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Mortgage lending engine

Development of the home loan market in Russia

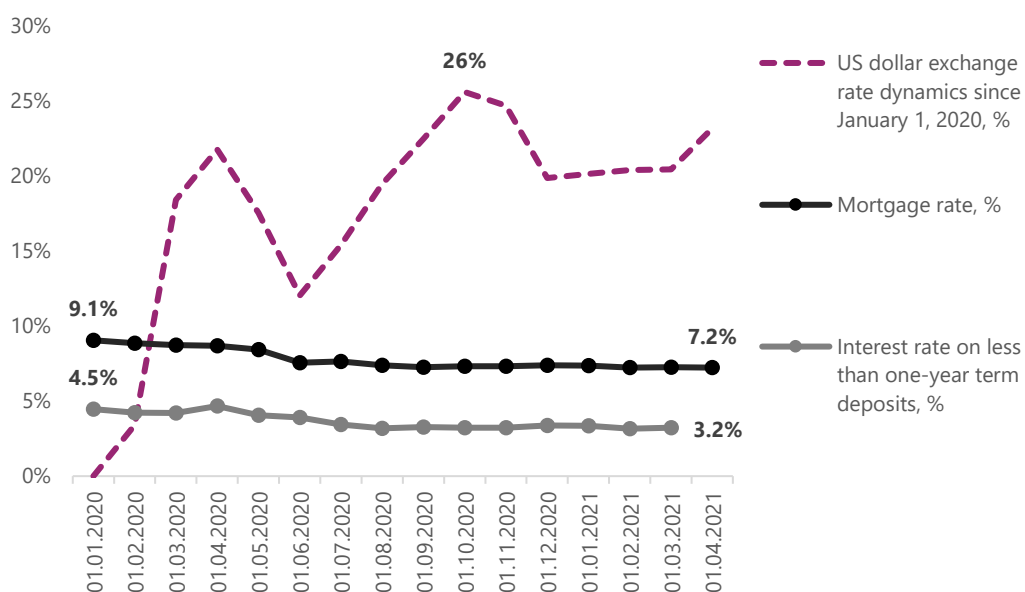
- **Preferential mortgages have served as an impetus for the rapid growth of mortgage lending.** However, the population only benefitted from it in the first six months after the program was launched. Support provided to the economy during the pandemic resulted in an increased debt burden for the population due to the size of the average mortgage growing by 14% (and by 21% under equity participation agreements), which in turn was the result of higher real estate prices.
- **The benefit that citizens derived from the low interest rate was already offset by the increased cost of housing by the end of 2020.** Borrowers had to increase the length of their mortgages in order to ensure a comfortable repayment schedule (from July 1, 2020 to April 1, 2021, the average mortgage loan under an equity participation agreement increased by 2.2 years to more than 20 years).
- **According to a survey of 23 banks (27% of the mortgage portfolio) held by ACRA, active growth of mortgage lending has not yet led to the formation of a bubble in the market.** A large share of the banks are still interested in increasing business profitability by generating profit from mortgages, and the average expected growth in mortgage lending in 2021 stands at 10–15%. Only the regulator is capable of making the mortgage lending market “calm down”.
- **Growth of delinquent mortgages is unavoidable, but the associated risks are not critical for banks.** According to ACRA’s assessments, over the next 12 months, problem mortgage debt (NPL90+) may exceed 2.5% of mortgage loans and the growth of risk may be around 150 bps. However, the current capital buffer and profit generated by banks will allow them to withstand possible losses on potential problem debt. At the same time, the impact of NPL90+ growth may affect banks in different ways, depending on the importance of the mortgage business to them.
- **Mortgage loans with a down payment made using borrowed funds are the most dangerous.** According to ACRA, the initial payment on at least 7% of mortgages has been directly or indirectly paid using consumer loans. At the same time, possible limitation of the term of mortgage loans to twenty years amid the introduction of floating rates may further spur demand for consumer loans to pay the down payment.
- **ACRA expects mortgage interest rates to grow.** In view of the projected rise in the cost of funding and the expiration of the term of preferential mortgages in regions with the largest residential construction markets, rates may reach 9–9.5% by the end of 2021.
- **The absence of an officially established time limit for the preferential program could contribute to more systematic growth in the volume of mortgage loans.** Already in Q3 2021, after the end of the program and the introduction of increased macroprudential mark-ups to risk ratios for mortgage loans, we will see a correction in demand for mortgages and, as a result, a likely stagnation in housing prices. Prices may decline by 5–7% in the most pessimistic scenario.

Preferential mortgages propelled rapid market growth

In recent years, mortgage lending has been one of the most dynamically developing areas of consumer lending in Russia. The population's interest in improving their living conditions and maintaining/multiplying their capital coupled with the set of measures deployed by the state to support the economy by stimulating growth of housing construction have acted as factors in the growth of issuance of mortgages. However, recently the sector's growth has accelerated significantly, which has provoked discussions about the validity and risks of this phenomenon.

The trigger for the rapid growth of mortgage loans was the preferential mortgage program launched in April 2020 offering mortgages with an annual rate of 6.5% for housing in new buildings¹. However, the current situation in the mortgage market also has fundamental prerequisites. In particular, factors such as low interest rates on deposits, the lower exchange rate of the ruble, and high inflation expectations forced Russians to think about investing their money in real estate in 2020 and early 2021. In addition, lower interest rates on loans also acted in favor of advantageous purchases of housing.

Figure 1. Fundamental prerequisites that encouraged the population to purchase real estate



Sources: Bank of Russia, ACRA calculations

Credit organizations were also interested in this program and gladly increased mortgage lending in order to support profitability. Moreover, at the beginning of the pandemic the Bank of Russia supported banks by dissolving the accumulated capital buffer (which helped free up RUB 126 bln in mortgages and another RUB 168 bln in unsecured consumer loans), as well as by reducing macroprudential mark-ups to risk ratios for mortgage loans. The flywheel of mortgage lending has started spinning in full force.

¹ In accordance with the Decree of the Government of the Russian Federation No. 566 dated April 23, 2020. There are currently other preferential programs in Russia, including those set by the Decree of the Government of the Russian Federation No. 1609 dated December 7, 2019, No. 1567 dated November 30, 2019, No. 1170 dated September 7, 2019, No. 1711 dated December 30, 2017, and No. 370 dated May 15, 2008. However, all of them are targeted ones, therefore, their effect on the economy as a whole is relatively small.

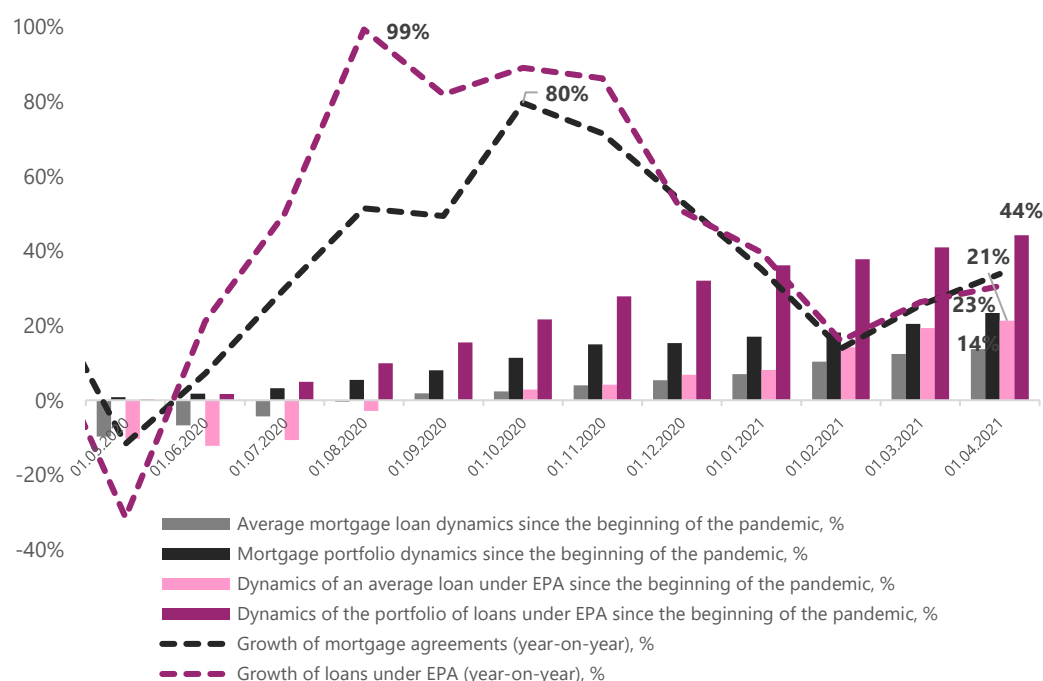
People no longer have benefit

For an in-depth analysis of unveiling trends in the mortgage market and consequences of the introduction of the preferential program, ACRA held a survey of 23 Russian banks (27% of the mortgage portfolio), which have an ACRA rating and boast significant positions in mortgage/housing lending. According to the results of the survey, banks generally consider preferential mortgages profitable for them, although they see some risks. They believe that the active growth of mortgage lending has not yet resulted in the formation of a bubble in the market, but there are prerequisites for it. Twelve out of the 23 credit institutions surveyed positively assess the current situation in the mortgage market with no negative feedback given.

At the same time, this April the Bank of Russia noted signs of overheating of the mortgage market, calling on banks to consider the risks associated with this trend. Nevertheless, a significant part of credit institutions are still interested in increasing the profitability of their business by generating profits on mortgages (according to the survey, the average expected growth in mortgage lending in 2021 stands at 10–15%). In this regard, it is only the regulator that can “calm down” the market.

Initially, the Russian Government considered the introduction of preferential mortgages for new buildings as a general anti-crisis solution aimed at supporting various sectors of the economy related to housing construction², as well as banks and the population during the pandemic. In particular, the range of new mortgage borrowers was expanded by those people who previously had no loans (according to the Bank of Russia, their share rose from 22.8 to 24.2% in the third quarter of 2021, although this ratio maintained its steady downward trend from the fourth quarter of 2018 to the second quarter of 2020). However, already in the fourth quarter of 2020 support provided to the economy during the pandemic resulted in an increased debt burden for the population due to the growth of the mortgage because of an increase in house prices (during the pandemic, the average mortgage surged by 14%, and by 21% under equity participation agreements).

Figure 2. Feverish demand led to a sharp increase in the size of the average mortgage

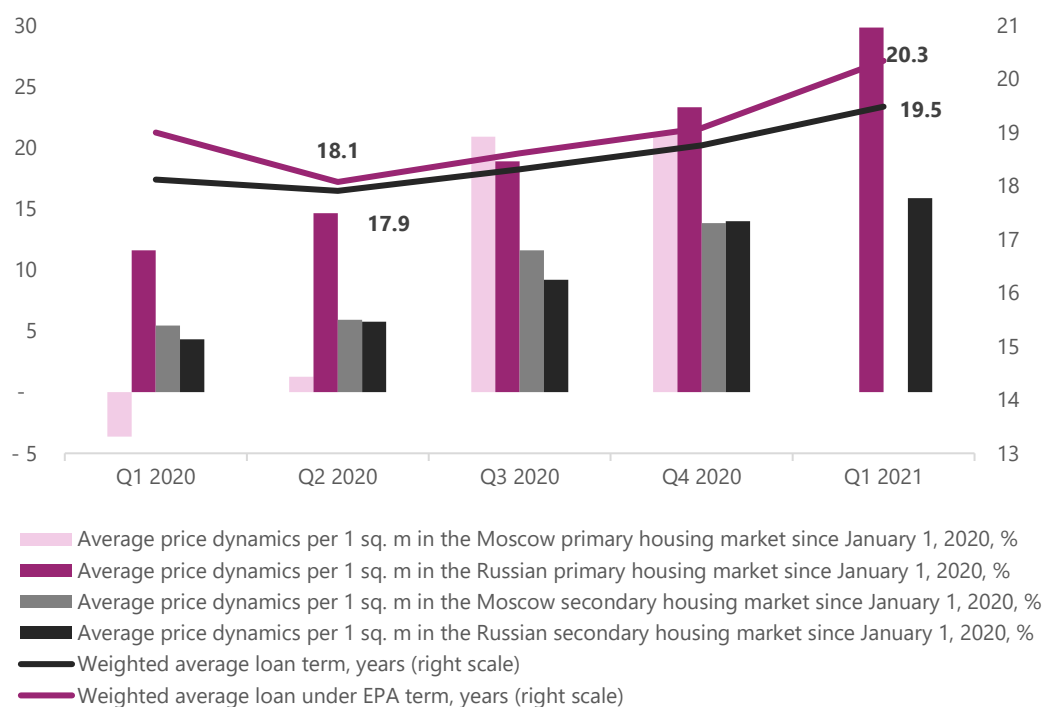


Source: Bank of Russia, ACRA calculations

² According to ACRA estimates, the construction sector's contribution to GDP in 2020 totaled nearly 6% of GDP.

Additionally, the benefit that citizens derived from the low interest rate was already offset by the increased cost of housing in the primary market in late 2020 (up 25.7% in Moscow and 10.5% in Russia as a whole from April to December 2020), as well as in the secondary market (up 7.9% in Moscow and 9.2% in Russia as a whole over the same period). Borrowers had to increase the length of their mortgages in order to ensure a comfortable repayment schedule (from July 1, 2020 to April 1, 2021, the average mortgage loan under an equity participation agreement increased by 2.2 years to more than 20 years).

Figure 3. The increased length of mortgages helped avoid a significant growth of a monthly payment



Source: Bank of Russia, UIISS, ACRA calculations

Continued rapid growth of mortgages poses higher credit risks

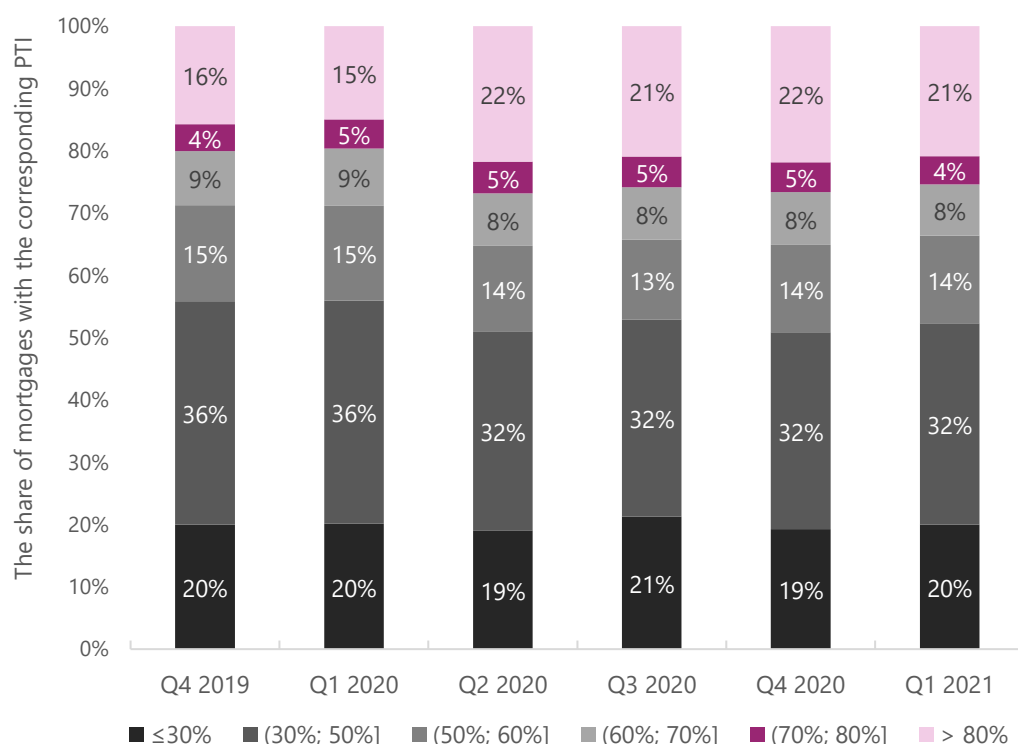
The share of non-performing loans tends to decrease and, according to the Bank of Russia, it stood at around 1.2% of the residential loan portfolio as of April 1, 2021. However, the rapid growth of the mortgage portfolio of banks distorts its quality parameters.

Considering that real disposable income of the population (down 3.6% in the first quarter of 2021, year-on-year, according to the Rosstat data) has not recovered yet, as well as the expected decline (due to several reasons) in mortgage lending and the feverish nature of loans issued over the last 12 months, we will see an increase in problem mortgage loans not only in absolute terms, but also in relative ones in the near future. According to ACRA estimates, the overdue debt on residential loans (considering the restructured loans, mainly under the banks' own programs, which will become overdue and remain problem) may exceed 2.5% of residential loans within the 12-month horizon.

See ACRA's research ["Retail lending has received a "vaccine" against the crisis"](#) from September 2, 2020, for more information on inadvertent masking of the existing quality problems of retail loans.

This forecast is also supported by the relatively less conservative approach of lenders with regard to the payment to income (PTI) ratio, considering the feverish nature of mortgages. Borrowers' PTI deteriorated slightly in the second quarter of 2020 and remains at this level. According to the results of the survey, the share of mortgage loans with PTI of less than 50% decreased from the pre-pandemic 56 to 52%, while the share of loans with PTI over 80% rose from 15 to 22%. At the same time, the level of mortgage approvals during the pandemic did not change significantly, remaining at around 55%.

Figure 4. Pandemic did not prompt banks to take more conservative approach to risk-taking

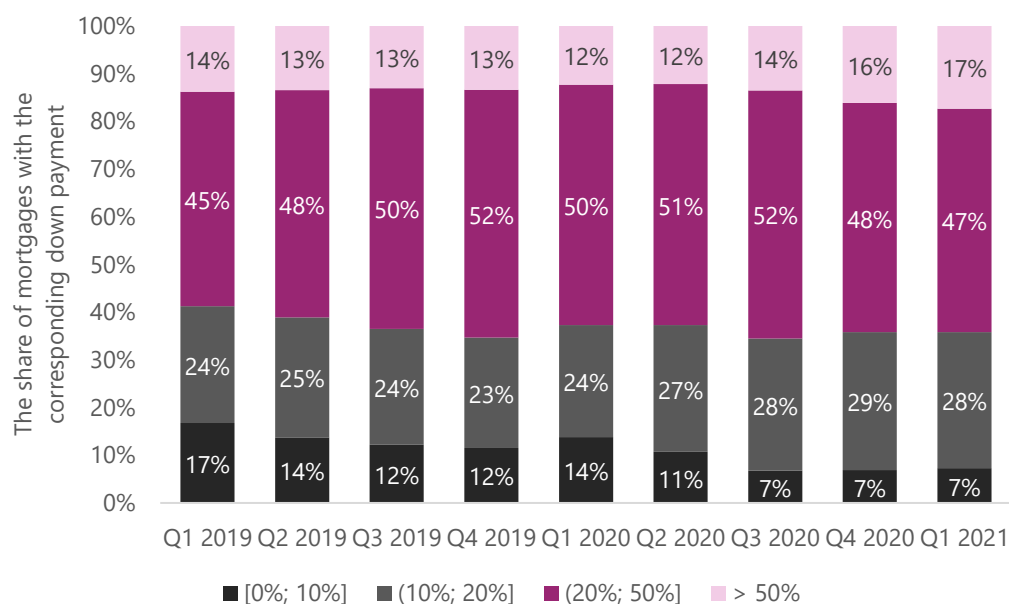


Source: ACRA calculations based on the results of the survey

The increased debt load of Russians (according to the Bank of Russia, the debt service ratio stood at 11.9% of disposable income as of April 1, 2021) due to the deteriorating economic environment, and the recommendation given to banks in late March 2021 to extend restructuring of retail loans until July 1, 2021, also indicate that people have financial problems. According to ACRA estimates, the initial payment on at least 7% of mortgages has been directly or indirectly paid using consumer loans, indicating an increase in credit risk in the near future.

Mortgage loans with the initial payment made using borrowed funds and not exceeding 20% of the cost of housing are the most dangerous. However, since mid-2020, the share of loans with a low down payment (less than 10% of the housing cost) has significantly decreased, settling at 7% of loans. The main reasons are the required down payment on a preferential mortgage of at least 15% of the housing cost, as well as higher macroprudential mark-ups on loans with a low down payment. At the same time, the share of higher-quality loans (with the down payment of more than 50%) tends to increase, accounting for 17% of all loans. This was not observed before the pandemic.

Figure 5. The increased down payment is one of the ways to reduce the risk of loan defaults during the pandemic



Source: ACRA calculations based on the results of the survey

Floating rates: profit vs risk

A rapid growth of the mortgage portfolio leads to a change in the term structure of assets. Mortgages are currently being given for a period of around twenty years and are fixed-rate. Although mortgage loans are on average repaid within seven–eight years, banks are faced with the interest rate risk during this shorter period (according to our estimates, this may happen as early as 2022–2023). In this regard, ACRA notes the banks' growing interest in floating interest rates.

It is worth noting that the risk of a return of high rates in Russia started to gradually materialize in the first quarter of 2021 due to a jump in inflation. The Bank of Russia raised the key rate on March 19, 2021.

According to media reports, the regulator and the banking community are currently in talks with regard to the introduction of floating mortgage rates, but with several restrictions, including the loan length. One of the scenarios implies a restriction prohibiting the use of floating rates, including on loans with a maturity of over 20 years. In this case, banks will be interested in providing loans for a shorter period, but this also incurs risks.

First, considering a house price growth, the forced limitation of the maximum length of a mortgage loan to twenty years is only possible by increasing the down payment. Given a plunge in real disposable income of the population, an increase in the down payment may spur the use of consumer loans, which will lead to a further growth of Russians' debt burden (the length of consumer loans is much shorter, while the rate is higher). According to the Bank of Russia, the debt burden of mortgage borrowers stood at 1.9% of the income of the population in early 2021, which is achieved solely due to a relatively longer loan term. At the same time, according to the Bank of Russia, the debt service ratio (the ratio of loan payments to the total amount of disposable income of the population) is at a record high of 11.9%.

Secondly, a twenty-year period is too long for a reliable forecast of the behavior of rates. In case of a sharp increase in interest rates, credit institutions will be protected from the interest rate risk. However, the credit risk (the risk of non-repayment of mortgages) is rising, which may lead to a growth in the volume of problem loans and even stronger pressure on capital than in case of the interest rate risk.

Banks already faced similar risks of a portfolio deterioration due to a sharp change in the operating environment in 2015. At that time, due to a sharp increase in the US dollar and euro exchange rates borrowers found it hard to fulfil their obligations under foreign currency mortgages.

It was the high share of loans provided at a floating interest rate that served as one of the factors triggering the housing bubble burst in the United States in 2007–2008. The increase in interest rates made it impossible for a significant part of borrowers to service their debt. This particularly affected borrowers with relatively low incomes. According to ACRA, the growth in mortgage lending in Russia is due, among other things, to an increase in demand from the lower-income segments of the population. An active issuance of mortgage loans at a floating interest rate will contribute to the heightened sensitivity of borrowers' solvency to adverse operating environment.

When it comes to the current situation, the golden mean could probably be the introduction of a floating rate ceiling for the entire period or for years, as well as tighter requirements for borrowers in terms of PTI at the issuance stage.

The end of preferential mortgages may affect house prices

One of the consequences of limiting the duration of preferential programs is the surge in the volume of loan issuance, which leads to an acceleration in the growth of house prices. At the same time, the absence of an officially established time limit for the duration³ of such programs, on the contrary, could contribute to a more systematic increase in lending.

We could see the feverish demand for housing, mainly in the primary market, in September–October 2020, and expect another surge in May–June 2021. The reason is that people are keen to get a mortgage loan at a historically low rate before the termination of the program. At the same time, it is worth noting that despite the key rate increase, some credit institutions are not in a hurry to raise the interest rate on mortgages in the fight for clients, and often reduce it. As part of the current mortgage program for housing in new buildings, several banks offered rates of 0.5–1 p. p. below the preferential level of 6.5%. Considering the approaching end of the preferential program, such rates look especially tempting for borrowers.

Another house price growth is highly likely in May–June this year, which in the future will only increase the risks of deterioration in the mortgage portfolio quality. However, we expect a correction in demand for mortgages in the third quarter of 2021. At the same time, the growth of house prices in the near future will slow down and may then stagnate. In the most pessimistic scenario, house prices will correct by 5–7%.

In late May 2021, the Bank of Russia decided to increase risk-weight add-ons for mortgage loans with the LTV ratio (loan/collateral) of 80–85%, which will be issued starting from August 1, 2021. This measure will improve the quality of loans and the

³ Initially the preferential mortgage program at 6.5% was valid until November 1, 2020, but then it was extended until July 1, 2021.

resilience of banks to possible shocks. On the other hand, this measure will help reduce the number of mortgages, meaning that it can be an additional factor in house price correction (mainly in the primary housing market) a month after the termination of the preferential mortgage program.

Anyway, the potential for lower house prices remains constrained since people are keen to improve their housing conditions and there is demand in real estate investments. In addition, the spike in house prices is not just speculative, it is also fueled by an increase in the cost of construction. That is why we do not expect a significant correction — building material prices will not decrease.

Due to the uneven growth of house prices in various Russian regions, the issue of extending the preferential mortgage program is being debated only in the context of particular regions of Russia. For regions with no signs of overheating in the housing market, the extension of the program seems appropriate, because it will stimulate sales in the primary market and support housing demand from the population. The lack of active demand for under-construction residential real estate in some Russian regions despite the preferential mortgage program may signal that the housing market and mortgage lending are stalling there. The lowest rates of price growth in the primary housing market are observed in some regions of the North Caucasian and Far Eastern Federal Districts. However, the reasons for this trend may be different; therefore, the extension of the preferential mortgage program in these regions may not solve the issue of housing affordability.

In addition to the decline in the volume of mortgage loan issuance and the correction of house prices in the third quarter of 2021, ACRA expects an increase in mortgage rates to 9–9.5% by the end of this year due to the projected growth in funding cost and the termination of the preferential mortgage program in the regions with the deepest housing market.

Negative consequences for banks are not critical

Despite the expected growth of non-performing mortgage debt from the current 1.2% to at least 2.5% of the total mortgage portfolio within the 12-month horizon, ACRA does not consider it to pose significant risks to the banking system in terms of capital pressure. The existing capital buffer⁴ (nearly RUB 510 bln for own funds and RUB 330 bln for fixed capital as of January 1, 2021) and banks' ability to generate profit (according to the Bank of Russia, the sector received RUB 778 bln of net profit in January–April 2021) will allow credit institutions to withstand possible losses on potentially problem mortgage loans and the potential amount of additional reserves for problem loans (around RUB 150 bln, or 150 bps, within the 12-month horizon, according to ACRA estimates). At the same time, the effect of the growth of overdue debt may affect credit institutions differently, depending on the importance of the mortgage business for them (the share of banks, which mortgage portfolio exceeds 75% of capital equals 56% of the sector's assets) and the existing lending standards.

In order to avoid the increased risk of pressure on banks' capital, the issue of careful monitoring of the dynamics of the debt burden of the population, which is currently at a historical maximum, remains relevant. However, in this case the supply in the

⁴ It is calculated as the product of Russian banks' capital and delta between the current (an average in the sector) value of the capital adequacy ratio and the minimum level required by the regulator.

housing market plays an important role. Under the circumstances when demand continues to exceed supply, which is triggered by the preferential mortgage program, the increase in the cost per square meter of residential property is inevitable. At the same time, given the lower housing affordability, the debt burden of the population, which serves as one of the key factors of the banking sector's vulnerability, may continue to grow, which will lead to an even greater tightening of regulatory requirements for credit institutions and a decrease in the profitability of the banking business.

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