Establishment of Mortgage Rules and Legislation – Ukraine

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Policy Report # 2

Consumer Protection Issues in Mortgage Lending in Ukraine: Case, Scope and Implementation Strategy for Regulation

The findings, conclusions and recommendations expressed in this publication are those of the authors' alone and should in no way be taken to reflect the views of the EUROPEAN COMMISSION

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PREFACE

This Working Paper Number 2 is the result of the Project's consultants' analysis of and recommendations to the risk situation of consumers in the mortgage and home loan market in Ukraine. The consultants were retained throughout September and October 2005, and in the end of their mission, two workshops were conducted for representatives from financial institutions and relevant government bodies and authorities. Because of enactment of the amended Law of Ukraine "On Consumer Rights Protection", the reported was supplemented with the overview of the consumer right protection legislation as of early 2006.

Although Mortgage Consumer Protection is sometimes characterized as a luxury item of developed markets, the Project believes that it is timely to have a debate aiming at improvement of the mortgage consumer conditions. Such a need is not only deemed necessary from a consumer perspective but also from the point of view of financial institutions. Especially regulation in areas that in addition to consumer protection improve the competition environment between lenders – rules addressing conflicts of interest – for instance in relation to developers – effective interest rates, minimum disclosure rules, definition of product classes, appears to be of interest to lenders.

The Working Paper consists of the authors' report and recommendation on elimination of detected the revealed problems and a drafted Code of Conduct attached as an annex.

It is the Project's hope that the Working Paper will stimulate the debate on Mortgage Consumer Protection and finally lead to regulation of the market either voluntarily through a Code of Conduct or through legislation.

Any comments or questions to this working paper are welcomed.

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Consumer Protection Issues in Mortgage Lending in Ukraine: Regulation and Implementation Strategies

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December 2005, amended September 2006

Convention:

In deviation from the precise legal terminology but in line with common use in literature and as a short-cut, at times the term "mortgage loan" is used in this report synonymously with loans for housing purposes or "housing loans". The legal discussion as well as the documents produced throughout the project use the precise legal definitions as well as related concepts, such as the summary term "home loans" which has been adopted in relevant European regulations.[5]

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[5] See the "European agreement on a voluntary Code of Conduct on pre-contractual information for home loans", downloadable from http://europa.eu.int/comm/internal_market/finservices-retail/home-loans/index_en.htm#study

1. INTRODUCTION

The authors of this document were retained from September through December 2005 by the EU-Tecnitas project to analyze the risk situation for consumers in the mortgage market in Ukraine, identify gaps between international best legal practice and current practices in Ukraine, and suggest appropriate changes in regulation of consumer protection in the Ukrainian mortgage lending system.

Although consumer protection is sometimes characterized as a luxury item of developed markets, the authors believe that it is timely to undertake these analyses for the emerging mortgage and home loan market of Ukraine.

After a long phase of stagnation, the Ukrainian market was as of fall 2005 characterized by strong growth of new originations, an increasing focus of lenders on the retail market and declining interest rates in an increasingly improved macroeconomic context. However, as typical for markets with similar environmental conditions, such as Russia, Romania, or Turkey, consumers – and via the default channel lenders - are facing significant risks when entering a long-term finance arrangement. Such risks arise from exorbitant house price growth in the cities and related solvency problems of consumers, from the character of current financing practices - especially the provision of loans to consumers for construction finance purposes, from increasingly divergent market covenants and products as more and more lenders enter the market, from intransparency about the products and even contractual conditions offered by them, and from a general lack of legal infrastructure to determine and enforce consumer rights vis-a-vis lenders.

This report analyzes these issues in three sections:

1. A financial risk analysis of mortgage lending from the perspective of consumers;
2. A legal gap analysis reviewing current Ukrainian legislation relevant for consumer protection;
3. An analysis of the scope and implementation options for consumer protection regulations.

A companion piece to this report is a specific proposal for a Code of Conduct for lenders of home loans in Ukraine in their relations to consumers.

The methodology adopted are lender interviews (six banks) and interviews with the mortgage credit association UNIA, the State Committee of Ukraine for Technical Regulation and Consumer Policy, the National Bank of Ukraine, the World Bank and other observers of the market.

2. FINANCIAL RISK ANALYSIS[6]

Due to the specific risk factors influencing the Ukrainian home loan and mortgage market, the analysis takes a broader perspective than what will typically be addressed in the canon of consumer protection legislation in Western countries.

The following four areas appear of main interest:

- Risks related to the widespread practice of providing long-term finance for unfinished housing units via consumers.

[6] For the purpose of this analysis, six lenders with seats in Kiev and Dnipropetrovsk as well as market observers in Kiev were interviewed. The questionnaire form is attached in the annex.

- Risks related to the increasing delinking of house prices from construction/land prices.
- Risks related to other underwriting practices, in particular the widespread use of foreign exchange denominated credit and issues around rate adjustment and prepayment.
- Risk related to deficiencies in the interaction process between consumers and lenders, including pre-contractual phase, contract closing, loan servicing, and foreclosure.

2.1 RISK ARISING FROM LEVERAGED INVESTMENT INTO UNFINISHED HOUSING

Background

The multi-family construction sector is of high relevance for the Ukrainian housing market and continues to dominate new construction activity in the cities. Some form of construction finance is clearly needed due to the large construction volumes to be financed, but either banks do not provide such finance at all or only under conditions imposing high costs on developers. Developers thus tap consumers for financing the construction phase, which has lead to a widespread practice of consumers being invested into unfinished housing units.

Different motivations of consumers support this financing model. In the present dynamic house price environment, some consumers hope to maximize their capital gains and share the significant developer profit margins[7] when investing early in the construction process. Other consumers simply lack the affordability to buy finished units at high prices and trade a lower price against the additional risk due to financial necessity.

While a construction finance involvement of consumers with their own funds is already problematic, it has become so more critically so in the past 2-3 years since the leveraging of such investment through bank credit has become possible. Based on our interviews, we estimate that by mid-2005 in Kiev more than 50% of a typical new multi-family construction project was prefinanced through consumers, with virtually cost free land provided by municipalities, capital/retained earnings by developers and highly priced bank loans to developers funding the remainder.

Table 1: Lender's Involvement in Construction Finance, September 2005

Lender No	1	2	3	4	5	6
Share of unfinished housing loans in new originations	~5%	50%	>50%	60% Kiev, 40% rest of Ukraine	Mostly SFH lending (~10%), MFH ~60%*	Just started
Increase of share relative to 2004?	Decrease	Increase	Increase	Increase	Constant	Strong increase
Earliest disbursement data, % of construction progress	80%	30%	No policy	60-80%	No policy	No policy
Approx. number of co-operating developers	Under 10	40	No policy	~20	~100	No policy
Risk policy focus	Portfolio limit, licensing system	Licensing system for developers	Focus on SFH*	Licensing system for developers, completion guarantees	Focus on SFH, licensing system for developers; mark-up for construct. loans	Corporate credit approach to developers

Source: authors' interviews during September 2005. *SFH – single-family houses, MFH – multi-family houses.

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[7] See section 2.2 for more detail.

And strikingly, rather than reducing consumer involvement in construction finance, as could be expected from the developments in comparator markets[8], Ukrainian lenders have shifted their attention back to this so-called 'primary' market. Four of the six lenders interviewed during the fall of 2005 indicated multifamily shares in their housing loan originations of around 50%, in Kiev generally above that ratio. This is up from around 20-30% indicated by the same banks in an interview series undertaken in January 2005 by the EU-Tecnitas project[9] and consistent with the general notion of a pick-up of related construction and construction financing activity – especially in Kiev. One retail lender who so far had only limited construction finance involvement entered the multifamily consumer finance market anew as part of a strategy to gain market share and boost profitability.

Considering strategies to contain risks related to the practice, only one out six lenders indicated to pursue an explicit and low (5%) portfolio limit with regard to construction finance, two others try to diversify into the single-family housing sector (SFH), which is severely supply-constrained in the urban areas. All interviewed lenders have a corporate finance appraoch for developers in place that involves a quasi-licensing, although the number of and standards applied to obtain such 'licenses' appear to be highly variable. Corporate finance underwriting techniques are hampered by a lack of reliable balance sheet and project data as well as outright fraud, leading two out of our six lenders to call for public regulation of the developer industry during the interviews. In addition, all lender representatives appear to be well aware of the potential risks that consumers face when leveraging up in this market segment with bank loans.

Risk factors for consumers

- Project risks. Property purchase contracts are typically very restrictively formulated and used to shift design and quality risk as well as completion delay risk due to lack of financing sources, cost overrun or even the lack of valid building permits to consumers.

- Unsound underwriting practices of lenders. While some lenders indicate to lend at minimum levels of construction progress only, the practice seems to be increasingly biased towards making financings available as early as the consumer or developer desire, including from the construction start. Only one of the six lenders differentiates his margins by construction progress, as well as by construction vs. finished vs. existing housing financing status, to steer consumers away from risky financings.

- Lack of sureties. In Ukraine, neither the developer nor the acquiring consumers usually become the owners of the land underneath the buildings. In a few cases, completion guarantees are given by developers or their mother companies to lenders; these do not benefit directly consumers, however. This situation leaves the consumer with an unsecured claim to the developer's assets.

- Collusion risk between lender and developer. Close economic ties between lenders and developers – in a few cases exclusive business relationships or even direct ownership linkages – align the interests of both against consumers by maximizing prices and minimizing construction costs, often via reduced quality or saving administrative procedures (such as getting a proper building permit). Such situations have triggered bold responses by law-makers elsewhere: in many EU countries, but also in emerging markets such as Turkey, if a close economic tie is present between lender and developer the lender risks being held responsible for deficiencies in the property sales contract that he financed. As we will

[8] For instance, in neighbouring Romania mortgage lenders withdrew almost completely from construction finance within a few years. Similarly, involvement of consumers in construction finance has become rather unusual in the Central European transition countries.

[9] Source: individual questionnaire returns made available to the authors by the Technitas Consortium. For the questionnaires see the Annex of Technitas Consortium (2005).

discuss in Chapter 3, the legal situation in Ukraine is confusing, as older elements of legislation even protect such close economic ties against consumer claims while newer ones rather comprehensively protect the consumer.

In fairness, there can be risk-mitigating functions of a close relationship to developers, for instance the fact that many lenders bring corporate credit underwriting and project management capacity to the investment process that consumers utterly lack. However such capacity differs between lenders and is applied under widely varying standards.

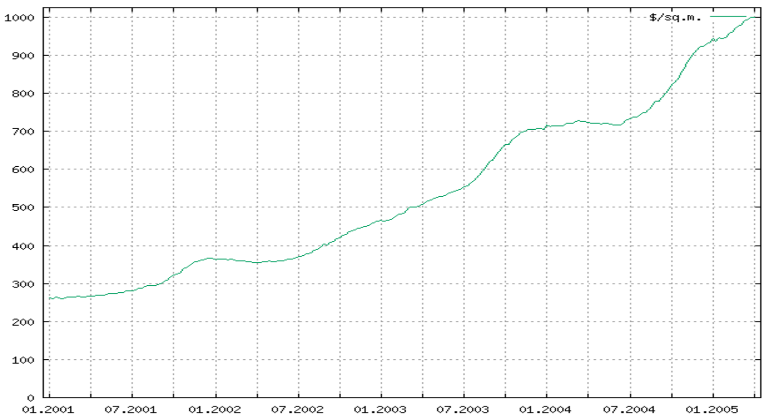
2.2 HOUSE PRICE / NEGATIVE EQUITY RISK

Background

A second key risk for consumers (and lenders) in Ukraine is house price risk. Given the current rates of house price growth in urban areas and in particular in Kiev, a major price decline is becoming more and more likely. Such a decline would inevitably raise defaults. In particular it is likely that defaults would start triggering losses with lenders, which in the current environment of price increases do not arise as lenders and borrowers use their joint interests in free-handed sales. Naturally, risk is especially high for the last borrower cohorts coming into the market, who could become easily 'locked-in' due to loan values exceeding house prices.

Figure 1 reports data for the period of January 2001 to January 2005. As of fall 2005, prices on the secondary market in Kiev exceed USD 1000/sqm or approx. 5 times gross annual income for a 60 m^2 apartment and a typical borrower family household. Average prices quadrupled between January 2001 and January 2005, and rose in real terms - deflated by consumer prices - by 33.5% p.a. According to the Ukrainian Real Estate Market Association prices in Kiev rose further during the first half of 2005 and it is only in late fall 2005 that first signs of a cooling off of the market have appeared.

Figure 1 Average residential real estate prices in Kiev in USD/sqm, 1/2001-1/2005



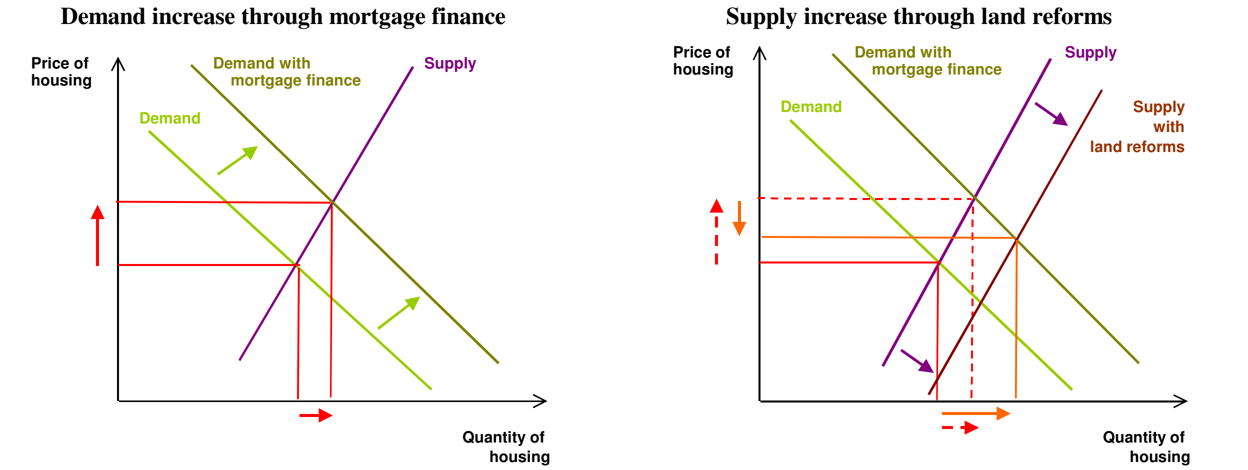
The key driver of house prices in Ukraine seems to be developer profit margins, not construction costs. In recent years, the latter have risen only slightly faster than consumer prices. Developer margins in urban areas in Ukraine are considered to start from 100% upward – with the Kiev average currently in the range of 500-700%. For Kiev, one interviewed lender for example suggested typical constructions costs of 300 USD per sqm in contrast to sales prices of 1000 USD per sqm. These numbers are extremely high in regional comparison - for example in perspective of typical margins of approx. 35% in neighboring Romania. Similar profit margins are reaped in Ukraine by professional and semi-professional traders that buy and sell or rent out housing units.

To a great extent high development or trading margins do reflect real scarcity factors, i.e. both Ukraine's high urban housing demand, fuelled by rural-urban migration and household formation trends, as well as – despite the recent pick-up in activity - particularly severe housing supply constraints. The latter include limitations on agricultural land conversion (to expire by the end of 2006), absent or obsolete urban zoning rules, a lack of public infrastructure investments, high tariffs on cars and distorted transport prices, oligopoly structures in the building and development industries – often varying on the regional level, chaotic and corruption-ridden urban land transfer practices and concentrated urban land ownership.

In this situation of highly imperfect and stressed housing markets, the increasing leverage of buyers in urban areas of Ukraine must be a matter of concern and can certainly be held at least partly responsible for recent price (or rather developer margin) increases.[10] Long-term credit supply more than doubled in real terms in 2002 and 2003 and still rose by over 50% in 2004.

Figure 2 provides an illustrative story board of house price and investment/output development as a consequence of greater availability of mortgage finance.

Figure 2: A story of house price inflation in Ukrainian urban areas



Source: authors' representation.

An increase in mortgage finance availability usually generates two rounds of economic effects: in a first round, lending to consumers has the effect of enhancing their housing demand, by spreading payments over a longer period that would otherwise become due immediately. However, supply only changes with a time lag and hence the main first round effect is a price rise. Some housing supply surely will be mobilized as a result of rising prices – e.g. space reserves in the existing stock - however new housing output takes time to be planned, zoned, subdivided, serviced, permitted and delivered through construction. In a second round effect, as time elapses, land (and housing) supply reacts, allowing prices to fall to more moderate (yet most likely higher than initial) levels. However, countries without liberalized land and housing markets, including Ukraine, may not come easily to this stage, or only with serious time delays, which means that the spell of high prices could become extended through supply-side rationing effects. Housing could become less, not more, affordable through mortgage finance.

A second issue is that with the current levels of supply inertia seen in Ukrainian urban areas it is likely that once supply begins to react more swiftly, house prices could decline even abruptly and severely. This in turn could trigger a default wave on the mortgage market.

Risk factors for the consumer

- Housing demand and supply changes. While tight market conditions prevail in the short-term in particular in the most attractive urban areas, a relaxation of the supply constraints in

[10] Anecdotal evidence suggests that the situation in rural areas and smaller towns of Ukraine is the reverse: land and housing supply here is very elastic, while housing finance does not yet reach to these regions in sufficient scale to enhance demand.

the way described above could lead to a significant supply response to current price levels and induce price erosion. Consumers are reacting already to current prices by shifting demand towards smaller units or less favorable locations. Lender interviews suggest an increasing volatility of consumer demand at current price levels.

- Financing conditions/capital gains expectations. Financing conditions are favorable by historical standards – especially in the domestic currency Gryvnia (UAH) where rates have dropped from approx. 24% in 2002 to 16% and below by mid-2005, enhancing demand. Certainly, rate increases - already witnessed in the foreign-exchange denominated credit market in a spell during 2004 - could trigger a negative house price response. Whether excessive capital gains expectations are present in the market, as typical for a financial bubble situation, is unclear, given that the rental market is small and the relevant rent data to arrive at a yield estimates that would allow such a judgement are unavailable.

- Inappropriate underwriting. The danger of excessive house prices – whether due to real or financial factors – should give rise to greater cautiousness in underwriting among lenders. This is unfortunately not the case, for both systemic and market reasons.
  The exclusive use of open market value techniques in property appraisals, which is also the promoted by currently valid appraisal legislation, by design tends to passively record a possible price excess rather than provide reliable guidance to lenders and consumers about sustainable collateral value assumptions needed for a long-term financing.
  This leads to the insight that, in the current Ukrainian context, every valuation method should be applied that could bring lenders closer to identifying sustainable collateral values. A start could be that appraisers and lenders record replacement values, which are currently seen by interviewees in Kiev at a fifth or less of open market values. When samples for residential rent observations become available and the bond market yield curve further develops, a cash-flow (income) valuation technique could supplement both the open market value and replacement value techniques as a third option. Modifications of valuation results ('haircuts') could then be applied to the open market value according to the measured discrepancies to other valuation techniques.
  Lenders in practice appear still to be relatively unconcerned about the use of open market values. However, two in six interviewed lenders indicate that they already apply haircuts to the values presented to them by their appraisers, and one lender has during 2005 raised his downpayment requirements in response to an increased risk perception triggered by the ongoing price increases.

- Captive appraisals. A related issue is the widespread notion from the interviews that, given the still shallow market, appraisers are in practice hardly independent from lender interests. This makes it more difficult to introduce conservativeness along the lines discussed before into valuations.

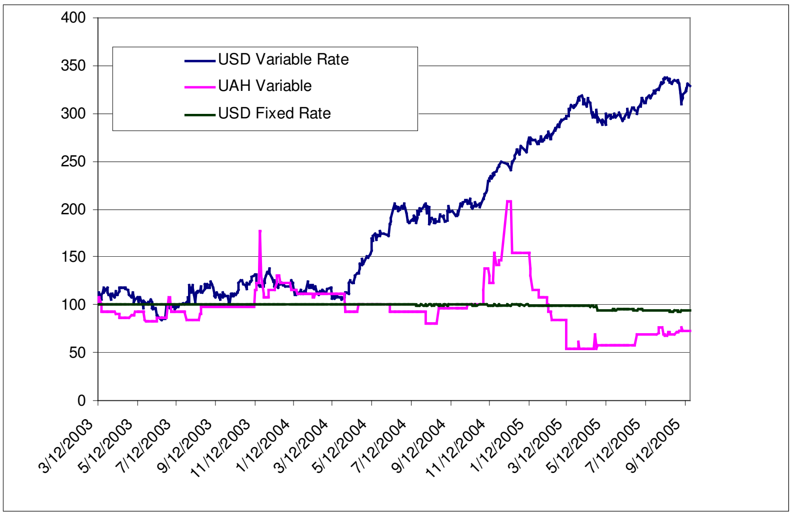
2.3 CASH FLOW RISKS

Background

Debt service coverage (DSC) requirements in Ukraine sometimes refer to residual income – the income derived from the deduction of mortgage and other fixed commitments of the household of the gross - and sometimes to gross income. Given the still high interest rate levels of around 12-17% (both in UAH and USD currencies), high house price levels and loan-to-value ratios in the range of 70-80%, it is not surprising that flexibility of debt service limits is used intensively as a competition variable between lenders: in the interviews, maximum of admissible debt-service ratio reported was 80% (!) of residual income. Reported limits on gross income were in the range of 40-50%. Given the high expectation in the market of further house price increases and thus low loss-given default levels, whatever probability of default levels, it is unlikely that DSC levels will any time soon drop to ratios in the 30%-35% range which are acceptable prime lending values in Western Europe and North America. Clearly, as a result even minor income shocks could put many financings in jeopardy.

A second problem are debt service variations themselves. Although the USD-UAH rate has remained remarkably stable in the past years – see the almost flat USD fixed-rate payment profile displayed in Figure 3 - the high share of unhedged foreign exchange lending nevertheless establishes significant debt service risk for consumers. The forex lending shares recorded in the interviews are uniformly in the range 80-90% vs. approx. only 50% in the total long-term credit market, according to Central Bank data. As in the case of most other transition countries Ukraine will likely go through cycles of the use of USD lending vis-a-vis UAH lending. So did several lenders during the interviews, usually those with no or limited access to the Eurobond market, express their desire to expand UAH lending. However, even if UAH is used more frequently as a result of further UAH rate declines, recent experience in other transition country markets (e.g. Poland, Hungary) has that forex shares may increase again swiftly if that rate decline trend stops or is reverted.

Figure 3: Payment indices for different mortgage products converted to UAH, index 3/03 = 100



Source: HVB Ukraine, authors' calculations. Note: assumes no loan amortization. The indices simulate payments on three different loan contracts: a USD loan with 3 months Libor interest rates, a UAH loan with 3 months money market rate, and a USD loan with fixed-rate.

The problems of forex lending may be exacerbated by interest rate fluctuations. Whether in USD or UAH currencies, the Ukrainian market is currently still single product with regard to rate adjustments. However, while loans are generally marketed to the public as "fixed rate", in five of six interviews lenders indicated that contract clauses render the interest rate unilaterally adjustable by them. Even though those clauses have not been used in practice so far as rates declined, lenders thus technically practice reviewable-rate loans, a class of adjustable-rate loans, rather than fixed-rate loans. We will return to the classification issue below, and note in the meantime that the current "fixed-rate" loans convey interest rate risk to consumers.

It is also evident from our survey that new variable rate mortgage loan products are of interest to the industry. One of six interviewed lenders had already started an adjustable-rate product priced over his own deposit rates, and three others were actively developing such products. One lender in Ukraine that was not interviewed uses a self-constructed price index, which appears to be seen as risky practice by his interviewed competitors. The interviewees generally welcomed the suggestion of the use of formal indices for adjustable-rate products, in particular well-known ones in the forex market such as Euribor or Libor. However, there was a great deal of skepticism towards possible candidates for indices in UAH currency. Figure 3 provides an example of a payment index in the 3 months money rate in UAH currency. Within 30 months, payments could have varied between 50% and 200% of the payments - i.e. were very volatile.

Certainly, if variable rate lending is combined with a forex loan, risks may multiply. See the 3 months USD Libor payment profile in Figure 3 during a period of almost constant USD-UAH exchange rates.

Concerning fixed rates, the currently practiced review clauses are seen as potentially problematic by two interviewed lenders, and as a distorting form of competition by the only one lender interviewed that does not practice them. Lenders generally find the suggestion of adding mortgages with rates fixed to term rather than maturity, which better match available fixed-rate funding terms, interesting. One lender has started to look into developing such fixed-to-term mortgages.

Table 2: Lender interview summary, cash flow risks, September 2005

Lender	1	2	3	4	5	6
Share of FX loans	95%	80%	80%	90%	80%	Lower than average
Interest in UAH loans	Moderate (access to FX funding)	Strong	Moderate (access to FX funding)	Moderate (access to FX funding)	Strong	Strong
Interest in variable rate loans	Strong	Looking into new product	Product freshly launched	Very interested, esp. FX	Product under development	Strong
DSC/LTV policies	Aggressive	Moderate	Moderate	Aggressive	Conservative	Conservative
Risk policy focus	Haircuts (valuations, LTV for USD)	None	Price differentiation (A-B borrower classification).	FX stress test, haircuts (valuation)	Price differentiation increased LTV requirements.	Haircuts (valuation, LTV)

Source: authors' interviews during September 2005.

It is interesting to note the variety of risk mitigation responses to cash flow risk, which range from total neglect to the application of stress testing of payments with regard to foreign exchange variations. Two out of six lenders have started to differentiate prices by risk categories, and more see the need for such policies clearly.

Risk factors

- High share of unhedged foreign currency exposure. The current most likely adverse scenario for the Ukrainian mortgage portfolio is a house price decline combined with a USD exchange rate increase (or interest rate increase in the case of variable-rate financings). Such a development would both minimize housing equity for consumers and put severe stress on debt service capacity. Worrisome is that the relative stability of the USD-UAH exchange rate in the past years seems to have generated risk amnesia with both lenders and consumers (see again Figure 3).

- Interest rate risk is currently limited due the overwhelming use of fixed-rate contracts. Yet, arbitrary rate increases due to the exercise of upward adjustment clauses embedded in many loan contracts could generate payment shocks; the likelihood of such exercise is becoming larger with the length and depth of the current rate decline process. Moreover, variable rate financings appear on the market without the use of objective indices or caps that could limit the risk of payment adjustment delay (when rates decline) and payment shock (when rates increase) for consumers.

- Exclusion of early repayment (prepayment). Related to the dominance of fixed-rate loans, Ukrainian lenders are experiencing high levels of prepayments. Because of prepayments, expected or average loan portfolio durations are currently in the range of 2-3 years. This contrasts with far longer contractual maturities of 10 years and beyond. Lenders try to extend the durations of their portfolios by precluding prepayments at least for a short initial period of the loan: the range reported in the interviews was between 6 and 18 months. Prepayment fees are usually not charged; however, one lender charges a nominal fee (0.1%). The current pricing structure appears to bear little rationality: it mixes a price charged for the exercise of the option (e.g. an indemnity) with a significant prepayment option premium to compensate for the actual reinvestment risk for the lender. Ideally, fixed-rate mortgage products should be differentiated between those that are economically protected against prepayments, e.g. through sufficiently high indemnities, and those which are not protected, but in return carry an options price (as an interest rate markup).

- Adverse selection risk due to underwriting uniformity. Because stress tests are rarely applied, debt service coverage constraints are extremely accommodating, and debt service levels/interest rates are not differentiated by risk, there is risk that many borrowers are adversely selected into products or practices with a high default likelihood given their financial circumstances.

2.4 RISKS ARISING FROM DEFICIENT INTERACTION BETWEEN LENDER AND CONSUMER

Background

Public advertisement of mortgage loans in Ukraine usually focuses on the nominal interest rates and carries little information about ancillary costs and material clauses affecting the effective costs of the credit, for instance rate adjustment clauses or requirements for high upfront fees that buy lower nominal rates.

One interviewed lender so offers an 11% USD rate requiring the payment of a 3% fee, instead of the normal 13% rate. Such practices are increasingly seen as distorting competition by the lenders themselves. Consequently, all six interviewed lenders endorse the idea of using effective rather than or in addition to nominal interest rates in consumer relations. From back on the envelope calculations, we believe that based on a 5 year duration horizon of loans, effective rates would exceed advertised nominal rates by 2.5% and more.

There is some disagreement, though, whether non-bank charges which are nevertheless mandatory, such as insurance premia, should be added to such an effective interest calculation. Clearly, some lenders have exclusive relations to insurers, and kickbacks made by insurers to lenders are likely to exist or emerge if such fees are excluded from an effective rate calculation. Also, a majority of lenders charges recurring currency conversion fees – most loans are repayable in UAH while being denominated in USD – and a subgroup of these appeared opposed to adding those fees to effective interest rates.

Lender websites and leaflets distributed on premise to consumers contain overviews of general loan conditions offered to the public in the pre-contractual stage; however, such information is not standardized and thus not easily comparable for consumers, and it often lacks important information (e.g. about prepayment conditions, ancillary costs, typical contract terms). Also, consumers are often provided only with very broad ranges of interest rates. So, nominal rates are often quoted as valid only 'from xx% on'.

At the time of the survey in fall 2005, lenders could have requested a potential borrower to provide information which was unrelated to a loan application, and also forwarded this information to third parties – either on a contractual basis or just informally. Such practices have been formally prohibited by the amended consumer protection law.

We discussed underwriting conditions above; only one in six lenders applies stress tests to test the financial stress absorption capacity of their clients. Generally there seems to be little underwriting response to possible default triggers (e.g. professional status, loss of second income), let alone a general concept of what would establish responsible lending practices and what not.

Once the application has been approved, four in six interviewed lenders do not provide loan offer documents and directly proceed to invite the consumer to sign the contract. This deprives consumers of a thorough review of their *individual*, rather than general, conditions before reviewing the much more detailed contract. For the two remaining lenders, loan offers are quoted and open up to 30 days before signature; however, conditions in there may change before signature.

A number of contract terms used in Ukraine must be considered unfair, including limited disposure rights over the property, unilateral rate or fee adjustment clauses, prepayment exclusions or disbursements significantly below par that leave financing gaps. There was agreement among the interviewed lenders that such conditions should be rather governed by regulation than by contract.

Consumers can also not cool off after contract signature. Given that loan offers are not made a priori, and given the widespread practice of prepayment exclusion, at least a short cooling off period would be advisable.

The consultants abstained from a detailed analysis of default and foreclosure. On the one hand, there are so far very few arrears cases - lenders quote between 0.2 and 1.7% aggregate arrears ratio based on caseload - and anecdotal evidence suggests much fewer repossession/foreclosure cases. On the other hand, the Mortgage Law has just been passed in 2004 and still awaits testing. However, we note that current conditions of swift price increases are exceptionally favorable for resolving situations of financial distress without generating losses for both, lender and consumer, by avoiding formal foreclosure procedures altogether. In the vast majority of the arrears cases, lenders will assist consumers to sell the units and trade down, e.g. by buying a smaller or more remotely located unit. Two of the six lenders are buying lower quality property in order to rehouse defaulting borrowers, as a means to fulfill the current legal requirements for rehousing. Only few cases go to evection.

Risk factors

- Misleading advertisement. Effective rates and, more broadly, complete and comparable pre-contractual information are important tools to both protect the consumer and avoid competition distortions among lenders. Misleading information will raise the risk of consumer default due to unforeseen, or unaccepted, debt service burden.

- Flawed closing practices. Lack of individual loan offers and cooling off create a closing environment in which consumers have little room to reflect on the financial implications of the financings and his default likelihood. It would be in the interest of both lenders and consumers to better structure this process, without placing undue financial risk on the lender (e.g. by excessive periods through which loan conditions would have to be kept constant).

- Unfair terms. Some issues subject to material consumer protection regulation elsewhere, such as prepayment, rate adjustment and use of the property, are of contractual nature in Ukraine. This generates intransparency for consumers and legal risk for lenders if such contracts are contested in court.

- Foreclosure. Given favorable environmental conditions when for trading down, the new foreclosure regime is so far basically untested. Thus, it is premature to draw conclusions on the efficiency of the newly designed process.

3. LEGAL GAP ANALYSIS

3.1 LEGISLATION FRAMEWORK FOR CONSUMER PROTECTION IN MORTGAGE LENDING

Consumer protection in the area of mortgage lending is a new concept for Ukrainian legislation.

The Law "On Consumer Rights Protection"

The basic piece of legislation in the field of consumer rights protection in Ukraine is the Law of Ukraine "On Consumer Rights Protection" dated May 12, 1991. Until its recent amendment, the Law's scope of application was limited to product purchases.

The Law became amended in December 2005 and effective in January 2006. The Explanatory Note to the amended Law states that it's intention is to bring the Ukrainian legislation in compliance with European statutory requirements to consumer rights protection, specifically, the EU Consumer Credit Directive (CCD).

However, it is more than a technical note to remind the Ukrainian legislator that the CCD currently explicitly excludes mortgage loans from mandatory application.[11] While almost all EU countries have transposed the CCD to mortgage lending, a majority has done so only incompletely because of the lack of fit of individual CCD rules to the specific national practices of mortgage lending.[12] This should be a warning sign for Ukraine to reflect the validity of individual rules for its market and institutional development situation prior to promoting a new law - the subject of this report.

The new law moreover adopts the strategy of amending a piece of consumer protection legislation focused so far on deficiencies in the delivery of products. This approach can be plausible, however, in the current version it leads to misunderstandings and possibly inconsistencies. In that regard it should be noted that the initial implementation format of the CCD in almost all EU countries was one of drafting a separate consumer credit act.

One source of misunderstanding is the link that the law makes between credit and the acquisition of 'products', a definition that includes both goods and services. Article 11 for example is named "Consumer Rights in Case of the Acquisition of Products on Credit" and Article 1 defines "consumer loan" as "the funds granted by the lender (a bank or another financial institution) to the consumer for the procurement of products."

This seems to reflect unclarities about the nature of consumer credit, which are natural at the current stage of development in Ukraine. The definition of 'credit agreement' in Article 1 c) of the EU CCD (1988) in contrast does not refer to any loan purpose, let alone a specific acquisition target. Rather, it reflects the main purpose of consumer protection in finance which is to protect the consumer against adverse consequences of taking up debt, for whatever purpose that debt could have been taken up.

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[11] See Part 1 (a) and Part 3 of Article 2 of Council Directive 87/102/EEC of 22 December 1986 for approximation of the laws, regulations, and administrative provisions of the Member States concerning consumer credit. Part 2 (a) of Article 2 of the Draft Consumer Credit Directive of the European Parliament (to replace Directive 93/13/EEC) excludes consumer loans (regardless of lending purposes) from the scope of application of this Directive.

[12] See the review of Dübel, Lea and Welter (1997) for a detailed analysis.

The need to abstract from or at least carefully consider loan purpose definitions is exacerbated in the case of housing: consider figure 4, which classifies different types of housing and mortgage credit by whether a housing purchase/construction intention is pursued or not and by whether a mortgage exists or not.

Figure 4: Mortgage and housing credit definitions with examples

		MORTGAGE	
		YES	NO
HOUSING PURPOSE	YES	FIRST HOME SECONDARY HOME	CONSTRUCTION UNCLEAR TITLE
	NO	HOME EQUITY LOAN SME LOAN	

Due to a broad definition of the term “product” in Article 1 of the Law which covers goods as well as services it seems clear that loans taken up for modernization purposes are within the scope of the consumer credit definition of Article 11.. Thus the definition of the Consumer Protection Law does fully cover the first row in figure 4.

The currently most widely used EU definition of the European Home Loan Code states that “A “home loan” is a credit to a consumer for the purchase or transformation of the private immovable property he owns or aims to acquire, secured either by a mortgage on immovable property or by a surety commonly accepted.”[13] The loans described here fall under the definition of consumer credit in Article 11 of the Consumer Protection Law.

At the same time, although mortgage collateral is mentioned in a cursory manner in Article 11, Part 7, on a stand alone basis, it is doubtful whether consumers that use mortgages to leverage up their existing collateral for other purposes, e.g. income generation in a small and medium-sized enterprise (SME) or for consumption purposes (the second row in figure 4) are covered by the law’s ambit.

As to its material contents, Article 11 of the Law of Ukraine "On Consumer Rights Protection" treats consumer and mortgage lending equally on most issues. It defines:

1) Lender's responsibilities for providing information to the borrower at the pre-contractual stage;
2) Limitations on information to be provided by the borrower to the lender and limitations on use of this information by the lender;
3) Form and content of the consumer loan contract;
4) Types of interest rates on consumer loans; interest rate adjustment mechanisms;
5) Unfair (discriminatory) clauses of the consumer loan contract;
6) Consumer's right to withdraw from concluding the consumer loan contract (does not apply to mortgage loans);
7) Consumer's right for early prepayment of a consumer loan;
8) "Linked contracts" in consumer lending;

[13] See the website of the European Mortgage Federation for detail: http://www.hypo.org/Content/Default.asp?PageID=224

9) Limitations on lender's right to demand early prepayment of the consumer loan by the borrower in case of non-performance under the loan contract.

The only exception of the equal treatment are a consumer's right to withdraw and return borrowed funds within 14 days of the conclusion of a consumer loan contract (Part 6 of Article 11). Part 7 of Article 11 specifies clearly that this right does not apply to consumer loans secured with mortgage and consumer loans for purchase of housing.
Beside that, the Law contains a general prohibition of "unfair business practices" including, among others, aggressive business practices. This is a move to encompass some of the rules of the EU Unfair Terms Directive.

We will discuss the validity of those provisions in detail further below.

The Law envisages finally certain sanctions for violating consumer rights protection provisions which can be divided into two groups: (i) individual legal sanctions and (ii) administrative legal sanction.

Individual legal sanctions include:
- Consumer's right to cancel a contract;
- Consumer's right for reimbursement of losses incurred;
- Consumer's right to request for relevant information on the subject matter of the contract;
- Invalidation of the contract or some of its provisions.

In addition, in the event of violating the consumer rights protection legislation, economic entities bear administrative liability in the form of penalty payable to the state budget of Ukraine. In particular, such liability is envisaged for (i) lack of essential, available, trustworthy, and timely information on the produce[14] and (ii) failure to execute or untimely execution of writs issued by officials of the authorized government body in the consumer rights protection area[15], etc.

Other applicable law

Before the amendment of the consumer protection law, within the last few years a series of mortgage-related legislation had come into effect. Particular tribute must be paid to the Law on Mortgage (Mortgage Law), which was adopted by the Parliament of Ukraine on 5 June 2003 and took effect as of 1 January 2004. The Mortgage Law is the framework legislative document governing the use of mortgage collateral (hypothec) through the entire process. In particular, the Mortgage Law defines grounds and rules for creation of mortgage collateral, scope of mortgage, mortgage creditor’s and borrower’s rights and obligations, requirements to publicity of mortgages, priority rules, foreclosure and enforcement procedures etc. In this regard, the Law covers important aspects of consumer protection legislation, especially in the area of default and foreclosure.

Effective January 1, 2004, the Law on Mortgage Crediting, Transactions with Consolidated Mortgage Debt and Mortgage Certificates (Mortgage Crediting Law) took effect. The provisions concerning mortgage collateral in the Mortgage Crediting Law seem to be very close to those in the Mortgage Law, but are expressed in different terms, thus giving rise to interpretation collisions between both legal norms. In particular, the Mortgage Crediting Law stipulates that “property rights to real estate under construction” can be used as mortgaged property. Creating a mortgage against such uncertain and unusual object, which, from legal point of view, constitutes pledge assignment of rights under investment contract with the developer, obviously gives rise to collisions with the

[14] For the purpose of this Law, the term "produce" is used in a broad sense and extends to consumer loans; see Article 1, Item 19 of the Law.
[15] The State Committee for Technical Regulation and Consumer Policy of Ukraine.

Civil Code and the Law on Securing Creditor's Claims and Registration of Encumbrances, both defining property rights as movable property. This collision also entails an indefinite consumer protection treatment in respect to those borrowers who have pledged their contractual rights as collateral, since such a loan de-facto is not secured by the mortgage of real estate. This fact may be rather characterized as unhelpful to consumer protection purposes.

Mortgage finance is also subject to a broad range of the laws of general effect which do not establish particular rules in the field. However, they influence it via regulation of such various aspects as property rights in real estate, transactions with land, performance of obligations, securing such performance, creation and operation of legal entities, banking and financial institutions activities, notary's deeds, taxation of transactions with mortgages etc. The list of such laws shall include, but is not limited to the following norms:

- Land Code (2001) – provides for a legal regime for land and transactions with land plots. Inter alia it imposes a moratorium for sale of agricultural lands until 2007 and stipulates a number of other restrictions regarding transactions with the lands.
- Civil Code (took effect as of 1 January 2004) – provides for general grounds of performance of obligations, securing such performance, status of legal entities, property and ownership rights system etc.
- Commercial Code (took effect as of 1 January 2004) – provides for general grounds of business entities' operations.
- Marital Code (2002) – provides for joint ownership treatment of the real property in disposal of spouses.
- Housing Code (1983) – a drastically obsolete Law which regulates the housing sector based on former Soviet-style concept of the state granting housing on free of charge basis. This Code establishes a privilege for residents to retain housing under most circumstances or to be evicted only when supplied with substitute shelter. A number of attempts to adopt a new Housing Code have failed. In 2003, the Housing Code was amended in the way that allows eviction of residents from housing serving as collateral against a loan in case of default.
- Law on Banks and Banking (2000) – governs banking in Ukraine with due regard to best international practices. General requirements to banking operation stipulated in this Law must be honored in the course of bank's activities related to mortgage lending.
- Law on Financial Markets and State Regulation of Financial Markets (2001) – provides general grounds for regulation of and supervision over non-banking financial institution.
- Law on Enforcement Procedures (1999) – provides for extremely uncertain, time- and cost-consuming procedures of forced execution of court decisions and other enforcement documents via Execution Department attached to the Ministry of Justice of Ukraine. The inefficiency of the enforcement procedures stipulated by this Law directly affects the quality of the judicial procedures of the enforcement against mortgages.
- Law on Notary Deeds (1993) – stipulates procedures for notary authentication of transactions with real property (sales and mortgage contracts inclusive) and verification of legal title thereto.
- Law on Property Evaluation and Professional Evaluators Activities (2001) – this Law provides for regulation of the appraiser profession as an independent and exclusive type of professional activity. The Law is not specific on the valuation methods for real estate.

- Law on Financial and Credit Mechanisms and Property Management in the Course of Construction and Transactions with Real Estate (took effect as of 1 January 2004) – a disputed Law providing for the financing of residential construction business for account of investor's funds attracted in trust of a foundation managed by a developer.

Passage of the amended Law of Ukraine "On Consumer Rights Protection" settled and rationalized certain aspects of relationship between lenders and customers (borrowers). However, consumer protections clauses in the mortgage lending legislation still have numerous flaws which can be eliminated by new regulations or in a practical way.

3.2 INTERNATIONAL BENCHMARKS

In order to perform the gap analysis, we benchmark the existing Ukrainian legislation primarily to the currently most relevant piece of EU legislation, the Consumer Credit Directive. We refer here to the 2002 proposal for a revision of the Directive, which was passed in 1988. While the 2002 proposal and subsequent amendments called for by the European Parliament were at the time of this legal review – September 2005 - still under discussion, we believe that much of its content can be applied to generate the desired benchmark. In the meantime, the EU Commission has published a new version of the proposal on Oct 10, 2005 which does not vary substantively from what is discussed here.[16]

It should be stressed that a full transposition of the proposal for the case of mortgage lending in the EU is unlikely, and that the question of harmonization of mortgage-related legislation has been put on a separate track in the EU. However, it is the consultant's view that the motives for such separate treatment in the EU – the desire to protect partly centuries old national products and practices – are hardly relevant for an emerging market's context. Also, earlier research has shown that the Consumer Credit Directive has already been transposed to a large extent to national law, leaving only specific contested areas out.[17] Finally, since 2003, the EU possesses a piece of quasi-harmonization in the form of the European Code of Conduct (European Agreement on a Voluntary Code of Conduct on Pre-contractual Information for Home Loans).[18]

For these reasons our approach, consistent with the notion of applying the acquis communautaire as of September 2005, is to lean on the Consumer Credit Directives as well as on the European Code of Conduct in structure and main content while applying judgments where necessary to tailor rules for the specific circumstances of Ukraine.

We note also other consumer protection regulations of interest for the discussion, which partly overlap with the Consumer Credit Directive. These are in particular U.S. loan purchase standards in the secondary market imposed by the government-sponsored enterprises Fannie Mae and Freddie Mac, U.S. federal transparency regulations[19], and individual state (U.S.) and national (EU) legislations and Codes of Conducts.

As a rule of thumb, federal U.S. regulations focus on transparency, consumer information and education standards, while U.S. GSE, some of the U.S. state and EU national regulation go deeper into 'material' consumer protection issues such as standards for rate adjustment, prepayment, unfair terms and foreclosure. Among the broad menu of EU national regulations of particular interest are the rate adjustment regulations of Spain, which laid the legal foundations for one of the fastest growing European markets, and the transparency and information standards of the U.K., which are currently arguably the most advanced in Europe.

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[16] Downloads are available from http://europa.eu.int/comm/consumers/index_en.htm.
[17] See Dübel/Lea/Welter (1997)
[18] For download instructions, see footnote 1.
[19] Such as the Real Estate Settlement Procedures Act and the Homeowners Equity Protection Act.

Finally, of indirect relevance for our discussion are the UN Guidelines on Consumer Protection passed in 2003.

3.3 DETAIL AREAS OF REGULATION

3.3.1 Advertisement[20]

In 1996 the Law of Ukraine "On Advertisement" was adopted. This law defines advertisement as any information about the person or goods distributed in any form or manner and designated to form or maintain consumer's knowledge and interest of such person or goods. This law is not specific on advertising home loans. However, it establishes a number of rules that must be followed in advertising any goods or services. In particular:

- Advertisement must be accurate and trustworthy;
- Advertisement must not undermine competition, ethical, human or moral basics;
- Advertisement must not contain any references of discriminative nature;
- Advertisement must honor intellectual property right requirements;
- Advertisement must specifically refer to license or permission if rendering of advertised product is subject to licensing or permission requirements;

Beside that, the Law provides general prohibition of "unfair advertising" (Article 10). The Law defines 'unfair advertising" as *advertising which misleads or may mislead customers; does harm to individuals, the state or society due to inaccuracy, lack of credibility, ambiguity, exaggeration, concealment, violation of requirements with regard to a time, place, and means of dissemination*. The competence for qualifying adverting as unfair is granted to the specialized government body in the consumer rights protection area (Article 10, Part 3 and Article 26 of the Law of Ukraine "On Advertising").

The Law on Banks and Banking (Article 54) and the Law on Financial Markets and State Regulation of Financial Markets (Article 11) establish a general principle - banks and other financial institutions are prohibited to place advertisements which reflect untrue information of their respective activities and services. However, financial sector legislation does not go any further in description of this principle and leaves a lot of space to provide in advertisement even true, but non-adequate data.

Law of Ukraine "On Consumer Rights Protection" # 3161-IV does cover "information on produce" which due to an express rule of the law (Article 15 Part 1) is not advertisement but rather a direct communication with a consumer, which presupposes a concrete interest in the acquisition of a specific product. One may, or may not, interpret this as a loan offer situation.

Article 15, Parts 8 and 9 on the other hand establishes full liability of a lender in case of losses that a consumer has incurred through 'unfair advertising'.

On the whole, even after the amended Law "On Consumer Rights Protection" has been passed, the Ukrainian legislation lacks specific and comprehensive regulation of advertising in the area of mortgage loans, which are essential from consumer protection point of view. The law fails to regulate the content of advertising information properly as it does not set criteria by which information could be regarded as incomplete (inaccurate). In particular, legislation does not impose on the lender the requirement to provide due, clear and comprehensive disclosure in advertisement of essential characteristics of mortgage loans (their currency, effective interest rates, identification

[20] Reference: Article 4 CCD proposal of 2002.

of financed object etc.) that could enable the consumer to obtain clear picture of actual general conditions on which a mortgage loan can be granted. In a turn, this circumstance does not prevent a misleading nature of mortgage loan advertisement to potential consumers.

The "interim" draft of the new EU Consumer Credit Directive of 2005 establishes a clear list of "standard information" which must be included in a consumer loan advertisement should it specify financial parameters of the loan (for instance, interest rates). Specifically, such advertising should specify:

- Total amount of credit;
- Annual percentage rate of charge (effective interest rate);
- Duration of the credit agreement;
- Amount, number, and frequency of payments to be made; and
- Any kind of fees connected with the credit agreement in conformity with its terms and known to the lender.

Going forward, assuming that a more focussed legislation approach is adopted in Ukraine, we believe that inclusion of such list in mortgage loan advertising would improve the competitive environment, in which lenders operate, and help consumer make a conscientious choice of a mortgage product. Respective rules have been formulated already in a proposed Code of Conduct for UNIA in December 2005.

3.3.2 Exchange of Information at the Pre-contractual Stage[21]

The Law of Ukraine "On Consumer Rights Protection" # 3161-IV attempts to regulate various aspects of informing consumers on lending conditions prior to the conclusion of a consumer loan contract in detail.

One of basic consumer rights formulated in the law is the right to receive essential, accessible, trustworthy, and timely information on produce so that a consumer is able to make a conscious and competent choice (Article 4, Part 1, Item 4; Article 15, Part 1).

Specific conditions for consumer loans taken in Article 11 of the Law determine a list of data to be provided to a potential borrower (consumer) in writing *prior to* conclusion of a consumer loan contract. Specifically, a lender is bound to provide customers with the following information (verbatim quote from the Law):

"1) the personality and the seat of the lender;

2) the lending terms and conditions, for instance:

a) the purpose, for which the consumer loan may be spent;

b) forms of securing the consumer loan;

c) available forms of lending with a brief description of differences among them, including the differences between the duties of the consumer;

d) the interest rate type;

e) the amount, in which the loan can be granted;

f) the tentative aggregate value of the loan and the value of the service of the execution of

[21] Reference: European Code of Conduct of 2003.

the loan contact (a list of all expenses related to the loan obtainment, service and repayment, for instance, the administrative fees, the insurance and legal fees, etc.);

g) the tenor, for which the loan can be obtained;

h) the options for the loan repayment, including the number, frequency and amount of payments;

i) the possibility of the early repayment of the loan and the conditions thereof;

j) the need for the property valuation and, if such valuation is required, the party to perform the valuation;

k) the tax treatment of the interest payment and the state subsidies, to which the consumer is entitled, or the information about the party, from which the consumer can obtain more detailed information;

l) the advantages and disadvantages of the offered lending arrangements."

Although our interpretation would go to the latter case, it is not entirely clear from the formulation of the law whether this list refers to a *general information* exchange with consumers about loan products or to a specific *loan offer* made to a specific consumer. The European Home Loan Code makes a clear distinction between the two concepts: in the former case it requires tabulary information similar to the above, in the latter case it demands the provision of the consumer with the more detailed European Standardized Information Sheet (ESIS).

It would be highly recommendable to also apply the ESIS in the Ukrainian situation. The ESIS does not only specifies all actual lending conditions to the given consumer but also provides illustrative amortization tables and other detail. It therefore helps in particular financially inastute borrowers to understand the financial impact of the loan offer.

With regard to general information concept apparently adopted by the Law, the provision of the above list to explain advantages and disadvantages of the offered schemes is clearly inappropriate since it gives rise to potentially costly litigation without referring to a specific advice situation. Such rules are, if at all, appropriate as part of a concept for responsible lending and financial advice (see below).

On the other hand, the list makes no reference to the costs of lending, ideally disclosed in the form of an effective interest rate, which would be the main instrument of comparison for a consumer[22]. Nor is the lender required to inform consumers of conditions and procedure for adjusting the interest rate (if the interest rate is adjustable or fixed to term) or limitations on using mortgaged property which are quite common in practice. This gap may also be due to wording problems in the law.

There are also other acts of legislation in Ukraine which regulate the information of the consumer at the pre-contractual stage. For instance, the Law on Banks and Banking (Article 56) provides for general commitment of banks to disclose to the consumer the following types of information:

- Financial standing of the bank as of the day of publication;
- List of the bank managers and holders of essential interest in such bank;
- Range of bank products offered to consumers;
- Prices for the bank products;

[22] See below.

- Other information and consultations regarding banking services.

Article 3 of the Mortgage Crediting Law is more specific in setting up requirements for the exchange of information at the pre-contractual stage between mortgage lenders and their customers. It obliges the mortgage lender prior to conclusion of mortgage loan contract to disclose to the potential borrower major economic and legal requirements to provision of the mortgage loan. Such disclosure must be made in writing and contain the following data:

- Description of all fees and expenses related to establishment of the mortgage;
- Principles of determining payments under the mortgage loan contract;
- Inflation reservation;
- Conditions of early repayment of the loan in case of debtor’s insolvency or his/her failure to comply with the obligations established in the mortgage loan contract;
- Debtor's right to notify the lender of a possible failure to repay the loan;
- Other terms and conditions.

On the whole the Ukrainian legislation sets forth sufficient numbers of rules for informing consumers on a particular financial product by a lender at the pre-contractual stage.Yet, it would seem that streamlining and integrating these provisions into a home loan information concept along the lines of the European Home Loan Code would be advisable.

3.3.2 Data Protection

Concerning the reverse information flow, there should be limits imposed on the type and amount of data and documents to be supplied by the potential borrower to the lender. In this regard Ukrainian legislation so far was not very specific.

For example, Article 346 of the Commercial Code stipulates a necessity for the lender to assess the financial capacity of the borrower and the risks of the loan default. Article 2 of the Mortgage Crediting Law also states that the lender may establish “additional procedures” for identification of the borrower and his\her solvency. Generally speaking, Ukrainian legislation in the past left it to the lender’s discretion how to verify a borrower’s financial standing, without limitating his right to request the borrower to submit any sort of information and documents.

The Law of Ukraine "On Consumer Rights Protection" # 3161-IV now addresses data protection issues in Article 11, Part 3 with the following provisions:

- The lender shall not have the right to require the consumer to provide information not related to determining his solvency and not necessary for granting the consumer loan;
- The personal data obtained from the consumer or another party in connection with the conclusion and the performance of the consumer loan contract may only be used for assessing the financial standing of the consumer and his ability to perform under such a contract;
- The communication of the consumer's data by the lender to the credit information bureau that collects, processes, stores, protects and uses the information in accordance with the legislation on the generation and maintenance of credit histories shall not be deemed to violate the provisions of paragraph two of this part;
- Financial institutions shall be liable for the violation of rights of consumers in the field of the protection of personal data in accordance with the law.

It is possible that this clause conflicts with the bank secrecy protection principles provided for by the Ukrainian legislation (Articles 60-24 of the Law of Ukraine "On Banks and Banking"). Moreover, the law of Ukraine, "On Organizational Arrangements for Creation and Turnover of Credit Histories", dated June 23, 2005, sets up hurdles for transferring data to credit bureaus, by specifying that:

1) The lender needs to obtain borrower consent for transferring borrower individual data to the Credit Bureau;
2) At the pre-contractual stage, lenders may access (potential) borrower individual data available from the Credit Bureau only at the written consent of this borrower;
3) The borrower may familiarize him/herself with his/her individual data kept by the Credit Bureau as well as with records of requests for these data.

1) and 2) could render the implementation of Article 11, Part 3 in practice for lenders quite difficult despite the fact that lenders commonly use standardized contracts that contain a transfer of information provision. The issue can be addressed by standardizing contracts *formally* through General Business Conditions that are governing each loan contract closed with a consumer. Such general business conditions have become the norm in Western Europe.

Otherwise, the existing statutory mechanism for data protection in the area of consumer (and, specifically, mortgage) lending can be deemed as sufficient.

3.3.3 Responsible Lending[23]

There is no mentioning of "responsible lending" in the Ukrainian legislation despite elements of a responsible lending concept being addressed implicitly through a number of clauses, specifically, those of Law of Ukraine "On Consumer Rights Protection" # 3161-IV.

The responsible lending concept means that mortgage lending should be based on set of principles intended to prevent default and overindebtness caused by deliberate behavior (either actions or inactivity) of the lender. In international practice, putting this principle into law is often contested. For example, many U.S. states have in recent years started to adopt new ‘predatory’ lending rules as a response to high default rates in the so-called “subprime” mortgage market where loans are provided to borrowers with low scoring results at high interest rates. The rigidity of some of the laws has triggered harsh protest by lenders and partly rating agencies. In the discussion about a reformulation of the CCD in Europe, an article on responsible lending had been first introduced, but after industry protests been withdrawn again.

Yet, despite these problems, establishing certain general rules may be appropriate to an emerging market context, which is characterized by a lack of familiarity of consumers with mortgage finance and a dearth of financial education. A responsible lending concept should extend at least to the following core responsibilities of the lender in dealing with consumers:

- Make the borrower familiar with his entire home loan product range: this issue is relevant as more and more lenders expand their product menu.

  The Law of Ukraine "On Consumer Rights Protection" binds the lender not only to familiarize the consumer at the pre-contractual stage with available lending options, but also to describe the differences between these options with specification of advantages and disadvantages of each lending option. (Article 11, Part 2 of the Law of Ukraine "On Consumer Rights Protection").

[23] Reference: Article 9 CCD proposal of 2002.

The last provision seems problematic as it establishes a potentially large legal liability as a result of possible wrong advice given. It seems rather that the issue of advice should be regulated separately, ideally as a voluntary and actively advertised service offered by lenders or preferably – due to absence of conflict of interest with selling the most profitable products – intermediaries or financial advice specialists.

- Allocate professional personnel to provide the borrower with comprehensive information on any matters substantial and relevant to credit and\or surety agreements before their conclusion.

  The Ukrainian legislation does not provide for such a responsibility. Going forward, this issue could be addressed at the Code of Conduct level. Some countries, e.g. Australia, demand professional liability insurance from lenders and intermediaries – an issue that could be considered for Ukraine in the future.

- Refrain from imposing pressure on the borrower, which could lead to dictating his\her choice of mortgage products.

  Pursuant to the amended Law of Ukraine "On Consumer Rights Protection, any pressure on consumer at the stage of a loan product selection may be regarded as a prohibited unfair business practice. One of such unfair business practices is a so called aggressive business practice i.e. one that contains elements of compulsion, annoyance, improper influence and has or may have impact on consumer's freedom of choice or consumer's product purchase behavior.

- Duly assess borrower’s capacity to repay the loan, including under reasonable assumptions of financial stress.

  The Ukrainian legislation does not consider assessment of borrower's ability to pay in the context of consumer rights protection. The responsibility for borrower assessment is established by the banking legislation, specifically, by the Regulation on Forming and Using Provisions for Covering Credit Losses approved by the National Bank Decree dated July 6, 2000. In practice, each bank establishes its own procedures for assessing borrowers' ability to pay.

  It seems that a corresponding rule, in particular establishing an important stress test – most loans are given for instance in foreign-exchange denominations – would be fit well into a Code of Conduct.

- Disclose to potential borrowers information about related entities involved in the home loan transaction (e.g. insurer, appraiser, developer or real estate broker who sells financed real estate).

  Although communication of this information neither eliminate the risks identified in Section 2 nor make the lender liable under other contracts or actions related to mortgage loan transactions, it establishes at least a disclosure solution, thus helping the consumer be aware of these risks and liabilities. The current Ukrainian legislation does not bind lender to disclose this information, and the issue should be addressed at least at the Code of Conduct level.

3.3.4 Formal Requirements, Unfair Terms in Credit and Surety Agreements[24]

The Ukrainian legislation is very specific on the form and essential terms of the credit and surety agreements. The Civil Code provides the legal basis for both agreements, in particular indicating that the contract must be made in written and should contain all provisions which may be deemed as essential for the respective type of the deal.

Article 11, Part 4 of the Law of Ukraine "On Consumer Rights Protection" # 3161-IV states that the loan contract must be concluded in writing and contain the essential terms and conditions below:

1) the value of the loan;
2) the detailed breakdown of the total value of the loan for the consumer;
3) the disbursement date of the loan or, if the loan is to be disbursed in instalments, the dates and amounts of the disbursement of such loan instalments and other conditions for the disbursement of the loan;
4) the right to repay the loan early;
5) the annual interest rate on the loan;
6) other terms and conditions as prescribed by the legislation.

As with the precontractual information, this list does not envisage a need to specify the effective interest rate in the loan contract. The "interim" draft of the EU Consumer Credit Directive provides for a necessity to specify the following additional terms and conditions in the consumer loan contract:

- Interest rate adjustment conditions;
- Detailed description of the loan repayment scheme;
- Costs associated with maintaining the loan repayment account and processing borrower's payments;
- List of sureties and mandatory insurances;
- Costs of an early prepayment of the loan.

These conditions seem reasonable enough to make them mandatory.

It is an important progress that the Law explicitly binds the lender to give a copy of the contract to the consumer and charges the lender with the responsibility to prove that he has met this requirement.

The Law of Ukraine "On Consumer Rights Protection" # 3161-IV has introduced the concepts of unfair contract terms and business practices for the first time in Ukrainian legislation and makes extensive use of them. The model used here is Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts.

As in the corresponding EU legislation, terms and conditions of a contract are considered by the Law as unfair if they lead to material disbalance of contractual rights and responsibilities which is harmful to the consumer. The legal implication of inclusion of unfair terms in the contract is an invalidation of relevant contract clauses rather than the invalidation of the entire contract. Only if the modification or invalidation of unfair terms of the contract necessitates a modification of other clauses of the contract, the consumer may require either the revision of other terms or the invalidation of the entire contract.

General provisions on unfair terms of a loan contract (Article 18 of the Law) regard as unfair any clause of the loan contract by which the lender is allowed to revise terms and conditions of the loan contract at own discretion or on grounds not specified by the contract.Specifically, the Law states in Article 11 that the consumer is not responsible for paying to the lender any charges, interest, or

[24] Reference: Articles 10 and 15 CCD proposal of 2002.

other cost elements of the loan which are not stipulated by the contract. According to general principles established for interpreting contracts with consumers, any unclear or ambiguous contract clauses must be interpreted to consumer's benefit (Part 8 of Article 18). This construction should increase the incentives for lenders to specify all cost elements of the loan in the loan contract in sufficient detail and in a transparent manner.

Another problematic issue is that according to Article 19 the list of unfair terms in a loan contract and business practices stated in the Law is not exhaustive. Courts may thus invalidate also clauses and practices leading to "material disbalance" of contractual rights and responsibilities which is harmful to the consumer. In particular, the lender must be very cautious in formulating both loan and hypothecation contracts. In fact, it would be preferable to arrive at some form of formal contract standardization that avoids such court interventions, such as General Business Conditions (see also above).

In the same vein, in order to avoid legal ambiguity additional provisions would be useful that define unfair terms positively. The list of issues addressed in Article 11, Part 5, already includes prohibitions to retain loan principal, to oblige the consumer to use supplementary service which are not mandatorily related to the loan contract, or to agree on unilateral adjustments of interest and fees by the lender.

Missing is a discussion of contractual limitations imposed on the borrower's right to dispose of the collateral without the consent of the lender. The Ukrainian Mortgage Law rules that renting out a mortgaged property or undertaking a capital modernization is subject to the mortgagee's consent. Such statutory limitations are questionnable and rather seem to address flaws in other pieces of legislation – for instance, the consent requirement on renting implicitly deals with excessive protections for tenants with children. However, additional limitations to the statutory ones should be avoided altogether.

On the whole, the empirical analysis of the current legal practices in Ukraine would suggests that contracts generally feature very detailed description of the rights and responsibilities of the parties. The principle "what is not specified in the contact does not exist" is dominating.
The Mortgage Crediting Law defines some conditions that *may* be included in the loan contract (Article 2). Since under the general private law principle parties may include in the contract any terms and conditions which do not conflict with the legislation, the list of terms and conditions of the loan contract suggested by this law is of little significance.

The Law of Ukraine "On Mortgage" sets forth mandatory clauses of the hypothecation contract irrespective of whether the mortgage loan constitutes the principal obligation. The hypothecation contract is a separate legal contract with regard to the loan contract[25] and regulates encumbrance of the property with hypothecation which services as a security of the principal obligation. The hypothecation contract is subject to certification by notary whereas the hypothecation is subject to state registration.

3.3.5 Interest Rate Adjustment Mechanisms[26]

The Law of Ukraine "On Consumer Rights Protection" # 3161-IV currently deals only rather peripherally with the question of admissible interest rate adjustment mechanisms.

Next to general pre-contractual information requirements about the type of loan offered, it rules in Article 11, Part 4 that "the consumer loan contract may specify that the interest rate on the loan may change depending on changes in the discount rate of the National Bank of Ukraine or in other

[25] Despite the fact that due its "accessory nature" hypothecation is dependable on the principal obligation.
[26] Reference: Articles 15 CCD proposal of 2002; Spanish ARM regulations of 1994.

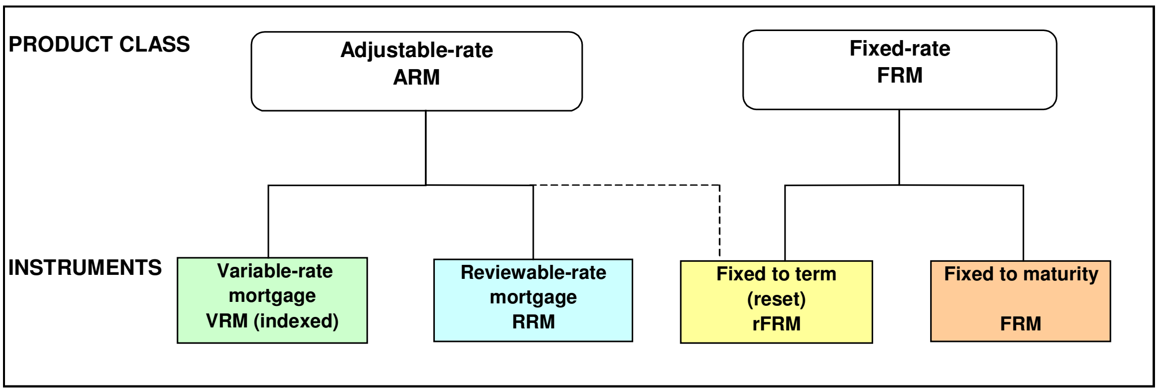
cases." It also regards discriminatory rules regarding interest rate adjustment as unfair terms of contract (Art. 11 Part 5), but it does not clearly specify, what "discriminatory" means.

In essence, these provisions leave the type of interest rate adjustment to the lender's discretion – i.e. the interest rate spread can be fixed over a reference rate or not ("other cases") –, makes no reference to the admissible adjustment frequencies, and also provides no guidance as to the eligible selection of reference rates, which ought to be limited. Besides, suggesting a policy instrument as the discount rate as a reference would be highly inadequate to both lenders and consumers concerns. We will turn to these issues below.

The Law also makes notification of the consumer of the adjustment of the loan interest rate in writing within seven days of the adjustment date mandatory. A failure to notify the consumers leads to invalidation of interest rate adjustment. If the consumer is unwilling to continue repayment of the loan at the adjusted rate, he/she may prepay the loan at the "old" interest rate. Therefore, the Law protects the consumer from modification of the loan interest rate without his/her consent.

Article 7 of the Mortgage Law implicitly stipulates the application of fixed and variable interest rates to home loan mortgage products. The legislation refers to the right of the lender to adjust or index both principal and interest rate in mortgage lending. As an example, a reference to an "inflation clause" can be made according to Article 5 of the Mortgage Crediting Law. This would establish a version of *variable-rate mortgage loans* as they are commonly understood in developed mortgage markets – the first of the four loan instruments or types shown in Figure 4.

Figure 4: Classification of adjustable-rate and fixed-rate products in U.S. and European practice



Source: Dübel. Notes: Figure does not depict mortgages with inflation-adjusted balances. All mortgages with rates not fixed to maturity are classified as adjustable-rates in the U.S., including reset FRMs In European markets, adjustable and fixed-rate markets are generally delineated by term of fixing, usually under and including 1 year (adjustable-rate) and over 1 year (fixed rate).

Article 5 of the Mortgage Crediting Law contains some unclear wording, though, referring to possibility of allowing in a mortgage loan contract for a so called "inflation reservation". This is understood as a method of preserving the real value of monetary claims and of the other creditor's proceeds under the contract. According to the said Law it's application pre-supposes the indexation of payments (both principal and interest) under the mortgage loan contract by using "conditional indexation and payment units" or other mechanisms not prohibited by the said Law. Since neither origin nor for formula for computing "conditional indexation and payment units" are clear, their application by the lender might appear to lead to unpredictable and potentially detrimental results for consumers. Therefore, our recommendation is to require from lenders who offer to the public indexed mortgage product to explicitly refer in the advertisement and other information exchange of such product to the reference index used to adjust outstanding borrower's debt.

Nor does the Civil Code of Ukraine establish clear rules for adjustment of variable interest rates. Article 536 of the Civil Code stipulates that interest size shall be defined in the way specified in the contract. This provision enables lenders to establish in credit agreements any procedure for the adjustment of the interest rate. As a rule, fixed interest rates are applied jointly with a contract clause reserving the lender's right to review unilaterally the interest rate depending upon changes in the financial circumstances. This sort of a very indefinite adjustment mechanism has never been tested. However, under critical circumstances it can lead to manipulations to the detriment of the consumer. We consider those loans thus reviewable-rate, and not fixed rate mortgages.

In general, reviewable-rate mortgages – the second adjustable-rate class in Figure 4 from the left - are no longer widely practiced in the vast majority of developed mortgage markets and outlawed in many.[27] The basic rationale is to make sure that on loans whose conditions are frequently changed consumers are not overcharged by subjective judgment or equivalently being forced to renegotiate terms with the lender. As a result, for loans with high adjustment frequencies, we would suggest to require that lenders apply variable-rate mortgages that rely on official reference rates or indices for adjustment.

Concerning the neighboring loan instrument depicted in Figure 4, *mortgage loans with interest rates fixed to term* (say 3, 5 or 10 years), but not to maturity, there is conflict in definitions between the U.S. and Europe. The U.S. would classify such loans as adjustable and Europe as fixed (see footnote to Figure 4). We advise in the Ukrainian context to adopt the European classification of such loans as fixed, provided that the rate fixing period exceeds 1 year. The main reason for this recommendation is that appropriate long-term fixed-rate reference rates or indices that could be used for the pricing of those loans under a variable-rate definition are not available because the underlying capital market instruments are illiquid and lenders rarely attract long-term fixed-rate deposits. In a situation without appropriate benchmark it must be the lender's unilateral option to propose, upon renewal, a new fixed interest rate that matches his internal risk management assessment. Otherwise there would be risk that the product would not be offered at all.

As reviewable-rate mortgages – loans with rates fixed to term contain thus an element of renegotiation with the lender: after the expiration of the fixed-term the lender makes a new rate offer to the consumer which the latter can accept or reject, i.e. prepay the loan and switch to another lender. However, this loan class is essential for providing consumers with a certain level of interest rate protection while keeping the interest rate at competitive levels. It is in particular very unlikely in the Ukrainian interest rate risk context that *mortgage loans with interest rates fixed to maturity* – including 20 years and longer as in the United States - will be sufficiently in demand or supply. The reason on the demand side is that such loans compete with variable-rate loans that usually offer significantly lower rates. On the supply side, lender's have problems to manage the associated risk, including prepayment risk and mismatch risk. A solution to eventual consumer protection concerns for loans with interest rates fixed to term could be seen in constraining the lender's repricing behavior by requiring him to not exceed in his interest rate offers to existing customers upon repricing the level of interest rates that he in parallel is offering to attract new borrowers.

In conclusion, we propose to generate three broad loan instrument options for lenders: variable-rate mortgages linked to a reasonable and objective reference index, mortgages with interest rates fixed to term and mortgages with interest rates fixed to maturity. We would suggest to exclude unilaterally reviewable rate mortgages from the menu.

The regulatory framework of Ukraine should be accordingly be amended by a definition of appropriate mechanisms for these options of interest rates adjustment:

[27] Important exceptions are the United Kingdom and Ireland

- The credit agreement should explicitly indicate which type of interest rate regime is used – fixed or variable.
- If fixed, any unilateral change or adjustment of fixed rates by the lender is prohibited for the term over which the fixed rate conditions apply, i.e. term or maturity.
- If fixed to term, upon renewal of the interest rate agreement the lender shall be held to offer rates that do not exceed rates currently offered to new borrowers, for the same proposed interest rate fixing terms.
- If a variable-rate regime (adjustment frequency of 1 year and below) is chosen, the credit agreement shall indicate a rate-adjustment formula based on a contractually agreed reference rate which allows adjusting interest rate level at predetermined regular intervals within the duration of the credit agreement.
- Moreover, for variable-rate loans the credit agreement must define that frequency of the interest rate adjustment, not to be under three months, ideally six months and longer.
- The applicable indices for interest rate adjustment for variable-rate loans shall be periodically published. They should be based on reasonable and objective financial indicators.
- When confronted with an interest rate adjustment in either variable-rate or fixed-to-term loans, the borrower shall have the right to prepay the loan without any extra costs.
- The credit agreement finally ought to indicate a cap for interest rates to be applied to variable-rate – and, if applicable, fixed-to-term loans, at least in the initial phase of the loan (between 2 and 5 years).

The question *which* reference rates can be deemed reasonable and objective must be decided after an analysis of the circumstances on the Ukrainian capital market, which is partly illiquid and displays high rate volatility. In any case, foreign currency interest rates such as EURIBOR or LIBOR USD and Euro rates should be eligible in the case of foreign-currency denominated loans. It would also seem that, following the Spanish example, lender trade groups should be allowed to construct their own cost-of-funds index, which in all likelihood will be initially a deposit-rate index and at a later stage could include other funding instruments. Deposits in Ukraine are originated in USD, Euro and UAH, so that such a type of index could be used for all types of loans. An aggregation of the data over a sufficiently large number of banks is pivotal, since the credit standing of many smaller and mid-sized banks renders deposits rates in some corners of the market rather volatile – in aggregation this effect should at best be moderate.

In Annex 1, we provide details of the computation methods for reference rates based on the discussed. The suitability of additional candidates for reference rates in UAH, next to deposit rates interbank rates and short-term government bond rates, needs to be reviewed further.

Any reference rate or index ought to be published by a highly reputable entity which is not related to the lender. This function could be assigned to the National Bank of Ukraine or the State Mortgage Institution. The current practice where banks quote proprietary indexes lacking transparency of computation should be discontinued.

3.2.6 *Effective Interest Rates*[28]

The Ukrainian regulatory framework does not provide for an effective interest rates concept (also termed as ‘annual percentage rate of charge’), which is a major element in consumer protection standards. As stated before, the effective interest rate should be disclosed to a potential borrower in the mortgage loan advertisement and through exchange of information at the pre-contractual stage. Disclosure of the effective interest rate will (i) help consumers make a conscious choice of a mortgage product and (ii) improve the competitive environment in which financial institutions operate.

We propose to calculate effective interest rates on an annual percentage basis considering the nominal interest rate, any lump-sum or recurrent bank fees or commissions as well as mandatory insurance or guaranty premiums relevant to the credit and\or surety agreements.

A problem with computing effective interest rates could be that the expected duration of the Ukrainian mortgage loan portfolio is very short due to prepayments. Taking contractual maturities for the effective rate calculation would in this situation severely misleading consumers about effective credit costs over their investment horizon. Since it will take several years to develop a clear understanding about mortgage prepayment behaviour in Ukraine, we therefore propose as a short cut to fix a maximum applicable duration to the effective interest calculation of 5 years. This number seems to be a reasonable approximation of factual holding periods of loans for the time being – it can be changed or replaced by portfolio durations as more data become available..

The lender should be obligated to disclose to the borrower any other transaction costs and expenses which are *not* included in the effective interest rate calculation. In particular, this rule should apply in respect to notary and registration fees, appraisal costs, taxes, state duties and any other expenses associated with execution of credit and surety agreement and payable by the borrower.

3.3.7 *Early Repayment*[29]

Article 531 of the Civil Code entitles the borrower to early repayment of the loan, if otherwise nothing is provided by the credit agreement. This clause is discretionary, allowing the lender to include a provision in the loan contract whereby loan prepayment would be prohibited. This is indeed practiced widely at least for the initial phase of the loan in Ukraine.

This legal gap is closed by an imperative clause in the the Law of Ukraine "On Consumer Rights Protection" establishing a borrower's right for early prepayment of the loan (Article 11, Part 8). The Law says that "the consumer is entitled to prepay the loan including by means of increasing the amount of regular payments". Yet, while a universal prepayment option for consumers is now the standard in all European countries with the exception of Germany, it would be reasonable to add a provision which provides lenders with the right to deny small volumes of early repayment for reasons of causing excessive administration costs. A typical threshold value would be 10% of the initial loan volume (e.g. used in the Netherlands). Some Ukrainian lenders demand at least an equivalent to one month’s annuity payment.

More problematic is the subsequent sentence of the law, which limits the option for lenders to recover financial loss in the event of an early repayment: “If the consumer has made use of the right to repay the consumer loan by means of increasing the amount of regular repayments as provided for by paragraph one of this part, the lender must adjust the liabilities of the consumer under the loan appropriately by reducing them.”

It is common interpretation in the Ukrainian banking market, that even under this formulation it is admissible to establish commissions (fees) for the case of early prepayment, and the banks use this possibility. At the same time the formulation does quite obviously not allow to impose penalties for

[28] Reference: Article 13 and 14 CCD proposal of 2002.
[29] Reference: Article 16 CCD proposal of 2002, U.S. GSE regulations, France: Scrivener Law, Germany Civil Code.

early prepayment, because a right as formulated in Article 11 is unconditional. Such banning of any conditionality is very unusual: in the European Union, for example, allowing conditions to be imposed on exercise while simultanseously granting the legal right of prepayment is almost universal practice.[30]

Arguments can be brought forward against the practice of arbitrary levels of prepayment fees established by contract on the ground of such fees rarely being objective and fair. Yet, ruling out even a compensatory indemnity that covers the actuarial reinvestment losses of the lender[31] in the case of a prepayment is clearly a problem: it would mean higher and more volatile interest rates on a fixed-rate loan, since the lender needs to charge a premium to cover his reinvestment risk when cash comes in. In the presence of an unconditional right, the premium is moreover charged from all borrowers, and not just from those exercising their prepayment right, which seems also unfair.

In our opinion, it would be feasible to implement fair and objective rules in Ukraine that define lender rights to charge compensatory prepayment indemnities in the case of loans with interest rates fixed to term (over one year, below contractual maturity). This would in turn allow lenders to price those loans over fixed-rate government and covered bonds and thus offer low interest rates, as in most of Europe. It should be noted that offering prepayable fixed-rate loans without such indemnities will clearly remain both completely legal for lenders and economically desirable for the Ukrainian market - these loans will just be necessarily more expensive due to the risk premium they carry. A specific rule for the computation of the proposed compensatory (‘yield maintenance’) indemnities is formulated in Annex 3.

It should be also allowed for lenders to charge a small prepayment fee (maximum 1% of the loan amount) that compensates for losses incurred by truncating his net (servicing) revenue from the loan. This rule should apply to all fixed-rate loans and at least to those adjustable-rate loans that carry cap, i.e. sufficient protection for the consumer against interest rate risk. The reason is that in a completely indemnity-free environment, consumers will have to pay high upfront closing costs imposed – again – on all borrowers rather than those only with willing to prepay, to compensate lenders for a short and volatile duration of revenue streams from the loan. In the U.S. for example, loan closing costs of 1-3% are frequent, while in Germany with a prepayment indemnity model loan closing costs are practically zero.

3.3.8 Lending for the Acquisition of Unfinished Housing. Linked Contracts[32]

Due to strong lobby interest and a dearth of other forms of construction finance, Ukrainian law enables, rather than discourages, construction finance through investment of consumers into unfinished housing units.

The Law of Ukraine on Financial and Credit Mechanisms and Property Management in the Course of Construction and Transactions with Real Estate (Financial Mechanisms Law) constitutes a very questionnable legal basis. It allows for the financing of residential building construction directly for the account of an investor (consumer) through construction finance funds held in trust by a financial intermediary. The law also allows investors to obtain a loan from a bank in order to finance the

[30] An unconditional right of early repayment is granted in Germany, France and Belgium, where prepayment fees for adjustable-rate loans are prohibited. In Germany, fixed-rate loans with fixing period over 10 years can be prepaid unconditionally after 10 years have elapsed. In Denmark, legal interpretation is similar. In the remaining European countries as well as in other situations in the above mentioned countries prepayment is a conditional right. However, conditions are often statutorily limited, for instance through global caps (France 3% or 6 months interest of prepaid amounts, for fixed-rate loans) or by waivers and caps in certain cases (death, house sale and move etc..). Practices vary widely and are partly severely distorting individual national mortgage markets (see Dübel (2006)). European harmonization efforts are under way to inter alia define common standards in the area.

[31] Many countries use applying a “yield maintenance indemnity” model whereby the borrower in the event of prepayment covers losses at the amount of the difference between the interest and cost of funding (say, funding through covered bonds).

[32] Reference: Article 19 CCD proposal of 2002.

respective investment. It considers such loans to be secured by pledge of the investor's rights under investment (purchase) contract which is according to Mortgage Crediting Law even classified as a mortgage.

In Ukraine both lenders and fund trustees are frequently (directly or indirectly) economically related to developers, e.g. through holding structures, shareholding, lending relations or other close business ties. This is also the case for lenders and fund trustees, which frequently are even identical. As a result of this statutorily endorsed construction finance model, two separate fields of banking business are mixed in one – financing of construction (lending to the developer) and financing of housing (lending to the consumer) in a way in which construction-related risks are shifted to consumers (on the specific risks, see discussion in Chapter 2).

Yet, despite the obvious conflicts of interest, failure of the purchase contract to perform does not entail non-performance of the loan contract under *any* circumstance. The Financial Mechanisms Law explicitly states that "… delays in construction or poor performance of the developer will not affect legal relationship between the bank and the borrower under the mortgage loan contract and will not constitute any grounds for discontinuing performance of loan obligations by the borrower" (Article 50, Part 7 of the Law). Therefore, all risks associated with construction of new residential property are shifted onto the consumer from the financial institution which (especially when it acts as the manager of the construction finance fund simultaneously) should be much more capable to predict and manage these risks.

On a related point, securing the consumer's investment in unfinished housing units is difficult and the idea of creating a mortgage-style surety over the purchase contract is obsolete.

- First, in Ukraine unfinished buildings are not subject to registration as a separate real estate object.[33] Moreover, many buildings have no formal building permits or violate other laws, which creates strong legal risk. Developers will also acquire the respective land plot under short term leases, freehold transfers are rare exceptions. Therefore, neither the land nor the building does deliver acceptable sureties for any investor, or their creditor's, claims, until land is eventually transferred to freehold or long-term leases are closed and buildings are technically and legally completed.
- Secondly, according to the Civil Code, investors of funds in trust management bear all the risks associated with such management with the exception to circumstances when investor's losses were caused by deliberate trustee negligence, which is a subjective judgment.

For these and other reasons, there is considerable legal risk for lenders: if the construction is not finished due to the developer's default, the since the consumer does neither have a legal title nor a claim to the land or buildings situated on to the land.

Most importantly, the fate of the consumer's loan contract with the lender is supposed to share the fate of the consumer's contract with the developer under the provisions of the Law of Ukraine "On Consumer Rights Protection", which introduced the concept of "linked contracts" into Ukrainian legislation. The Law rules in Article 11 "the lender must refund to the consumer the amount of the payments made by the consumer on the rescission of the sale (work or service) contract or adjust the loan liabilities of the consumer appropriately." If the consumer excercises rights arising from Article 8 and 10 regarding non- or poor performance of a contract for carrying out works or providing services, Article 11 entitles him to lower his debt or make claims against the lender.

It is important to note that the Financial Mechanisms Law formally prevails over the provisions of the Consumer Protection Law because it is a lex specialis.

33 Civil Code of Ukraine (art. 331 par. 3) has been recently amended so that unfinished buildings can be now subject to registration. But failing the necessary executive regulations this mechanism is still not functioning in practice.

Whatever the legal hierarchy, both provisions - Article 50 Part 7 of the Financial Mechanisms Law and Article 11 Consumer Protection Law – take mutually incompatible and extreme positions that call for a rethinking of the legal approach to the issue.

The main economic problem with the provisions such as those in Article 11 is that they intend to create a universal link between developer and loan contract that leads to unacceptable risks for lenders and is bound to eliminate the practice altogether. Consumers essentially receive a costfree put option on a purchased property to the bank, which will likely be exercised even in case of minor defects of the housing units.

Such a strategy is undesirable, for two reasons:

- First, there will be always circumstances in which consumers finance the construction phase because this can be an optimal financing form: consider the progressive construction of a customized single-family home, where construction is actively monitored by the consumer. In this case, banks finance the installments paid by the consumer to the developer according to construction progress, with very limited risk for the consumer and little reason to assume collusion between bank and developer against the consumer. Such situations should not be excluded altogether.
- Secondly, even considering the high risk in current multi-family construction practices in Ukraine, the preferred legal strategy should be to attempt to assign the true costs of using construction finance through consumers to that practice, in order to encourage the greater use of more costly bank or capital market finance through developers, as opposed to making the practice just prohibitively expensive.

One option to assign the true costs to financing unfinished housing units would be to demand sufficient protection of the consumer through a completion guarantee underwritten by a third party. This is a frequent practice in the United States ("builder's warranty") and other anglo-saxon countries. For Ukraine, our findings suggest that only lenders benefit from such guarantees, but not consumers. If consumers would be made the beneficiaries, a link between a loan and a deficient developer contract could be denied without fear of negative consequences for the consumer.

Clearly, introducing freehold land transfers for the construction phase and immediate title transfer to the borrower could also improve the borrower's – and the lender's – position and at least reduce the costs of any lender liability substantially.

A third option, ideally related to the second, would be to define clearly the conditions under which the lender is liable for deficiencies, namely in particular if and when avoiding such deficiencies can be deemed to be within the range of control of the lender when closing the contract with the consumer. This is tantamount to assuming that loan and property sales contracts form a 'commercial unit'.

The EU CCD discussion pursues precisely this route. Understandably, the precise definition of what establishes a 'commercial unit' has been contested. The modified CCD proposal of 2005 uses the following wording in Article 14 on 'linked transactions', which limits the definition to clearly described circumstances, which must be simultaenously fulfilled:

> "2. Where:
> (a) in order to buy goods or obtain services the consumer enters into a credit agreement with a person other than the supplier of them;
> (b) the creditor and the supplier of the goods or services have a pre-existing agreement whereby credit is made available exclusively by that creditor to customers of that supplier for the acquisition of goods or services from that supplier;
> (c) the consumer referred to in point (a) obtains credit pursuant to that preexisting agreement;

> (d) the goods or services covered by the credit agreement are not supplied, or are supplied only in part, or are not in conformity with the contract to supply them;
> (e) the consumer has pursued his remedies against the supplier but has failed to obtain the satisfaction to which he is entitled, the consumer shall have the right to pursue remedies against the creditor.
> Member States shall determine to what extent and under what conditions these remedies shall be exercisable."

It would seem that the demand for proving the pre-existence of an agreement between developer and lender could be relaxed in the Ukrainian circumstances, and for example be assumed as existent if there is a strong alignment of business interests such as derived from direct ownership links, exclusivity of relationship, or common project development.

The German Civil Code, for instance narrows down the commercial unit assumption for the case of real estate to situations where[34]:

- The creditor himself has procured the real estate, or
- The creditor beyond the loan contract has promoted the acquisition of the real estate through cooperation with the seller, by
    - either aligning the seller's interests partially or fully with his own interest, or
    - assuming functions of the seller during planning, advertising or execution of the project, or
    - unilaterally favoring the seller.

(Translation by the authors)

In a corresponding negative definition it should be made clear that the mere existence of a business relationship is not sufficient to establish a commercial unit. Our survey results in that regard yielded highly variable practices in Ukraine – in many cases it would seem that most lenders operate with a handful of developers that can be efficiently monitored by the corporate finance department, an at arms length relationship that which should be in the interest of consumers.

In particular a commercial unit should not be assumed simply because a lender provides in parallel to the lending to consumers other construction finance to the project. This is in practice not just often unavoidable - an involvement of the lender also may improve the monitoring of the project. Yet, in such a situation one might consider additional constraints imposed on a lender behaviour: for instance, if a lender should not be more preferentially secured by collateral and other means than the consumers she has financed, it should have the duty to share information with consumers that would lead to the assumption that the developer may fail to deliver, and it would also have to make sure that her own actions against the developer do not preempt the consumers to pursue adequate remedies against the developer.

Lender liability should also be limited to a specific time period after the termination of construction during which the consumer needs to make his claims. Appropriate should be a maximum of 3 months after the consumer has moved in. If liability is not limited in time, Ukrainian mortgage

[34] German Civil Code, Para 358 (3): „Bei einem finanzierten Erwerb eines Grundstücks oder eines grundstücksgleichen Rechts ist eine wirtschaftliche Einheit nur anzunehmen, wenn der Darlehensgeber selbst das Grundstück oder das grundstücksgleiche Recht verschafft oder wenn er über die Zurverfügungstellung von Darlehen hinaus den Erwerb des Grundstücks oder grundstücksgleichen Rechts durch Zusammenwirken mit dem Unternehmer fördert, indem er sich dessen Veräußerungsinteressen ganz oder teilweise zu Eigen macht, bei der Planung, Werbung oder Durchführung des Projekts Funktionen des Veräußerers übernimmt oder den Veräußerer einseitig begünstigt."

loans could never be efficiently securitized or placed into the cover of covered bonds. Even 3 months would already cause significant warehousing interest costs.

Beyond a necessary delimitation of lender liability, as a general ethics rule designed to reveal potential conflicts of interest, lenders should be forced to actively and comprehensively disclose the nature of their relationship to developers whose construction projects are being financed, to the consumer. The details of such disclosure need to be determined, but should encompass at least a description of business relations and revelation of joint business and project interest as noted above, if existing.

Clearly, together with a modern legal formulation of the issue, the financial models supported by the Financial Mechanisms Law and Mortgage Crediting Law should be repealed, since both laws provide for high risk profile model for construction business financing of a pyramid-type, where all financial risks burden is shifted to consumers. A breakdown of these schemes risks to undermine the validity of mortgage finance in general.
Finally, financing of the construction ought to be segregated legally from the financing of acquisition of apartments in completed building (property/construction vs. standing investment lending) in other technical regulation, for instance bank regulation etc..

To enhance the options for construction finance, land underneath incomplete construction should be used as collateral against bridge construction loans. This requires outright freehold or long-term lease land auctions or sales. New rules of land distribution in urban areas must be approved to this end. In particular, these rules should stipulate the acquisition by the developer of the ownership title (or at least long-term lease arrangement) to a land plot underneath a future building. This will enable developers to obtain bridge-type construction loans secured by land plot mortgages, and take out consumers of an intrinsically risky financing activity.

3.3.9 Mortgage Enforcement and Foreclosure[35]

Enforcement and foreclosure are highly regulated areas in Ukraine. The Mortgage Law stipulates enforcement against mortgage collateral in two ways - by using judicial or non-judicial methods. Judicial enforcement can be based either on court decision or on notary writ. If there is a conflict between a lender and a debtor, notary writ is usually appealed in the court. Therefore, judicial settlement basically is a court process. The court decision (or notary writ) is subject to execution according to provisions of the Law on Enforcement Procedures by the State Execution Department attached to the Ministry of Justice of Ukraine.

Court proceeding and execution procedure are highly uncertain, time- and cost- consuming. This creates a major problem from the lender's perspective. In 2004 the law was adopted establishing private arbitration system, which may expedite terms of dispute settlements. However, private arbitrators are not allowed to resolve on eviction. Therefore, the scope of private arbitration in respect to enforcement of creditor's rights in residential mortgages is very limited.

As far as eviction is concerned, Mortgage Law has amended the Housing Code, whereby restrictions on eviction of residents from housing in case of their default on mortgages were lifted. However, such eviction is conditional - if a debtor is not financially capable, the State must grant him\her temporary housing. Even though respective regulations for creation of temporary housing were adopted by the Cabinet of Ministers of Ukraine in 2004, this sort of accommodation does not physically exist. Inability to supply temporary housing may lead to significant problems in the area of judicial enforcement in part of debtor's eviction.

The Mortgage Law outlines detailed and transparent procedure for sale of mortgaged property at a tender hold by specialized organization. This market at the moment is highly monopolized. The

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[35] Reference to Articles 24-27 CCD proposal of 2002.

only organization authorized to operate with forced sales of seized property is Ministry of Justice subsidiary called “Ukrspetsjust”.

Since procedural legislation can hardly be improved in a short run, the Mortgage Law, as an alternative to judicial enforcement, provides for extra-judicial settlement, which does not require courts or the State Execution Department involvement. Respective procedures have negotiable character and may stipulate a repossession of mortgaged property by a creditor or a direct sale of this property by the lender to any person, who offers the best price. Despite detailed and reasonable definition of extra-judicial procedures in Mortgage Law, the practical effect of this innovation remains untested due to extremely low default rate on residential mortgages for the last few years and the predominance of free-handed sales in distress resolution.

From the consumer protection point of view, the Mortgage Law stipulates application of numerous instruments, including requirements to default notice, cure period, amicable settlement etc.

Closely related to foreclosure of mortgaged property is lender's right to demand loan acceleration. Obviously, the right to foreclose on mortgaged property may be given to the lender only if the lender may demand to repay the loan or else the lender could try to satisfy his claims with mortgaged property (as it follows from the hypothecation contract) without a need to claim fulfillment of the principal obligation.

The revised Law of Ukraine "On Consumer Rights Protection" sets certain rules concerning lender's right to demand acceleration of the loan in case of borrower's non-performance under the loan contract (a failure to fulfill the principal obligation). According to Article 11, Part 10 of the Law, the lender may use this right only in following situations:

1) the delay of the payment of a part of the loan principal and/or interest by at least one calendar month; or

2) the excess of the outstanding amount over the loan amount by more than ten per cent; or

3) the consumer's failure to make more than one repayment that exceeds five per cent of the loan amount; or

4) other substantial breach of terms and conditions of the consumer loan contract.

Beside that, the Law establishes that lender's claim becomes invalid if a violation of the loan contract is remedied within 30 calendar days of the day of receiving the demand to repay the consumer loan.

At the same time, the Law of Ukraine "On Mortgage" sets forth its own preconditions for foreclosure on mortgaged property in case of non-fulfillment of the principal obligation. Specifically, Article 35, Part 1 of the Law "On Mortgage" allows the lender (mortgagee) (i) to send to the borrower (mortgagor) the demand to fulfill the violated obligation within 30 days and (ii) to notify the borrower of the initiation of foreclosure on a mortgaged property in the event of any failure to fulfill the principal obligation. Thus the minimum delinquency period contained in Article 11, Part 10 of the Law of Ukraine "On Consumer Rights Protection" is not granted under this law.

Therefore, in this situation, provisions of the Law of Ukraine "On Consumer Rights Protection" should have a higher priority: the lender should be given the right to demand acceleration of the loan and foreclose on mortgaged property only with due regard to limitations and requirements of Article 11, Part 10 of the Law of Ukraine "On Consumer Rights Protection". It makes little sense to establish limitations on the demands of loan acceleration if these limitations do not apply to the hypothecation situation.

In addition, the Law of Ukraine "On Consumer Rights Protection" establishes certain important rules for lender behavior when the lender demands loan acceleration from the consumer. According to the Law, if the lender demands from the consumer to prepay the loan prepayment or fulfill any other delinquent debt obligation in an extrajudicial procedure or prior to court proceedings, the lender may not charge anything on the consumer for this demand. In so doing, the lender is prohibited:

1) To communicate untrue information on implications of the failure to repay a consumer loan;
2) To take the produce away from the consumer without his/her contents or without relevant court judgment;
3) To make notes on envelopes with notifications that the notifications concern delinquent debt under consumer loan;
4) To demand payment of any charges which are not specified by the consumer loan contract;
5) To request third parties affiliated with the consumer to provide information on the consumer's financial standing;
6) To do actions deemed to be unfair business practices;
7) To demand repayment of a consumer loan with the expired statute of limitation.

Since these instruments have not been tested in practical activities, it is not possible to judge whether they are adequate to consumer protection purposes. That is why in the processes of foreclosure and forced sale of mortgaged property consumer protection issues should be addressed on a case by case basis with due regard to existing banking practices and court proceeding experience.

Since mortgage lending has been extensively developing in Ukraine only for the last 3-4 years, without being tested by numerous defaults, respective arbitration or court practice in the foreclosure area is missing in Ukraine. Therefore, there is no indication on how the enforcement process will evolve. In practice, the foreclosure process as established by the Mortgage Law may appear to be irrelevant because lenders, as a general rule, would continue to practice amicable solutions, as their counterparts in Western Europe and increasingly American banks do. However, due to the above reasons, regulation governing amicable settlement should be set up only once sufficient practice cases have been accumulated.

3.3.10 Sundry Items[36]

Article 1056 of the Civil Code entitles the borrower to refuse from obtaining the loan until it is being drawn, if otherwise is not provided by the respective agreement. The Law "On Consumer Rights Protection" says that this clause does not apply to mortgage loans. However, for the purpose of consumer protection in the mortgage lending area, the borrower should enjoy the right prior to disbursement of loan proceeds to withdraw from the home loan. The respective credit agreement should specify a time limit within which such withdrawal can be exercised, no shorter than 3 days.

As a general rule, if the assignment of the mortgage is made between lenders, the borrower must be entitled to plead against the assignee any defense which was available against initial creditor. Article 518 of the Civil Code duly follows this principle by stating that the debtor may object the claim of the new creditor in the obligation on the same basis as against the initial creditor enjoying the same rights as existed on the moment when such debtor was notified of the assignment.

[36] Reference to Articles 11 and 17 CCD proposal of 2002.

For consumer protection purposes, the lender must be prohibited to claim the borrower to issue bill of exchange as the payment method under home loan. This rule is not applicable in Ukraine, since according Article 4 of the Law of Ukraine on Circulation of Bills of Exchange in Ukraine it is prohibited to issue bills of exchange or promissory notes under loan contracts - bills of exchange may be issued only as a payment against delivery of goods, services or works.

4. SYNTHESIS AND IMPLEMENTATION ISSUES

4.4.1 Need for Consumer Protection Regulations

During our interviews, Ukrainian lenders have broadly acknowledged the need for creating consumer protection rules in mortgage finance. Two of six lenders emphasize at the same time that also lenders are vulnerable, esp. as a result of fraud, insufficient information given and default tactics. However, especially regulation in areas that in addition to consumer protection improve the competition environment between lenders – rules addressing conflicts of interest (e.g. w. developers), effective interest rates, minimum disclosure rules, definition of product classes - appears to be of interest to lenders.

While consumer groups in Ukraine that could express practical consumer concerns are not yet established, the State Committee for Technical Regulation and Consumer Policy ex officio emphasizes its interest in further developing consumer protection into the so far unserved area of retail finance. In the view of the Committee, in addition to developing rules there is clearly a need for developing the enforcement infrastructure. Further discussion shall be held with the Central Bank and other public authorities to discuss the role of the Ukrainian government.

4.2 SCOPE OF CONSUMER PROTECTION REGULATIONS

It is obvious from the comparison of our risk analysis and the legal gap analysis that a regulatory approach for Ukraine will have to be narrowed down on the range of issues that can be dealt with effectively by regulation. Other mortgage and housing sector policy instruments will have to be used to launch an overall attempt to contain the risks for consumers.

- Transparency standards in advertisement, pre-contractual and contractual information exchange should be at the core of a regulatory approach. They should center around two basic concepts – sufficient information disclosure and help to structure and process such information for consumers, esp. in the form of standardized information sheets and the effective interest rate concept.

- Underwriting standards are a less appropriate tool for a regulatory approach. They trade against potentially severe limitations for competition dynamics between lenders which is needed in order to drive down spreads and differentiate the product menu. While it could very well be that standards for capital market instruments will limit underwriting practices – typical candidates are loan-to-value or debt service coverage limits - whether such limits become universal should be a market decision and not be imposed by regulatory fiat. What regulation can do for underwriting is to define a framework of 'responsible lending', i.e. underwriting practices that measure, including by stressing financial variables, and contain the likelihood of default of the financing - in the interest of both parties, lender and consumer.

- More relevant for regulation than the technical underwriting aspect is full information of the consumer with regard to the available product menu and a certain degree, at least initially, of product standardization to help consumers to make their select between clearly delimited product classes. The thrust of the approach is to contain potentially unfair terms and practices (e.g. unilateral rate adjustment clauses, arbitrary changes in spreads) that could lead to back book discrimination, not curb product differentiation. In that regard, we propose a clear separation between fixed-rate, fixed rate to term and variable-rate arrangements with certain, broadly defined pricing rules to be observed. However, at the same time we feel that such standardization *by regulation* should be limited to the initial 5-10 years of market development. After that period, pricing covenants on the market will be sufficiently transparent and homogenous to replace product regulations; also, greater product differentiation will make a regulatory approach counterproductive.

- A question mark at this point are regulatory policies towards idiosyncratic products and practices, especially construction finance and contract savings for housing (“Bausparen”). The typical conflicts of interest arising in Ukraine in construction finance should certainly be addressed at least by disclosure of the relationships between lenders and developers as we proposed; on the other hand, stronger measures such as lender liability for housing unit deficiencies in the case of retail lending may be more feasible protection techniques once construction finance techniques have developed. Bausparen clearly should be financially regulated as under best practice elsewhere in Europe (e.g. Germany, France).

- Broader risk factors such as house price risk certainly cannot be easily addressed by consumer protection regulation. Imposing stricter valuation methods, for example the European sustainable mortgageable value concept, may help to limit the risk of a financial bubble (produced by overoptimistic capital gains expectations); however, even those techniques are notoriously weak at capturing a ‘real’ bubble (produced by land/housing scarcity matching high demand, e.g. due to migration). To address the house price risk issue commands a coordinated response of financial regulator and monetary authority on the demand side (e.g. limiting underwriting practices anticyclically) as well as local governments and possibly competition regulators and courts on the supply side (e.g., land market and land servicing policies) are required.

- The Central Bank may finally improve consumer protection with regard to the risks of foreign-exchange denominated lending indirectly through credible monetary policies – in particular by avoiding fixed-exchange rate policies that might come under attack and thus end in large exchange-rate shocks – and through providing data and standards for stress tests. Clearly, the Central Bank should observe the current risky parameter constellation of a high foreign-exchange denominated lending share meeting a high price environment in many urban areas carefully.

4.3 IMPLEMENTATION FORM OF CONSUMER PROTECTION REGULATIONS

The financial risk and legal gap analyses undertaken throughout fall of 2005 have shown that a vital necessity exists in Ukraine to improve on the current consumer protection regulatory framework. The concerns have only been partially addressed by the Law of Ukraine "On Consumer Rights Protection" # 3161-IV, which passed in January 2006.

By December 2005, we saw two basis approaches:

(i) to improve on the existing statutory legislation, and ideally pass a separate Consumer Credit Act, or

(ii) to pass a Code of Conduct negotiated between lenders, or between lenders and consumer groups.

We saw arguments in favor and against of both:

- As discussed above, the applicable consumer protection rules in Ukraine were dispersed in a variety of various legislative documents. In the given circumstances, the initiation of a single Consumer Credit Act would imply changing a number of existing laws in order to generate a single and consistent concept. This could be problematic both from technical and policy points of view, as well as time consuming.

  A key problem could be lender's opposition, especially regarding lenders with politically powerful special interest. On the other hand would the introduction of legislation provide a better basis of enforcement: courts would have a legal basis for rulings and public authorities could be given a role to effectively intervene into distortive market practices.

- The alternative, a Code of Conduct for Lenders for Home Loans in Ukraine would be negotiated between lenders, and eventually lenders and consumer groups, rather than be imposed by the legislature. Rather than empowering the government, the implementing agent could be the Ukrainian National Mortgage Association (UNIA). The accession of lenders to the Code moreover would be voluntary – adhering lenders would be entitled to advertise their conforming covenants, which should become a strong argument for consumers to select only those lenders.

  Depending on the progress with the implementation of the Code, its essential provisions could be transformed in legislative norms, where and if appropriate. Experience in EU countries, e.g. the U.K., has that a Code of Conduct can along this line of though be a useful first step to a regulation, intended to broker agreement and collect data before more hard-to-review rules are established.

In the Ukrainian context of 2005, our judgment went clearly towards attempting to establish a Code of Conduct before proposing legislation. The State Committee could simultaneously monitor the process and initiate a research and data collection program to prepare possible legislation. Its inspectors could be trained on enforcing existing laws; the Committee could also prepare an easily understandable information booklet to support the implementation of the Code.

The promulgation of the Law of Ukraine "On Consumer Rights Protection" # 3161-IV has changed the strategic situation. In fact, it proved us right on one of our key points – the amount of time that it needs to develop a consistent and problem-adequate consumer protection framework for Ukraine.

The new law has obviously also not been sufficiently discussed with industry, nor consumer representatives. Going forward it would seem that entering such a discussion would be a priority in order to reach the common goal of greater consumer confidence in the mortgage market in Ukraine.

4.4 ENFORCEMENT OF CONSUMER PROTECTION REGULATIONS AND IMPROVEMENT OF FINANCIAL LITERACY

Any implementation form of regulation is irrelevant without an easily accessible enforcement infrastructure, for consumers and lenders alike. Ukraine is underdeveloped in that regard: the single opportunity which is explicitly granted by legislation is an appeal to court. But the court litigation process is costly, slow and unpredictable.

Therefore, out-of-court mediation should be set up in order to facilitate dispute resolution and redress. The potential candidates for mediators between lenders and consumers at this stage include the financial market regulators (primarily the National Bank of Ukraine), the State Consumer Protection Committee and the Ukrainian National Mortgage Association.

- According to the Law of Ukraine on the National Bank (1999) the National Bank of Ukraine does not have the authority to solicit resolving consumer protection issues and\or to review consumers' complaints. It appears also technically infeasible at the present stage that the National Bank may assume this function. However, given the numerous models of regulators in developed markets that have simultaneous consumer protection functions this option should be considered in the long term.

- The State Consumer Protection Committee acts on the basis of the Law of Ukraine on Consumer Protection which does currently not provide sufficient ground to treat borrowers' rights under home loans as consumer protection issues. However, this Law could be amended in order to fit the area of mortgage lending under its scope. A serious problem with the option could be that lenders would perceive a public consumer protection agency as a regulator rather than a mediator.
- The most feasible option at this stage from the perspective of lenders would be to initiate the creation of an Ombudsman position or committee within the mortgage association UNIA. This approach does not require any amendments to the regulatory framework; the financial input would also likely be limited. While this option would ideally be combined with the implementation option of the Code of Conduct, with UNIA simultaneously as a general implementation agent, it could also work under legislation. A drawback is that consumer groups, once established, might raise the issue of conflict interest of UNIA when mediating between consumers and lenders, and push for a more independent mediator.

If legislation is further deepened, clearly monitoring and enforcement would become an explicit task of public authorities. In this case, the State Committee for Technical Regulation and Consumer Policy could as the most likely implementing agent would assume those roles.

Next to enforcement, a substantial education and awareness campaign for consumers, banks, financial market regulators and other public agencies is required for the better understanding of the importance and of the principles of consumer protection for mortgage borrowers. Such information provision should receive sustainable public funding. An important option linking to the aspect of mediation would be to empower consumer groups to provide education, information and advice for consumers; in the EU, many consumer groups fund themselves from the sales of advisory journals as well as additional public funds.

5. CONCLUSIONS

We have identified the key risk factors arising for consumers entering into mortgage finance contracts in Ukraine. These include the risks arising from leveraged finance provided via consumers for unfinished housing units, house price risk, cash flow risk – especially with regard to forex loans, adjustment clauses for 'fixed-rate' loans and variable rate loans, and risks arising from deficiencies in the lender-consumer relations, especially with regard to insufficient consumer information and dominance of contracts in the absence of law.

We have in a second line of thought compared the Ukrainian legal context of consumer protection in retail finance with the best practice canon of consumer protection rules as in particular represented established by the proposed EU Consumer Credit Directive. We discussed and identified gaps in the Ukrainian legislation, including the absence of transparency and effective interest rate rules, of unfair terms rules and of material consumer protection rules regarding rate adjustment and prepayment. Our discussion of fall 2005 had to be amended to reflect new legislation that had passed in the meantime, taking up many of the motives of our draft work.

We finally provided a synthesis of our findings by discussing the need for improved consumer protection regulation in the field and the possible scope of regulation, which cannot effectively address all the risks identified. Especially, house price risk is an issue calling for coordinated public sector action and public-private partnership. We discussed the two main implementation options for regulation, Code of Conduct closed between lenders and legislation, and opted – for technical and political reasons – for proposing a Code of Conduct, acknowledging that it will be in all likelihood a first step towards legislation. Given that new legislation had passed in January 2006, we recommended to work on improving that legislation going forward. We finally gave thought to the question of implementation of any regulation, which in the Ukrainian context requires an out-of-court mediation system and public information and awareness campaign, whatever the implementation format of regulation will be.

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ANNEXES

Annex 1: Computation rules for reference indices admissible for variable-rate lending

Annex 2: Computation method for effective interest rates

Annex 3: Computation method for prepayment indemnities for fixed-rate loans

Annex 4: Code of Conduct Proposal for the Ukrainian National Mortgage Association of December 2005

ANNEXES

ANNEX 1: COMPUTATION RULES FOR REFERENCE INDICES ADMISSIBLE FOR VARIABLE-RATE LENDING

A) Costs of fund index in USD, Euro and UAH

The cost of funds index is defined as the weighted average of costs of funds of individual members of the Ukrainian mortgage banking association or other banking trade groups.

The applicable weights are the outstanding volumes of the debt instruments included in the index, possibly also other business volume indicators.

Individual bank costs of funds quotes submitted by banks to the aggregator comprises debt instruments (deposits, securities issued), excluding derivatives, with maturities between 3 months and 5 years. Individual quotes are submitted for all three currencies separately.

The type of data to be submitted is the effective annualized interest rate payments on the applicable debt instruments, considering also possible issuance discounts or premia, or equivalent indices.

Periodicity of submission, computation and publication is monthly. Applicability for interest rate adjustment is for the subsequent month.

B) Mortgage lending prime rate in USD, Euro and UAH

The mortgage lending prime rate is defined as the weighted average interest rate of mortgage loans of individual members of the Ukrainian mortgage banking association or other banking trade groups.

Loans eligible for computation carry mortgage guaranty and are made to consumers in good standing for housing purposes, have residual loan maturities of over 3 years, and have been either originated or repriced by the lender with reporting duty in the given month.

The applicable weights are the volume of new mortgage originations within the above definition in the given month, possibly also other business volume indicators.

The type of data to be submitted are effective annualized interest rate payments on the mortgage loan instruments within the above definition, considering also possible issuance discounts or premia, or equivalent indices.

Periodicity of submission, computation and publication is monthly. Applicability for interest rate adjustment is for the subsequent month.

C) Interbank rates in USD and Euro

The permissible interbank rates in foreign currency are Euribor and Libor. The indices are applied as officially published on the respective websites (www.euribor.org, www.libor.org).

The interbank rate is defined by the simple average of the workday quotations for term deposits in the interbank market with maturity of 6 months and 1 year in a given month.

Applicability for interest rate adjustment is for the subsequent month.

ANNEX 2: COMPUTATION METHOD FOR EFFECTIVE INTEREST RATES[37]

The basic equation, which establishes the effective interest rate equates, on an annual basis, the total present value of drawdowns on the one hand and the total present value of repayments and payments of charges on the other hand, i.e.:

$$\sum_{k=1}^{m} C_k (1+X)^{-t_k} = \sum_{l=1}^{m'} D_l (1+X)^{-s_l}$$

where:
– X is the effective interest rate
– m is the number of the last drawdown
– k is the number of a drawdown, therefore $1 \leq k \leq m$,
– C_k is the amount of drawdown k,
– t_k is the interval, expressed in years and fractions of a year, between the date of the first drawdown and the date of each subsequent drawdown, therefore $t_1 = 0$,
– m' is the number of the last repayment or payment of charges,
– l is the number of a repayment or payment of charges,
– D_l is the amount of a repayment or payment of charges,
– s_l is the interval, expressed in years and fractions of a year, between the date of the first drawdown and the date of each repayment or payment of charges.

The starting date shall be that of the first drawdown.

Intervals between dates used in the calculations shall be expressed in years or in fractions of a year. A year is presumed to have 365 days (or 366 days for leap years), 52 weeks or 12 equal months. An equal month is presumed to have 30.41666 days (i.e. 365/12) regardless of whether or not it is a leap year.

The result of the calculation shall be expressed with an accuracy of at least one decimal place. If the figure at the following decimal place is greater than or equal to 5, the figure at that particular decimal place shall be increased by one.

37 The formulation here draws on the EU Proposal for a Consumer Credit Directive of 9/11/2002, Annex 1.

ANNEX 3: COMPUTATION METHOD FOR PREPAYMENT INDEMNITIES FOR FIXED-RATE LOANS

The level of indemnity payable by the consumer referred to in Article 9, Paragraph 4 shall reflect the reinvestment loss that the lender incurs when investing the prepaid cash amounts into new mortgage loans of the residual term of the fixed-rate agreement.

In a simplified definition adopted here, the reinvestment loss of the lender depends on the prepaid cash amounts, multiplied with the difference between the contracted interest rate and the average interest rate prevailing on the home loan market for the residual term at which the lender would reinvest the funds, multiplied with the residual term.

Mathematically:

$$P_t = \min(0, \max(5\% * E_t, X_t)), \text{ with}$$

$$X_t = E_t * D_t * (T-t),$$

$$D_t = R_0^c(T) - R_t^m(T-t),$$

$$t = 0,1,\ldots T \text{ and } (T-t) \leq 5 \text{ years.}$$

In this definition,

t: the date of prepayment in years after the origination of the loan, expressed in accuracy of at least one decimal place.

P_t: Prepayment indemnity payable at time t.

E_t: The cash amount (exposure), at time of prepayment, that the consumer wishes to prepay.

D_t: the difference, at time of prepayment, between the contracted interest rate over the entire term $R_0^c(T)$ and the average interest rate prevailing on the home loan market over the residual term $R_t^m(T-t)$, as provided by an entity as described under Article 6, Paragraph 5.3.

T: the term of the fixed-rate agreement in years, expressed in accuracy of at least one decimal place.

T-t: the residual term of the fixed rate of the contract in years, expressed in accuracy of at least one decimal place, which may not exceed 5 years.

Numerical examples

A consumer prepaying a loan over USD 50,000 with rates fixed over 5 years after the end of the 3rd year leaves the lender with reinvestment risk for a residual term of 2 years.

The interest rate contracted for 5 years is assumed to be 12% p.a.; the average interest rate of the home loan market over the residual term of 2 years at the time of prepayment is assumed to be 9%.

Then, the prepayment indemnity is computed as follows:

$P_{3.0}$ = min (USD 0, max (USD 2,500, USD 50,000*3%*2)) = USD 2,500.

In a second example, the average interest rate over the residual term is 10%, with everything else being equal to the first example.

In this case, the prepayment indemnity level is:

$P_{3.0}$ = min (USD 0, max (USD 2,500, USD 50,000*2%*2)) = USD 2,000.

ANNEX 4: CODE OF CONDUCT PROPOSAL FOR THE UKRAINIAN NATIONAL MORTGAGE ASSOCIATION OF DECEMBER 2005

CODE OF CONDUCT

for lenders of home loans in Ukraine
on their relations to consumers

Article 1. Definitions

1. Advertisement - any information referring to granting home loans displayed or placed at business premises of the lender, in media, at any public places or distributed in any other manner, which makes them available to potential consumers and is intended to attract such consumers to borrow.

2. Consumer – the natural person who is the borrower under home loan and who does not use this loan for the purpose of his\her entrepreneurial activity.

3. Home loan – the credit which is granted by the lender to the consumer for acquisition of housing and\or reconstruction of existing housing secured by mortgage or any other commonly accepted surety agreement. For the purpose of this Code of Conduct any loan granted for any other purposes to the consumer but still secured by mortgage of residential real estate shall be treated as the home loan.

4. Lender – bank or non-bank financial institution which grants a home loan to the consumer. For the purpose of this Code of Conduct any authorized agent, representative or other intermediary which on behalf of the lender acts in relations with the consumer in respect to home loan arrangements shall be treated as the lender.

5. Surety agreement – the mortgage agreement and\or any other security arrangement which is granted by the consumer or by the guarantor in order to secure the performance of consumer's obligations under the home loan.

6. Credit agreement – the agreement between the lender and the consumer serving as a legal basis which constitutes the home loan.

7. Guarantor – third party granting to the lender surety agreement in order to secure performance by the borrower of obligations under home loan.

Article 2. Scope

1. This Code of Conduct is intended to encourage lenders active in the home loan market to uphold high ethical standards in their relations with consumers.

2. The application of this Code of Conduct is limited to home loans.

3. The accession of lenders to this Code of Conduct is voluntary. However, lender's accession to and conformity of its practices with the requirement imposed by this Code of Conduct shall provide the lender with the right to advertise and exchange information with his adherence to the Code.

4. This Code of Conduct shall establish a minimum set of requirements relevant to consumer rights protection in the area of home lending, without prejudice to requirements established by legislation of Ukraine. Lenders shall be free at their own discretion to establish additional consumer protective terms in their relations with consumers.

Article 3. Advertisement

1. Any advertising must be clear, comprehensive and reflect with the necessary due diligence the actual terms and conditions on which home loans can be granted, taking in account quality characteristics of the financed investment and financial situation of the consumer.

2. In addition to the requirements established by the legislation in respect to advertisements, any advertising of home loans must contain, but is not limited to:

- the identity of the lender;
- the currency of the loan;
- the use of any indices to adjust outstanding principal of the loan if applicable;
- the nominal interest rate and effective interest rate.

3. Any advertising in respect to home loans must not contain:

- any data (including minimal nominal interest rate and\or minimal effective interest rate) that does not correspond to actual terms on which home loans can be granted;
- any data that can be misleading to or misinterpreted by the consumer.

4. Loans granted for construction or reconstruction purposes shall be clearly distinguished in advertisements from loans granted for the acquisition of finished housing units.

Article 4. Exchange of information at the pre-contractual stage

1. The lender may request the consumer to supply personal and property-related information (including documents proving this information) only to the extent that such information is adequate, relevant and sufficient to assess the consumer's financial standing, ability to repay the loan and state of the real estate subject to be financed. The consumer and\or the guarantor shall reply to lender's request for information accurately, in full and in the agreed terms.

2. Personal and property information supplied by the consumer according to provisions of paragraph 1 of this Article can be used and processed by the lender only for the purpose of credit risk assessment. Such information can be deposited by the lender to credit bureaus (or any other centralized database on borrowers) exclusively upon the consumer's written consent and under the condition that the consumer is fully aware of the purpose of such depositing.

3. The lender shall provide the consumer with all the exact and complete information in respect to home loans. This information shall be supplied to the consumer in writing on paper or on another durable medium before the conclusion of credit and surety agreements in the form of a pre-contractual information sheet.

4. The lender providing a home loan must disclose to the consumer the following information in the pre-contractual information sheet:
4.1. Lender identification.

4.2. Financial conditions:
- typical loan volumes financed;
- purpose, for which the loan may be used;
- types of surety arrangements required;
- duration of credit and surety agreements;
- required insurance policies (property, life, disability and unemployment insurances if applicable);
- requirement to appraise of the underlying real estate;
- description of types of home loans offered, their interest conditions and currency, together with a short description of the differences and their implications for consumers;
- conditions of and procedure for disbursement of the loan to the consumer;
- typical downpayment requirements, loan-to-value ratio limits applicable;
- nominal interest rate, effective interest rate and transaction expenses for a typical loan;
- procedure for loan repayment by the consumer and amortization schedule;
- conditions of early repayment, reference to exclusion periods or penalties for early pre-payment if applicable;
- conditions and procedures governing interest rate adjustment, including frequency of such adjustments, references to indexes or formula which shall be used for adjustments, maximal caps for adjustments etc.

4.3. Legal conditions:
- limitations of the rights of the consumer and\or guarantor to dispose and use of the mortgaged property;
- withdrawal period;
- triggers of default and enforcement methods;
- reference to issuance of mortgage note;
- third party personal guarantee requirements if applicable;
- information that the lender subscribes to this Code.

Article 5. Responsible lending and loan offer

1. The lender shall make the consumer familiar with his entire home loan product range, as well as possible variations or alternatives thereof.

2. The lender shall allocate professional personnel in order to provide the consumer with comprehensive information on any matters substantial and relevant to credit and\or surety agreements before their conclusion.

3. The consumer shall make his\her selection of home loan products at own discretion according to his\her personal assessment. The lender is prohibited to impose to or make any pressure on the consumer to dictate such selection.

4. Based on all available sources of information about the consumer, the lender shall undertake his best efforts to assess consumer's capacity to repay the loan. The lender shall avoid granting loans to consumers whose assessed capacity to repay appears dubious. The assessment shall take into account the impact of realistic scenarios of changes of interest rates and, if applicable, foreign exchange rates on the level of payments due by the consumer.

5. The lender shall make a written loan offer, indicating the time period to which he is bound to the offer. Within such period, only those financial conditions may be altered that change due to circumstances out of the lender's direct control. The loan offer shall contain all financially and legally relevant information of the proposed contract, including the negotiated terms for the items

disclosed in the pre-contractual information sheet according to Paragraph 4 of Article 4 of this Code.

6. Prior to the conclusion of the credit and surety agreements the lender shall disclose, in an appropriate form, to the consumer information about related entities involved in the home loan transaction, the nature of lender's relations with such entities and the possible effect on the consumer of their involvement in the transaction. In particular, this requirement is applicable to the following natural or juridical persons if they are related to mortgage lender:

- developer who sells (or who will sell) to the consumer real estate financed by the home loan;
- real estate broker who sells (or who will sell) to the consumer real estate financed by the home loan;
- insurer who will provide insurances according to the terms of mortgage agreement;
- property appraisers.

Article 6. Interest rate and adjustment mechanism

1. Interest rate regimes for home loans may be either fixed or variable. The credit agreement shall specifically indicate which type of interest rate regime is applicable.

2. Interest rates on home loans carrying fixed rates can be fixed to maturity or fixed to the term over one year. Unilateral change or adjustment of fixed rates before maturity or term to which they have been fixed respectively by the lender is prohibited.

3. Interest rates on variable-rate home loans may be periodically reviewed by the lender without the consumer's consent according to conditions and procedures established in the credit agreement. If a variable-rate regime is chosen by the contracting parties, the credit agreement shall indicate a rate-adjustment formula based on a contractually agreed index which allows adjusting interest rate level at regular intervals within the duration of the credit agreement. Such arrangement may not be altered unilaterally by the lender.

4. If the interest rate regime is variable, moreover the following rules shall apply:

4.1. The credit agreement shall stipulate the frequency of the interest rate adjustment. An adjustment cannot take place more frequently than quarterly.

4.2. The adjustment of the interest rate shall be made based on index indicated in the credit agreement which conforms to the requirements established in the paragraph 5 of this Article.

4.3. Upon each adjustment, the lender shall re-compute the repayment schedule to the final maturity of the loan, providing the consumer with the schedule.

4.4. The credit agreement shall indicate a maximum applicable interest rate (cap). Such maximum interest rate shall be disclosed to the consumer in all information exchange, including loan offer and credit agreement. The maximum rate shall at least be applicable to the first 5 years of mortgage loan.

5. Index that shall be used for interest rate adjustment shall meet the following requirements:

5.1. Index must be published periodically but not less than once per month in media or be available to public from any other regular sources of information. Reference to this source of information shall be indicated in the credit agreement.

5.2. Index must be quoted based on reasonable and objective reference indicators (inflation rate, National Bank of Ukraine interest rates, mortgage loans and\or deposit rates, more than three month LIBOR or EURIBOR rates etc.) which enable to determine present market value of the home loan in respective currency.

5.3. Quotation of index must be made by the entity which has high reputation and is generally acknowledged in the financial market. Index can not be quoted by originator of the loan, or any entity, whose business is closely related to such originator.

6. If the consumer objects to the variation or adjustment of interest rate according to the terms of the credit agreement he\she is entitled within one month of the date of adjustment to make early redemption of the loan in full whereby calculation of the interest shall be made based on interest rate existed prior to adjustment.

Article 7. Effective interest rate and transaction costs

1. Prior to execution of credit and surety agreements the lender shall notify the consumer of interest rate, effective interest rate and other transaction expenses.

2. Effective interest rate shall be calculated on annual percentage basis as overall sum of the following:
- nominal interest rate as specified in the credit agreement;
- any one-time or regular bank fees or commissions (including commitment, administrative, foreign exchange commissions, fees for maintenance of bank accounts and\or of cards etc), which are mandatory to the consumer and directly associated with origination of and servicing mortgage loan by the lender;
- insurance or guaranty premiums, which are mandatory according to the credit and\or surety agreements, calculated on annual basis as the percentage to the home loan principal.

The formula for the calculation of effective interest rate is attached in Annex 1.

The applicable loan duration for effective interest rate calculation purposes shall be 5 years.

3. Other transaction expenses shall include:
- notary and registration fees;
- appraisal costs if applicable;
- taxes and state duties;
- any other expenses associated with execution of credit and surety agreements payable by the consumer.

4. Within the duration of the credit agreement the lender is not entitled to impose any additional charges on the consumer aside from those which were directly stipulated by credit and\or surety agreements.

Article 8. Discriminatory credit and surety agreements

1. Credit and surety agreements shall not contain unfair clauses related to the following:
- unilateral amendment of the agreement without consumer’s consent;
- interest rate adjustment mechanism contrary to requirements set up in Article 6 of this Code of Conduct;

- prohibition for early prepayment of the home loan contrary to requirements set up in Article 9 of this Code of Conduct;
- retaining in any form of any amount out of home loan principal;
- obligation of the consumer to use any supplementary services of the lender or any third party, which are not directly associated with the home loan transaction;
- limitation of consumer's ownership right to financed property or of the right to reside therein;
- provisions of any other nature discriminative to the consumer.

Article 9. Performance of the credit agreement

1. From the date of conclusion of the credit agreement and prior to disbursement of loan proceeds to the consumer the latter shall enjoy the right to withdraw from the home loan. The credit agreement can specify the time period within which consumer's withdrawal right is valid, which shall be not shorter than three days. If the consumer used his\her right to withdraw all transaction expenses already incurred by the time of withdrawal are not reimbursable.

2. The consumer shall enjoy a universal right to early prepayment of the home loan fully or partially with exceptions and conditions stipulated in paragraphs 3, 4 of this Article.

3. The credit agreement may stipulate an exclusion period for early prepayment of the home loan, which should not exceed 1 year of the date of conclusion of the credit agreement.

4. If the interest rate is fixed, the credit agreement may stipulate an indemnity (penalty) for early prepayment of mortgage loan that shall not exceed the lesser of:
   - 5% of the prepaid balance of the home loan at the time of prepayment, or
   - the level of prepayment indemnity calculated as specified in Annex 2.

An indemnity for early prepayment of the home loan shall not be applicable if a variable interest rate is applied.

5. In case of partial early prepayment, the lender shall within 10 business days of the date of prepayment notify the consumer in writing of the adjusted repayment schedule. The credit agreement must stipulate the method of repayment schedule adjustment as well as of its delivery to the consumer.

Article 10 Implementing agent and sanctions

1. The implementing agent of this Code of Conduct shall be the Ukrainian National Mortgage Association (UNIA).

2. For the purposes of implementation of this Code of Conduct, UNIA shall appoint an Ombudsman for Home Loans. The ombudsman shall advise consumers with regard to their rights under this Code and shall mediate consumer's complaints against lenders in possible violation of this Code of Conduct.

3. If found in violation of this Code of Conduct, the rights of lenders defined under paragraph 3 of Article 2 may be temporarily suspended until the cause of violation is cured or, if severe and repeated, be permanently withdrawn by UNIA.