From shared construction to project funding

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Abstract. The article studies the process of development of the shared construction model as an investment scheme in the construction sector. Information on the housing issues in Russia, the constitutional right to housing and methods of exercising this right is provided. For a deeper understanding of the issue, it is necessary to study the history of development of the shared construction model, its strengths and weaknesses, as well as the factors affecting this type of housing purchase. The construction investment legislation lacks rules for organizing the process. Therefore, it is necessary to amend the legislation so that there were no "deceived equity holders". These circumstances determined the need for reforming the shared construction model and replace it with the project funding one. The legal acts governing shared construction activities and the latest innovations in the construction legislation are presented. The concepts of project funding and escrow accounts are defined. The algorithm of transactions under the agreements of equity participation with the involvement of banks and the government and the new mechanism for monitoring developers’ activities are analyzed. Based on the results of the analysis, conclusions on the main positive and negative aspects of the new system for consumers, construction companies and the construction industry as a whole are drawn.

The housing issue in Russia has remained one of the most urgent ones for many decades. The legislation of the Russian Federation establishes a specific mechanism for exercising the right to housing. In particular, paragraph 2 of Article 40 of the Constitution of the Russian Federation states: "Government authorities and local bodies encourage housing construction, create conditions for the exercise of the right to housing" [1]. Historical experience shows that it is impossible to solve the housing problem at the expense of state resources, and citizens need to solve their housing problems in any legal way [2].

According to Part 4 of Article 1 of the Housing Code of the Russian Federation: “Citizens of the Russian Federation have the right to choose living quarters as owners, tenants or on other grounds stipulated by law” [3]. In other words, the legislation provides for a variety of legal forms of satisfaction of housing needs. Until recently, the purchase of housing under equity participation agreements occupied one of the leading positions in the total number of real estate objects sold [4]. For a deeper understanding of the factors that affect the shared construction model in Russia, it is necessary to study the history of its development.

In Russia, this investment model was created in the 1990s. The reasons were economic changes and poor budget funding of the housing construction sector. The way out of this situation was to attract citizens' funds. In order for the relations between citizens and developers to be formalized, equity construction participation agreements were concluded [4]. In the agreements, the final price of the real estate object was prescribed. It was not allowed to change the price of objects and terms of the agree-
ment [5]. The construction investment legislation was poorly developed and there were no clear rules for organizing the process.

Many companies failed to fulfill their obligations. Due to the imperfect system of shared construction funding, there were 40-50 thousand “deceived equity holders” each year. Only in 2004, in order to regulate the relations between the developer and the shareholder, the Federal Law No. 214-FZ “On participation in the shared construction of apartment buildings and other real estate objects and amendments to some legislative acts of the Russian Federation” was adopted on December 30, 2004 [6]. The law made it impossible to conclude two shared construction participation agreements for one apartment, since the contracts were subject to mandatory registration. This law forbade to sell apartments before all construction permits have been issued. The law obliged developers to establish the construction deadline and penalties for its violation.

But the developers were able to choose the forms of agreements under which they could sell housing objects. The developers took advantage of this situation and concluded contracts on favorable terms. In June 2010, amendments to the Federal Law were adopted. They were aimed to unify housing purchase agreements. However, transactions under equity participation agreements remained risky, since developers had no restrictions on how to use money of equity holders [4]. Unscrupulous developers that did not sell all apartments at the excavation stage had the right to declare themselves bankrupt, and equity holders had no opportunity to return their money.

Under the shared construction model, many schemes for deceiving equity holders have been developed. Instead of shared construction participation agreements, unscrupulous developers concluded preliminary sale and purchase agreements which did not contain the commissioning deadline and other obligations. They were not registered by authorized agencies. When concluding preliminary purchase agreements, there was a risk of double purchasing, since the developer did not register the agreements. But even if the agreement was concluded with a bona fide developer, there was no protection from financial crises in the construction industry or bankruptcy of the developer.

In 2013, Order of the Ministry of Regional Development of Russia No. 403 of September 20, 2013 approved the criteria for declaring citizens defrauded equity holders. In order to protect equity holders from unscrupulous developers, in 2014, the Ministry of Construction and Housing and Utilities of the Russian Federation initiated the process of attracting citizens’ funds under equity participation agreements through authorized banks. But the construction industry was not ready for these changes. According to the statistical report of the Federal State Registration Service and expert estimates for 2015, about 50% of the total volume of housing objects under construction were funded by equity holders. Therefore, in spite of the fact that the number of “defrauded real estate investors” continued to grow, and the institution of shared construction had many shortcomings, it continued to exist.

However, amendments to the shared construction legislation were required. In 2016, amendments were made to the Criminal Code of the Russian Federation. Federal Law N139-FZ of 05/01/2016 introduced Article 200.3 in the Criminal Code of the Russian Federation "Attraction of citizens’ funds in violation of the legislation of the Russian Federation on shared construction participation" [7].

In 2016, the Federal Law “On Amendments to the Federal Law No. 304-FZ “On Shared construction participation” of July 3, 2016 was adopted [8]. The most significant changes included the requirements for the mandatory amount of the authorized (share) asset of the developer, which must be equal to the amount established by law, depending on the amount of the area of all residential premises of apartment buildings under construction. Other changes are the mandatory insurance of developer's liability, escrow accounts, obligatory compliance of the developer and the project declaration with the requirements established by Law No. 214-FZ, as well as mandatory contributions to the compensation fund.

Despite all the innovations, it was not possible to change the situation in the shared construction sector. According to the Ministry of Construction of the Russian Federation, in 2018, the register of affected citizens included 30,856 people in 69 regions of Russia, and only 16 regions did not experience such problems [9]. Since the register of affected citizens is declarative, the department keeps
counting by the number of challenging objects. In 2018, their number was 836 [10]. Moreover, it is worth noting that this figure is only increasing, and in, 2019, there were 894 challenging objects [9].

These circumstances made it necessary to reform the shared construction model and implement the project funding scheme [10]. On October 25, 2017, during the meeting with members of the Government, the President of the Russian Federation set the period of three years to abandon the shared construction model. On December 21, 2017, the Government of the Russian Federation developed a road map for the phased replacement of citizens' funds with funds borrowed from credit institutions [11].

“The road map is aimed at minimizing the risk for participants in shared construction projects by using the mechanism of escrow accounts and (or) other types of special bank accounts that protect the rights of citizens - participants in shared construction – and replacing citizens’ funds with bank loans. Involvement of banks will reduce the risk of loss of citizens’ funds” [11].

The road map of December 21, 2017 established three stages of transition: at the preparatory stage, the regulatory base for the transition from the shared construction to project funding model should be created; at the transitional stage, equity participation agreements should be concluded both under the old scheme, with the involvement of equity holders, and using the escrow account mechanism; at the final stage (from July 1, 2019 to December 31, 2020), all shared construction participation agreements should be concluded using the escrow account mechanism (by the fourth quarter of 2020 more than 95% of all transactions will be carried out under the project funding scheme) [10].

An escrow account is a special account where funds are held in trust whilst two or more parties complete a transaction. The concept of project funding can be defined as a type of long-term (for at least 3 year-old) funding of an investment project in the form of a loan, in which the source of debt repayment is income from the use or sale of property, created and (or) acquired under the investment project [12].

Amendments were made to Federal Law No. 214-FZ of December 30, 2004. In particular, the requirements for developers have been tightened. According to these requirements, the developer can be a company that has a permit for commissioning at least 10,000 m² of apartment buildings and have at least three years of experience in the housing construction sector. Design documents should be examined regardless of the number of storeys of the object under construction. The developer can use only targeted loans. The developer has no right to grant loans and issue securities, except for shares, and purchase securities. The developer cannot create commercial and non-commercial organizations, participate in these organizations and conclude agreements that are not related to the shared construction project.

Since July 1, 2018, the requirements for the governing bodies of the developer have become more stringent. Instead of bank guarantees or civil liability insurance, the developer is obliged to make contributions to the compensation fund in the amount of 1.2% of the cost of the equity participation agreement before the state registration of the agreement [10]. Requirements for the developer's information transparency have been tightened.

Current conditions in the construction sector and aggravated competition have increased the need for effective management of construction companies, since in Russia there have been contradictory trends in the development of the construction industry, which generated the emergence of risky situations and influenced the financial stability of enterprises (an increase in the number of overdue accounts, a decrease in the volume of investment, etc.) [13]. Additional restrictions have been imposed on the use of equity holders' funds for objects commissioned after July 1, 2018. The developer's administrative expenses (rent, advertising, wages, bank services, communications, etc.) may not exceed 10% of the construction cost.

In 2018, the Ministry of Construction of the Russian Federation developed a strategy for the development of the construction industry until 2030. According to this strategy, one of the priority goals in the housing construction sector for the period up to 2030 is to create conditions for increasing the annual volume of housing construction up to 120 million square meters. The main catalyst for this growth, according to the Ministry of Construction, should be escrow accounts and an increase in the
number of equity participation agreements (from 800 thousand agreements to 1000 thousand agreements) (Fig. 1).

In order to implement the project funding scheme in the construction sector, a specialized credit institution will be created with the participation of JSC DOM.RF.

One of the main tasks of the authorized bank will be to ensure the transfer of the construction facility portfolio to the project funding scheme. The second function of the authorized bank will be banking support and control over the targeted use of funds as part of the completion of construction projects for challenging facilities with the participation of the Fund for the Protection of the Rights of Citizens - participants in shared construction.

The transition to the escrow account scheme is underway. In particular, according to DOM.RF, 40% of Russian developers began to use escrow accounts.

The development of an innovative economy requires the modernization of production assets, the application of modern methods of production, effective management of innovative projects, taking into account risks. [14].

Low investment activity and construction risks are associated with the high level of tax burden, the low volumes of orders and own financial resources, the high cost of materials and structures and insolvency of customers [15, 16]. In this regard, the legislative reform of the investment activity in the housing construction sector is required.

Thus, the buyer can only purchase finished housing objects. In addition to the buyer and the construction organization, banks and the government will participate in transactions. The legislator has replaced the requirement for the size of the authorized capital with the requirement for the size of the developer's own funds. The developer's own funds must be at least 10% of the planned cost of the project. The minimum amount of funds on the account of an authorized bank should be 10%. This is sufficient for the developer to prove commitment to implement an investment and construction project [17]. Construction companies must invest their own funds in the construction project, that is, buy a land plot and perform design works, start construction works, and conclude equity participation agreements for most of the apartments (about 70%) [18]. The remaining amount is provided by a credit institution. Future homeowners open escrow accounts (included in the deposit insurance system for up to 10 million rubles), where their money remains as a guarantee to the developer [18]. Money can be added to the escrow accounts. The Bank is not obliged to form significant reserves and can reduce the loan rate for the developer. Upon completion of the construction project, money of apartment owners is used to pay the developer's loan and serves as developer's profit.

An indisputable advantage of the new project funding system is increased control over the developer. Control is carried out by three bodies. The authorized executive body of the region which controls whether the developer has the right to raise funds from participants in shared construction and exercis-
es control over the targeted use of funds invested by the participants in shared construction [17]. Developers are obliged to provide financial statements to the Fund for Protection of the rights of participants in shared construction. Developers are obliged to submit expenditure documents to the authorized bank.

When accepting the payment order, the authorized bank will control the compliance of the purpose of payment with the legislation on the targeted use of funds and its size with the content of documents submitted by the developer [17]. In case of inconsistencies, the bank is obliged to report them to the supervisory body and has the right to refuse to carry out operations related to the misappropriation of funds. This will allow the authorized bank to exercise full control over the targeted spending of funds of participants in the shared construction project [17]. The authorized bank will have to meet the criteria established by the Government of the Russian Federation.

The analysis identified the following advantages of the project funding model: no risks, since the funds remain safe until the apartments are transferred to the buyers; no unscrupulous developers; restoration of the reputation of shared construction projects for implementing the state housing policy; no “defrauded equity holders”; no inappropriate use of funds of equity holders and other abuses by unscrupulous developers; no discrepancy between the attracted funds and the stages of construction; uninterrupted funding of construction and reduction of the construction period; no risks for the government.

The need for budgetary support has become minimal: if the developer fails to fulfill obligations, the construction project will be completed at the expense of the banks.

The drawbacks of the project funding scheme are an increase in the housing cost by at least 20-30% due to the participation of banks (loan interest and servicing cost, expenses for banking supervision and control over construction objects; loss of the opportunity to buy apartments at the lowest possible price "at the stage of excavation"; a decrease in demand for housing as a result of a temporary decline in the construction industry; forced exit of small and medium-sized construction companies from the market, or their absorption by larger developers; difficulties when entering the market, and low competition and high market monopolization; restricted choice of contractors due to the stringent requirements established by the authorized banks.

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