State Support of Building Complex through Mortgage Rate Reduction: Prospects and Risks

Pavel Kostrikin

Moscow State University of Civil Engineering, Yaroslavskoe shosse, 26, Moscow, Russia

Abstract. In February 2020 the Russian government decided to develop public incentives for the mortgage rate reduction at least to 8%. What is the supposed economic effect of this decision? Can implementation of the new state program trigger another large-scale crisis on the market? The author makes an attempt to answer these extremely relevant questions by tapping into the experience of creation, development and a relatively recent failure of similar programs in the United States. The research done has revealed that the Russian government’s urge to harness the priming of economy through the support of mortgage lending, which was used in developed markets long ago, gradually gives rise to the same alarming symptoms that proved to be the forerunners of the world financial crisis in 2008-2009. Already available in Russia is an increasingly bulky and non-transparent system of mortgage loan securitization, a rapidly growing number of approved loans, mortgage rate reduction vigorously stimulated by the Russian government that brings about the gradual easing of claims on the quality of mortgage loans issued by retail banks in the backdrop of stiffening competition between banks and, as a consequence, the bank margin reduction. Thus all factors of the possible future collapse are on hand. The author comes to the conclusion that in order to prevent the situation getting out of control, the urgent development and adoption at the state level of scientifically grounded methodology is needed, whereby the development of real estate and contiguous sectors (banking infrastructure, in the first place) is to be put in sync with mechanisms of state support for the building complex.

1. Introduction

The building complex is a collective economic term standing for a form of market cooperation between sectors and production lines for the purpose of building and commissioning of new real estate projects, including production capacity and non-production facilities [1]. The building complex understood as a structural element of national economy, having a respective state governance body (like other cross-industry networks), ceased its existence with disintegration of the Soviet administrative and state-run system. The “building complex” term in modern market economy is solely used as a factual and quintessential concept allowing the fusion of various manufactures and institutional structures ensuring the creation of finished building products. 

Proceeding from this definition, the building complex includes capital construction (construction operations) as well as the totality of sectors and business profiles, mainly geared at services for building contractors, provision of the construction industry with logistical support, R&D, design, surveying, civil engineering works and services, personnel training at specialized educational institutions, etc. The main result of a functional building complex from national economy perspectives
is ensuring extensive reproduction (together with mechanical engineering) of fixed assets and capacity (immovable property) in all sectors of national economy.

The economic significance of the building complex in Russia is predicated on the fact that in 2018 it accounted for more than 5% of GDP [2].

In times of economic crises, as we can see from the experience of most developed nations [4], [5], [6], governments tend to support key industries to turn them into “points of growth” and to overcome the economic slump. When we are talking about support for the building complex, one of the most obvious methods is pepping up the demand for new housing. It is but natural for the government to heat up this demand by making mortgage loans more affordable for households with their falling incomes, which is quite typical of any recession. And so in February 2020 new Russian Premier Mikhail Mishustin instructed the government [3] to develop a plan of reducing the interest rates on both newly issued and former loans (through their refinancing). As a result, the mortgage loan must drop at least to 8%.

2. Methods

What could be the consequences of various decisions made? To answer this question, let’s use the method of comparative analysis of the processes unfolding in Russia right in our eyes, the experience gained by developed nations as well as extrapolation of the trends which have already been manifested in the development of the mortgage lending institute in the Russian Federation.

The so-called New Deal of US President Franklin Roosevelt is most often referred to as illustrating a successful use of the aforementioned strategy of state support for the building complex. As part of the New Deal, among other measures, the US budgetary funds were used to start large state-owned mortgage agencies called to redeem mortgages on loans earlier provided by banks, thus financing the mortgage banking and luring investment funds into residential housing construction – for more detail see [1], [4], [5], [6].

3. Results

In the United States this system functioned in the following way: a bank (primary lender on mortgage) would pool standard mortgages normally amounting to several million USD and sell this pool to one of the above-mentioned mortgage agencies. Writing those mortgages off its balance sheet, the bank would nevertheless act as a mediator serving the mortgage loans it had earlier provided, i.e. collecting the payments of borrowers on a regular basis, handing over the funds thus collected to a mortgage agency, and withholding its own commission. In its turn, the agency possessing a reliable tool (in theory) of generating a stable cash flow, issues securities (bonds) whose buyers actually become co-owners of a certain pool of mortgages and end beneficiaries of the financial instrument described above. This mechanism is known as securitization, while the issued securities are generally referred to as MBS – mortgage-backed securities. By the turn of the present century the MBS market had reached truly epic proportions, amounting to more than USD 1.68 trillion [7].

Yet the system of state support for the American building complex that showed its worth as a tool of rescuing the United States from the Great Depression of the 1930s by way of starting and subsidizing mortgage agencies, after going private and being repeatedly modernized, by the beginning of the 21st century had turned into an almost unmanageable conglomerate of banks, mortgage and rating agencies, numerous structural intermediaries, insurers, paid valuators, advisories, etc.

The result was rather sad: both American and international economists recognize that it’s the risk-prone investment policy of US (then private) mortgage agencies carried away by the buyout of unreliable mortgage loans and their securitization into so-called subprime bonds [8], [9] that was the main reason for the financial and economic crisis of 2008-2009, which initially broke out in the United States and then spread to the rest of the world. To rescue such a sensitive sector of the national
In the aftermath of the financial crisis in September 2008, the US government was forced to renationalize the mortgage agencies. This event cost the federal budget an estimated 12.8 trillion dollars [10], [22], [23].

The Russian government, in line with the United States after extensive discussions, decided to adopt a similar model: to establish the public joint-stock company Agency of Housing Mortgage Lending (AHML) in 1997, which was 100% state-owned. During the early years of its existence, AHML was relatively inactive and only became actively involved in the mortgage market development in June 2005, after the national government endorsed the "Conceptual development of a unified system for refinancing of mortgage housing loans" [11]. Since then, AHML has become the main channel for developing the housing mortgage lending system and its key institutional element.

Since 2006, AHML has consistently enhanced its weight and competitiveness in the market, and during the entire time of its existence (up to 2018, when it was transformed into DOM.RF Bank), the government has utilized it as a tool to "inject" more than 400 billion rubles into the building complex [12], although, in the author's opinion, the lion's share of these funds settled down in banking infrastructure, failing to reach building contractors.

When a new spiral of the crisis hit the Russian economy in 2014-2015, the government decided to provide additional incentives for residential housing construction through the direct subsidizing of interest rates on mortgage loans issued by banks in favor of end borrowers, compared to their market cost: within this program in 2016 alone (at the "peak" of the program) 304 thousand loans were provided at the rate of 556 billion rubles or 38% of total mortgage loans approved in 2016. Overall, as of December 2016, the total amount of state subsidies stood at 10.7 billion rubles [13], [14]. We are discussing the support of the building complex rather than the residential property market: the program implied subsidizing of interest rates on mortgage loans to be used exclusively for acquisition of housing based on co-investment agreements (so-called DDU) directly from developers and mostly at the stage of construction, rather than on the market of existing homes. A significant stimulating effect of these measures is graphically shown in Fig. 1.

![Figure 1](image-url)

**Figure 1.** Share of co-investment agreements (DDU) with mortgage leverage (subsidizing of mortgage rates taken into account)
In 2017, when the success of the above-described program became quite obvious, the Russian government suddenly wound down the state program of subsidizing the mortgage rates, injecting the funds thus released into other ways of the building complex support [15].

In the author’s opinion, the decisions of national economy governance bodies not justified by any reasonable economic calculations (not only does the Construction Ministry never publish such calculations; it does not even allude to their existence) is a rather questionable practice. The regulatory acts to the effect – in particular, Russian government resolutions “On the procedure of selecting and coordinating the implementation of high-priority investment projects…” [16], “On the procedure of managing the money accumulated in the National Wealth Fund” [17] and others – do not contain any intelligible economic criteria of selecting specific projects, whereas the choice of certain industry support tools in times of recession, as we already noted above, is made without any full-fledged economic rationale or agreed regulations. Developing a scientifically justified methodology of managing the state support of the construction industry (residential housing construction, in particular) in the volatile economic environment seems to be a necessary step.

4. Discussion

Meanwhile it is the massive expansion of the secondary market of mortgage bonds after the American “template” that is vigorously promoted at present as a strategic priority. The first issue of mortgage bonds was placed at the stock market section of Moscow Interbank Currency Exchange back in 2006 (then the issuer was Mortgage Specialized Organization GPB-Ipoteka, Plc [18]) and of the end of 2019 the bonds worth 557.7bn rubles were floated, with the annual trading volumes amounting to 290bn rubles [19].

Therefore, one of the factors of potential crisis in the building complex similar to the one that hit the United States has been rapidly unfolding in Russia, albeit going largely unnoticed by the general public. The second factor – a bubble in the mortgage market – has been steadily albeit smoothly inflating. From 2014 to 2019 the total debt of Russian customers on mortgage loans grew from 3.39tr rubles to 7.47tr rubles (i.e. more than doubled for five years), whereas the aggregate interest payments by debtors on the earlier approved loans exceeded 660bn rubles for 2019, as the author figured. And finally the last factor of the potential collapse – the reduction of mortgage rates, demanded by the government, looks as positive dynamics at first glance. Mortgage rates are going down indeed and will likely continue sliding down in parallel with the base rate reduced by the Bank of Russia. The base rate has already been cut 16 times from 2017 to Q1 2020, when the given work was written (see Table 1), and has fallen from 10% to 6% [20].

| Rate validity period                                      | Bank of Russia’s Base Rate, % |
|-----------------------------------------------------------|------------------------------|
| 16 December – 20 March 2020 (the date can be corrected)   | 6.00                         |
| 16 December 2019 – 09 February 2020                       | 6.25                         |
| 28 October 2019 – 15 December 2019                       | 6.50                         |
| 09 September 2019 – 27 October 2019                      | 7.00                         |
| 29 July 2019 – 08 September 2019                         | 7.25                         |
| 17 June 2019 – 28 July 2019                              | 7.50                         |
| 17 December 2018 – 16 June 2019                          | 7.75                         |
| 17 September 2018 – 16 December 2018                     | 7.50                         |
| 26 March 2018 – 16 September 2018                        | 7.25                         |
| 12 February 2018 – 25 March 2018                         | 7.50                         |
| 18 December 2017 – 11 February 2018                      | 7.75                         |
| 30 October 2017 – 17 December 2017                       | 8.25                         |
| 18 September 2017 – 29 October 2017                      | 8.50                         |
In accordance with the approved target parameters of the national project Housing and Urban Environment, embraced at the end of 2018 [21], the average interest rate on the mortgage loan was to sink below 8% only by 2024 (Table 2); however, the above-described new instructions of the government must dramatically speed up this process.

Other major players of the banking market, having access to relatively inexpensive funds (we certainly mean biggest and partly state-owned Russian banks) had to follow in the footsteps of Sberbank that repeatedly lowered its interest rates on mortgage loans in recent years, in order to come up with competitive offers. The next wave of interest in the segment from the banking sector creates prerequisites for the given trend to persist. On the horizon of three years this will result in the notable decrease of the banks’ mortgage margin, in the author’s opinion.

Table 2. Target Figures for Mortgage Lending Market till 2024 as per the “Housing and Urban Environment” National Project

| Target figure                                      | Period, year | 2020 | 2021 | 2022 | 2023 | 2024 |
|----------------------------------------------------|--------------|------|------|------|------|------|
| Average interest rate on mortgage loans, %         |              | 8.7  | 8.5  | 8.4  | 8.2  | 7.9  |
| Number of mortgage loans provided, mln loans       |              | 1.57 | 1.60 | 1.77 | 2.05 | 2.26 |
| Including leveraged acquisition of housing in the primary market, mln loans |          | 0.64 | 0.68 | 0.78 | 0.98 | 1.10 |
| Average price of reference housing in the primary market per square meter, thou rubles | | 75.2 | 81.5 | 87.8 | 87.9 | 88.0 |

Following the interest rate reduction for end borrowers and the falling bank margin in the backdrop of stiffening competition for the client, the softening of claims laid by banks on mortgage borrowers appears almost inevitable. The issue of risky loans (both mortgage loans and others) should apparently be curbed by mandatory norms of reserves set by the Bank of Russia; yet in real practice the opposite is often true: the current much softer requirements for the accounting of mortgage loans in calculating the capital adequacy ratio allow banks to increase the share of riskier loans while suffering no significant growth of load on their capital.

5. Conclusions

Therefore, Russia has embarked upon a dangerous path that ended in disaster for the United States literally in our eyes. In the author’s opinion, taking this negative experience into account in forming new guideposts for state support of Russia’s construction industry is an important challenge for the modern Russian science of economics. The Russian government actually invests exorbitant funds into the building complex support both on the federal and regional levels. The Federal Budget for 2020 anticipates expenditures on the national project Housing and Urban Environment that exceed 124.2bn rubles [24], whereas this year’s Moscow budget [25] allocates 201.6bn rubles for the Housing program alone (exclusive of the large-scale program of the rundown and dilapidated housing stock renovation).
In view of the economic risks and threats reviewed in the present work, the author thinks it absolutely necessary to develop applied scientific methods of managing the measures of state support for the building complex on all budgetary levels, to make sure they are in sync with integrated real estate development.

References

[1] Surveying: Organization, Expert Evaluation, Management. Part 1: Organizational-Technological Module in the Surveying System, a textbook / Kostrikin P.N. et al; edited by Grabovoy P.G. – Moscow: ACB: Prosvetitel, 2015 – 560 pages
[2] Bulletin of Current Trends in Russian Economy: Russian GDP Dynamics and Structure. Issue No. 48, April 2019 (e-resource). Mode of access: https://ac.gov.ru/files/publication/a/21974.pdf
[3] Decisions made at the government meeting on 13 February 2020 – official resource of the Russian government – Mode of access: http://government.ru/news/38980. Access date: 22.02.2020.
[4] Kostrikin P.N. (2016). Investment support of real estate development: Monograph. P.N. Kostrikin (pp. 328) Saarbrücken: LAP LAMBERT Academic Publishing.
[5] Collier S. Construction funding: the process of real estate development, appraisal, and finance / S. Collier, Courtland A. Collier, Don A. Halperin. – New York.: John Wiley and Sons, Ltd. - 2007. - 544 p.
[6] Richard B. Professional Real Estate Development: The ULI Guide to the Business / B. Richard, Reiser, Anne B. Freij/- Washington, D.C.: ULI-the Urban Land Institute. - 2003. - 452 p.
[7] Shadrin A. The market of mortgage securities. US experience and Russia’s perspective / Shadrin A. // Securities market – 2004 – No. 24 [e-resource] – Available at: http://www.old.rcb.ru/Archive/articles.asp?id=873. Access date: 25.06.2017
[8] Levitin A., Wachter S. Mortgage Market, Character and Trends: United States. International Encyclopedia of Housing and Home, P. 492-500 (2012).
[9] Thomas J. Flavin, Sheenan L. The role of U.S. subprime mortgage-backed assets in propagating the crisis: Contagion or interdependence? The North American Journal of Economics and Finance, Vol. 34, P. 167–186 (2015).
[10] Chatterjee S., Eyigungor B. A quantitative analysis of the U.S. housing and mortgage markets and the foreclosure crisis. Review of Economic Dynamics, Vol. 18, P.165–184 (2015).
[11] Conceptual development of The Unified System of Housing Mortgage Loan Refinancing in Russia (approved by the Russian government on 30.06.2005)
[12] Surveying: Organization, Expert Evaluation, Management. Part 3: Administrative Module of the Surveying System, a textbook / Kostrikin P.N. et al/, edited by Grabovoy P.G. – Moscow: ACB: Prosvetitel, 2015 – 552 pages
[13] The article Mortgage Lending in Figures: Statistics of Approved Mortgage Loans / Resource of the Mortgage Lending and Securitization Think Tank [e-resource] – 2017. Available at: http://rusipoteka.ru/ipoteka_v_rossii/ipoteka_statitiska.
[14] Russian Finance Ministry’s report “Information about approved (acquired) housing (mortgage) loans and the amount of subsidy to make up for short-received income” / Resource of the Russian Finance Ministry [e-resource]. – 2017. – Available at: http://minfin.ru/ru/perfomance/GovSupport. Access date: 14.01.2020.
[15] The article “Russian government to extend subsidizing of the interest rate on mortgage loans” / Russian News Agency TASS [e-resource]. – 2017. – Available at: http://tass.ru/ekonomika/3884615. Access date: 11.01.2020.
[16] Russian Government Resolution No. 648 dated 03.08.2011 (edited 08.05.2015) “On the procedure of selecting and coordinating the implementation of high-priority investment projects in federal districts as well as amending certain acts of the Russian government” (along with
“The rules of selecting and coordinating the implementation of high-priority investment projects in federal districts”

[17] Russian Government Resolution No. 18 dated 19.01.2008 (edited 01.11.2016) “On the procedure of managing the money of National Wealth Fund” (along with “The requirements for financial assets that can be used for investing the money of the National Wealth Fund”)

[18] The article “FFMS registers a report on the results of issuing mortgage-backed bonds of the Specialized Mortgage Organization GPB-Ipoteka” / Cbonds Group’s resource [e-resource] – 2017. – Available at: https://xn--d1aqf.xn--p1ai/about/analytics/icb-analytics/#1467971265422-14b57392-adc0. Access date: 05.02.2020.

[19] How to make mortgage cheaper: experts name an effective interest rate reduction instrument – Lenta.ru resource. – 2020 – Available at: https://lenta.ru/articles/2020/02/13/ipoteka/

[20] Bank of Russia’s base rate – the official website of the Bank of Russia [e-resource]. – 2020. – Available at: https://www.cbr.ru/hd_base/KeyRate/

[21] Passport of the national project “Housing and Urban Environment” – the official resource of the Russian government [e-resource]. – 2020. – Available at: http://government.ru/info/35560/

[22] Sharma S.D. Not an Exceptional Country: Russia and the Global Financial Crisis of 2008-2009. Mediterranean quarterly, 22 (2), P. 31-44 (2011).

[23] Grammatikos T., Lehnert T., Otsubo Y. Market perceptions of US and European policy actions around the subprime crisis. Journal of International Financial Markets, Institutions and Money, Vol. 37, P. 99–113 (2015).

[24] Infographics “National project Housing and Urban Environment” – News resource The Future of Russia: National Projects [e-resource]. – 2020. – Available at: https://futurerussia.gov.ru/zhile-i-gorodskaya-sreda.

[25] Financial support of the state programme Housing. – official website Open Budget of Moscow [e-resource] – 2020. – Available at: https://budget.mos.ru/gp_home