Impact of escrow accounts on construction rates

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Abstract. Equity construction is actively developing in the Russian Federation. At the beginning of the second half of 2018, there were fundamental changes in the Russian real estate market. Federal Act No. 1 of 2018 July 175-ФЗ was adopted, amending the Act of 2004 on the procedure for citizens’ participation in equity construction. In particular, the system of subsidization of objects under construction has been completely revised - the equity participation was replaced by the mechanism of project financing. Federal Law No. 175-ФЗ changes the legal and regulatory regulation of housing construction, defining project financing as the only source of attraction of funds to equity construction. In this regard, interest in investments in real estate is growing, and there is an increase in interest of private capital in the housing industry. Thus, today the real estate market is changing, construction companies adapt businesses processes to new requirements. In order to assess the impact of escrow accounts on the real estate market, a comprehensive analysis of market development should be carried out and trends in development should be monitored.

The construction complex of the country is a significant segment of the economy. Activity in the sphere of construction is the most accurate indicator reflecting the state and level of development of economic spheres of the country. The extent to which the processes of the construction industry function effectively depends on the provision of demand from the state, business and citizens with new capacities, houses, high-quality objects [1].

In order to ensure the continuous development of the construction industry, the Government of the Russian Federation is carrying out a number of reforms aimed at optimizing the construction industry, providing affordable housing for citizens and improving the comfort of the urban environment. The most important and all covering reform has been taking place in Russia since July 1, 2017. The purpose of the reform is to protect the funds of shareholders and simplify the work of construction organizations with control bodies at all stages of construction. From July 1, 2019, the state launched a new reform mechanism, approving new rules of equity construction [2]. Since 2019, the transition to project financing of housing construction has been carried out - construction of apartment buildings with priority attraction of funds of the bank, in particular using escrow accounts. The purpose of this reform is to minimize the risks of buyers of apartments under construction, to provide certain guarantees for the safety of funds paid by persons purchasing housing at the stage of construction, to increase the requirements for developers and to control transactions involving funds of shareholders.
Escrow accounts are special accounts that are held by banks called escrow agents. Settlements using the escrow account are based on a three-way contract between the buyer deposit, the seller beneficiary and the escrow agent. The transaction includes several stages of Picture 1 (Picture 1) [3,4].

**Picture 1.** Scheme of transactions with new buildings using escrow accounts

Let's look at each step in detail:

1. The parties conclude a contract: the seller undertakes to deliver the goods or provide the service, and the buyer pays for it. The bank in turn guarantees that the money will be transferred only after delivery.
2. The buyer opens an escrow account with the bank and contributes the required amount.
3. The bank is blocking money in your account.
4. The seller supplies the goods or service and presents evidence to the bank of this, such as the act of acceptance and transfer or the certificate of the new owner of the property, such as an extract from the Unified State Register of Taxpayers.
5. The bank releases the account and transfers the money to the seller.

This scheme of carrying out transactions with new buildings using escrow accounts caused a violent reaction in the professional community and posed a number of questions to the market participants. We will determine the advantages and disadvantages of innovations both for the developer and for the buyer (Table 1) [5].

**Table 1. Advantages and disadvantages of using escrow accounts**

| Advantages | Disadvantages |
|------------|---------------|
| 1. The developer is guaranteed to receive money if he meets his obligations and the buyer is protected from fraud. | 1. Not all banks in Russia work with escrow accounts [7]. |
| 2. If one of the parties decides to terminate the | 2. Before the transfer to the developer, the money in the account is blocked, and the |
1. If the account is closed automatically and the money is returned to the buyer [6].

2. The parties can choose which documents will be proof of the transaction for the bank.

3. As long as the money lies in the escrow account, it does not bring profit - unlike the deposit interest on it does not accrue.

4. If it is a matter of equity construction of housing, the content of the escrow account is free of charge, and amounts up to 10 million rubles are insured in the Deposit Insurance Agency.

5. The escrow account cannot be seized even if the buyer has debts on taxes, fines, alimony, etc. The buyer can return it only if the contract is terminated.

The launch of the mechanism of purchase of housing at the stage of construction through escrow accounts first of all allows to remove from the market the situation when on the one side of the transaction on the not yet built object there is a shareholder (individual), and on the other side - a developer (legal entity) [19]. This imposed legal and information asymmetry: in practice, it is impossible for an ordinary citizen to assess the reliability of a developer, and in case of bankruptcy, shareholders had to co-operate in any way to protect their interests. In turn, with the launch of project financing, the interests of all shareholders are protected by the bank, which accredited the developer.

This takes all relationships to a fundamentally different level. Firstly, the bank has professional competencies in evaluating the developer and an individual object, which already seriously reduces the risks. Secondly, in the event of bankruptcy of the developer, the fate of the property will depend on the bank: either search and attraction of a new developer, or payment to equity holders. In any case, it is not profitable for the bank itself to keep an unfinished object on its balance sheet, thus it actually has the same interests as shareholders.

Shortcomings in the application of escrow accounts in the real estate market result in the most efficient construction companies absorbing business, and volumes that inefficient companies cannot conduct [10]. The consequence is a slowdown in construction growth. As the graph shows, in the Irkutsk region in 2019 there was a sharp decrease in the number of issued building permits (Picture 2).

![Picture 2](Dynamics of issued building permits in the Irkutsk region from 2016-2019)
The number of building permits issued in 2019 decreased by more than 7 times. The decrease in the rate of construction permits issued is due to a decrease in the activity of developers of apartment buildings (Picture 3) [11].

![Permits for the construction of apartment buildings](image)

**Picture 3.** Dynamics of issued permits for construction of apartment buildings in the Irkutsk region since 2016-2019

Eight building permits were issued in 2019 four times the average for the past three years. Practice shows that the amendments made to Federal Law No. 214-ФЗ have had a negative impact on the activity of the construction sector. The application of escrow accounts in construction is still a challenge for developers [12,13]. Many of them are not ready to work on the market in accordance with the new legislation, as it has low profitability, which indicates that the necessary material resources are insufficient. The application of escrow accounts leads to a longer period of credit burden, as it is not possible to use funds from the sale of shareholders to pay for construction. At the same time, the floating lending rate depends on the security of the loan with funds from the actual sales received by the bank on escrow accounts. Accordingly, in the new conditions, developers will be forced to provide a smaller discount to apartment prices at the initial stages of construction relative to the prices of finished apartments. This will allow developers to compensate for the decline in profitability resulting from the increase in cost.

The sharp decline in construction permits is due to the fact that the implementation of equity construction reform is in an active stage, when the construction industry is only at the beginning of the path of forming the relevant competences that are necessary for the application of project financing using escrow accounts [14,15]. The purpose of escrow accounts realization is strict control over expenditure of funds by the developer. And it becomes a problem for those who are used to managing cash flows, taking money from one project, investing in another, taking first profits and then paying costs.

Accordingly, in order to build quality modern housing at affordable prices and in large volumes in a short time, developers will have to be able to attract financing with minimal costs and expenses. While developers and property developers bear a significant share of the costs at the pre-project stage before obtaining a building permit and starting sales.

Despite the difficulty of organizing an investment and construction project using escrow accounts, their number is open for settlements under agreements of participation in equity construction. And the amount of funds deposited by the participants of the equity construction on escrow accounts, In two months more than 2 times - with 10,1 thousand accounts and 30.2 billion rubles as of August 26 to 23,2 thousand accounts and 73.8 billion rubles as of October 28, 2019 (Picture 4). In 2019, five credit agreements totaling 3,372.7 million rubles were concluded in the Irkutsk region.
Dynamics of opening escrow accounts in 2019

Thus, the geography of project financing is expanding. Equity construction projects using escrow accounts are under way in most regions. Ultimately, the transition to project finance will create conditions for quality housing growth and increase public confidence in housing acquisition during the construction phase.

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