estate, purchased with a loan, and lends it to the lender bank after signing a contract.

At the second stage, the Agency provides lender banks with the opportunity to sell qualified mortgage loans at the outstanding mortgage balance. In this case, mortgage rights (claims) pass to the Agency and the loan servicing functions remain with the bank. As opposed to American model, banks are under a credit risk as well: in the case of borrower's failure, the mortgage is returned to the primary lender with a replacement claim.

At the third stage, the Agency issues mortgage-backed securities (MBS), secured by issued loans (mortgage bonds).

The Federal Law "On Mortgage-Backed Securities" No. 152-FZ (November 11, 2003) with additions and changes (December 29, 2004; July 27, 2006) has created a number of prerequisites for MBS to emerge in the Russian financial market [15]. Russian MBS market began to form only in 2006, when the Specialized Mortgage Organization GPB-Ipoteka registered a catalogue sheet containing its MBS in the Federal Financial Markets Service, and placed it in the national market [11].

The Law on MBS has identified two types of MBS. MBS Bonds are bonds, secured by a pool of mortgage loans. As equity securities, they are subject to registration in the Federal Financial Markets Service. Since bonds are debt securities, they grant their holder the right to receive only the nominal value of such bonds and a fixed percentage. Mortgage pool is pledged by the issuer in favor of all bondholders. This type of MBS can be divided into subspecies – mortgage bonds issued by banks, and mortgage bonds issued by specialized mortgage institutions.

Mortgage participation certificate (MPC) is a second type of MBS. MPC is a registered security certifying its holder's share in ownership right to a mortgage pool, as well as the right to demand from the issuer the proper trust management of a mortgage pool, the right to funds, obtained as receivables on the mortgage pool, and other rights provided for by the Federal Law on MBS.

Thus, this article considers the current state of mortgage lending, and provides a list of ways to develop it.

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## **2. Methodology**

Theoretical and methodological basis of the research involves the theory of sustainable development regulation in the banking sector under crisis, as well as the works of leading domestic and foreign experts in the field of economics and financial law.

We have used the following research methods: abstract-logical, economic-statistical, general scientific methods of analysis, as well as the method of Russian legislation monitoring in the field of mortgage lending.

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## **3. Results**

MPC structure is built on the Russian concept of trust management, which unlike the concept of

trust property (trust) does not entail the process of transferring ownership of a property to the trust management. The holder of MPC acquires also a share in the common ownership of a mortgage pool and automatically enters into a trust management agreement with the issuer acting as the trust mortgage manager. The manager only manages the mortgage pool. The ownership of a mortgage pool belongs jointly to the holders of MPC. MPCs are registered securities and can be issued only in a non-documentary form.

This mechanism has two features: a) only the "economic" condition for exceeding the size of a single "mortgage pool" over the total number of mortgage lists is stipulated by legislation, b) the primary holder's right (unsecured) to mortgage pool is stipulated in the context of bank failure.

The Law on MBS describes this type of bonds in extremely unsuitable way: the fundamental principle of a single mortgage pool has been violated (in the case of specialized banks) (The Federal law "On Mortgage-Backed Securities", 2003). Russian legislation has proposed a model dividing the mortgage assets of the issuing bank into several strictly delineated mortgage pools with one or several legally tied MBS bonds in each. They can be tied by transferring mortgage pool as the collateral to bondholders. Such a mechanism is alien to the banking business, as it deprives the issuing banks of the asset management flexibility and leads to an unreasonable fragmentation of the bank sheet (by assets and liabilities). These errors are the primary reason why the subordinate laws of the Federal Financial Markets Service (FFMS) go through a long-term preparation, since the unsuccessful regulation of MBS bounds makes it harder for banks to issue them for the first time, as well as to coordinate all the economic conditions. As a result, certain provisions of prepared documents raise logical questions. In particular, it seems that we violate the law by allowing the issuing banks not to include a part of mortgage receivables into the mortgage pool. In addition, Russian banking legislation hasn't adequately reflected the appearance of specialized mortgage banks that are potential MBS issuers (Andronovich, 2016). It is evident that the Law on MBS should be divided into parts in order to avoid confusion: a) section devoted to MBS issued by credit institutions; b) section regulating the activity of mortgage institutions (with a subsection of rules on MBS that belong to the federal agency).

To regulate the Russian MBS market, there must be the:

- amendments made to the Federal Law "On Mortgage-Backed Securities" on eliminating the pool of mortgage loans, introducing an issuance program, specifying the features of mortgage pool management in the event of issuer's failure, and on canceling the minimum mortgage loan-capital ratio standards, as well as the standards provided for the maximum ratio of credit institution's liabilities to creditors. In accordance with the regulations H17 and H19, the latter have a priority right to satisfy own demands unlike the bond- and fund holders;
- amendments made to the Instructions of the Bank of Russia "On Mandatory Banking Standards" No. 110-I (January 16, 2004) and "On Mandatory Standards for Credit Institutions Issuing the Mortgage-Backed Bonds" No. 112-I (March 31, 2004) in order to make the process of issuing MBS easier;
- an increase in the acceptable loan-to-value ratio (up to 80%) in the Law on MBS;
- improved system of MBS circulation: increased volume of issues, expanded investor base, stimulated repo transactions and mortgage lending with these tools.

Mortgage securitization through the Agency as a secondary market operator cannot meet the refinance needs of commercial banks. The corporate bonds, secured by state guarantees, are the major tool used by the Agency instead of the process of issuing the law-stipulated MBS through the mortgage institution. In April 1, 2010, the Agency began to offer new financial products to banks in the form of secured loans (with a loan term equal to the maximum term of a mortgage pool) and lending, secured by mortgages, guarantees, "bad" loans purchased under individual agreements with the Agency, pledge redemption, etc. (Kireeva, 2010). This was made in order to develop the capabilities of primary creditors in the mortgage lending market. Russian banks prefer to use cross-border securitization (when a specialized legal entity is created outside the Russian Federation) due to the lack of regulations allowing them to carry

out an effective local securitization and due to the lack of investors among Russian corporations.

Securitization through a special purpose legal entity is widely used throughout the world to refinance various assets. This method allows the initiator of the transaction to enter the developed foreign capital markets that have relatively low interest rates, developed infrastructure and legislation. However, mortgage crisis, erupted in the U.S. in 2007 and developed into the global financial crisis, has led to a sharp decline in demand for securitized MBS and showed how "narrow" and unstable is the Russian market, focused solely on foreign investors, in the face of unfavorable business environment. Therefore, there was a need to develop measures to stimulate the domestic market, including by involving regional lending organizations. Although carrying out independent securitization is difficult even for large Russian banks, recent assets have been assigned to a special purpose legal entity in accordance with Russian law. Small and medium-sized banks can use a securitization model by involving a large bank-organizer (conduit).

The process of asset securitization through a collective investment system is based on the use of closed-end mortgage-backed securities mutual funds (hereinafter, mutual funds). The mechanism for transferring the right to claim the primary mortgage payments, as well as the collateral mechanism, allows attracting financial resources of institutional investors to refinance mortgage loans. It may include mutual funds, state and non-state pension funds, etc. The process of securitization through the collective investment system is based on the debt recovery right as the process of transforming the loan into the MPC or investment units. The latter can be placed in the secondary market in order to refinance mortgage loans. This method of securitization can be described as follows: mortgages, owned by a bank or the Agency, are sold to a management company of a unit-linked investment fund, which property comes then into the ownership of investors purchasing units. The unit-linked investment fund is the Russian analogue of a trust. The closed-end mutual fund structurally reminds a model of MPC. MPCs are always covered by the debt recovery right. The closed-end mutual fund can be formed not by means of money, but with the same assets as a MPC was formed. Since they are allowed to purchase various securities, including MBS, it is actually possible to create mutual funds, which assets are the mortgage pools. Banks find this way of securitization to be attractive, as they can choose the type of loans that will be included in the pool.

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## **4. Discussion**

At classical securitization model, the major goals of the bank are to release the mortgage loan resources by selling a homogeneous mortgage pool to a special purpose legal entity and to develop mortgage lending [14]. The bank receives a discounted amount of future payments entirely and immediately, but not as the interest payments and principal redemption tranches are received. Thus, asset structure and quality changes and free funds appear. Achieving this goal contributes to the improving balance sheet liquidity, improving financial result, further developing the active operations of the bank, meeting its capital adequacy ratio, and reducing the level of risks.

This model efficiency is expressed in the growth of liquidity indicators after securitization. It is also determined by the level of securitization costs, reducing risk in loan portfolios, and by meeting the requirements of the Bank of Russia for the capital adequacy ratio.

It should be noted that securitization efficiency is largely determined by the subsequent distribution of attracted resources: bank's debt recovery and provision of new mortgage loans. The latter option is more effective. We propose to analyze the attracted resource distribution after securitization to assess the mortgage-backed securitization efficiency. Its results can be used as an additional indicator of classical securitization efficiency.

At the synthetic securitization model, there is no write-off of assets from the balance sheet, although securitized mortgages should be segregated. At the synthetic securitization model,

banks issue derivative securities in order to replicate the effect (financial result – profit or loss) of selling the asset pool without selling it. The main difference between the above securitization options is that whether or not the sell transaction was completed.

If the classical securitization model is used primarily to obtain cheaper financing, then the synthetic securitization model is mainly used to manage risks and improve financial results.

The major criteria of synthetic securitization efficiency assessment may involve the degree of risk minimization, improving liquidity indicators, compliance with the requirements of the Bank of Russia for liquidity standards, improving financial performance of the bank, reducing costs, improving the balance of security and asset securitization terms, increasing share of long-term resources, debt growth, and the share of resources that remain undistributed after securitization.

The economic content of indicators determines the efficiency of a synthetic securitization mechanism.

Banks can choose the preferred securitization model (classic or synthetic) in relation to own resources and goals.

In terms of other participants, above criteria are determined by their functions and goal. In particular, efficiency criteria for a special purpose legal entity may involve the level of risks associated with the quality of purchased mortgage pool and with the possibility of placing bonds. In terms of investors, criteria of mortgage securitization efficiency involve the bond's yield and liquidity.

Based on high risks in the mechanism based on securitization, used in developing mortgage refinance system, the importance of developing mortgage lending in Russia, a wide range of low-income families, weak lending/stock markets and related infrastructure, we advice to improve the financial mechanism of mortgage lending in the following areas:

- In the primary market:
- stimulating demand for mortgage loans and housing offers;
- regulating the overall level of risks;
- increasing public availability of mortgage loans;
- improving tax legislation.
- In stimulating demand for mortgage loans:
- maintaining the interest rate at a level acceptable to reliable borrowers by differentiating credit margin depending on the borrower's credit history and solvency;
- stimulating the creation of special home loan programs for certain categories of borrowers: military personnel, marriages, maternal (family) capital recipients;
- making amendments to the legislation that will allow the borrowers to use maternal capital to pay back the loan if their income has decreased, including the amendments regarding the borrowers' liabilities that appear after restructuring mortgage loans.

In order to stimulate the process of giving housing offers, project owners have to be provided with credit resources at reduced interest rates for the purpose of building economy-class real estate in the quantity corresponding to the needs and demands of citizens with average incomes. Besides, volatility in residential real estate price has to be lower.

The mortgage product should be determined by the type of settlement (big cities, towns, small urban and rural settlements), the level of residential property market development (home mortgage, construction mortgage) and historical features of regional development (multi-family residential houses, single-family houses and other forms of low-rise housing). There should be a differentiated territorial approach to mortgage market development through the classification of municipal entities.

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## 5. Conclusions

There should be set out the reliable mortgage standards in order to regulate the overall level of

risks in the mortgage lending system. The state has to support the differentiation of these standards depending on the mortgage quality in order to maintain an acceptable level of risk in loan portfolios in the banking system.

A system of risk distribution between various participants of the mortgage market (borrowers, creditors, insurers, refinance institutions, the secondary mortgage market, investors and the state) is required.

Public availability of mortgage loans can be increased by:

- participating in the accumulative mortgage system through the targeted saving accounts in banks and non-commercial funds, through the purchase of a certificate of deposit, and a special account with an increased insurance cover limit in the event of bank's failure. The latter is tied to the per-square-meter price of real estate with an interest charge on a deposit and savings, transferred to a down payment;
  - differentiating credit conditions by assessing the depositor's solvency in the process of accumulating the amount on the account. The income level should exceed the monthly home mortgage repayment in three times;
  - assessing the probability of mortgage repayment, determining its maximum amount in a period of up to 30 years; fixing an interest rate at the level of the refinancing rate of the Bank of Russia with a 2.5 percentage or at the level of a floating rate; fixing an annuity procedure for mortgage repayment, based on the amount of funds deposited in the account with the possibility of applying flexible plans of debt management;
  - mortgage insurance. The standard down payment is at least 30%. In terms of insured loans, its amount is 10%.
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[Index]

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