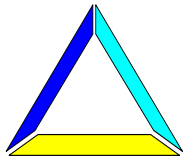
INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING IN UKRAINE

GERMAN ADVISORY GROUP ON ECONOMIC REFORM

Reytarska 8/5-A, 01034 Kyiv, Tel. (+38044) 228-6342, 228-6360, Fax 228-6336
E-mail: institute@ier.kiev.ua, http://www.ier.kiev.ua



T3

Mortgage lending in Ukraine: Three strategic questions and answers

Executive summary

Mortgage lending is of crucial importance for the economic development of a country. In Ukraine, mortgage lenders face severe difficulties in obtaining the necessary refinancing to provide mortgage loans. Consequently, this business is still underdeveloped. In this paper, we put forward several proposals to avoid worsening and to improve the refinancing situation of mortgage lenders by answering three strategic questions related to the Ukrainian mortgage system. Firstly, we propose to keep the existing universal banking system and not to introduce a specialised system. This will enable lenders to continue using deposits as a source of refinancing. Secondly, we recommend to favour the establishment of a system based on mortgage bonds, rather than on mortgage backed securities. The latter system is too complex to be implemented in Ukraine for the foreseeable future and the likelihood of it being successful is low. Thirdly, we propose the introduction of legal safety requirements for mortgage bonds, which will facilitate investment decisions and thus increase demand for mortgage bonds by both private and state institutions.

Content:

1. Introduction
2. The current situation
3. Should the state create specialised mortgage bank institutions?
4. Should the state favour mortgage bonds or mortgage backed securities?
5. Which legal safety requirements should be fulfilled by mortgage bonds?
6. Conclusions

1. Introduction

Many families in Ukraine would like to buy (new) housing. But housing is very expensive. Thus, most families can only afford (new) housing if they acquire a non-expensive loan, which they can repay over a long period of time (long term credit). Also enterprises depend on long-term loans for the acquisition of real estate. Consequently, the availability of long-term loans for real estate is very important for the well-being of private households, for the development of private business and for the general economic development of the country.

Currently, the supply of long-term credits for real estate in Ukraine is rather limited and expensive. Different things can be blamed for this unfortunate situation. But undoubtedly, one of the major impediments for mortgage lending in Ukraine is the lack of long term *refinancing*. In order to be able to provide long-term credits, commercial banks and other financial institutions need long term refinancing, which is rather scarce in Ukraine. Thus, the current attempt by the Ukrainian government and the National Bank of Ukraine to encourage mortgage lending should focus on long term refinancing. In this paper, we present our recommendations on how to improve long term refinancing by answering three strategic questions related to the Ukrainian mortgage system. But before this, we provide a short overview of the current situation of mortgage lending in Ukraine.

2. The current situation

The provision of housing in Ukraine is far from being adequate. Around one third of Ukrainians live in unsatisfactory conditions, i.e. in premises with less than 9 sq. m. per person. Approximately 2 million families, or more than 6 million people are officially registered in a waiting list for the improvement of their living conditions. On average, the provision of housing in Ukraine comes to roughly 20 sq. m. per person, which is 2 to 3 times less than in developed countries.

The construction of housing somewhat increased during the last several years and constituted approximately 6 million sq. m. per year. The prime source of investment in construction was the population, which accounted for almost 60% of total investment in construction; enterprises followed with a 37% share, while budgetary funds constituted only 3%. The state initiated a program of privileged housing finance for young families, but the amount of money appropriated for it is very small: in 2002 it was only UAH 77 m.

Due to economic growth and rising real incomes, demand for housing and for mortgage credits increases significantly. As a result, mortgage crediting in Ukraine developed quite rapidly during last years, but is still rather modest: as of the end of 2002, total mortgage loans constituted only UAH 1.5 bn, or 0.7% of GDP, compared to around 20% of GDP in developing countries or around 50-70% of GDP in advanced economies. Out of the total amount, 30% of loans were for housing finance.

In Ukraine there is no requirement for the establishment of special mortgage banks, although a discussion concerning this issue holds on for a long time. Presently, around 10 commercial banks are active in this market. On average, banks give credits for housing finance for 3-5 years, rarely for 10 years. Around 30-40% of real estate value should be paid initially. As of now, interest rates are approximately 14-16% for mortgage loans in US dollars and 20-26% for loans in national currency.

Until now mortgage loans are regulated by the Law "On Collateral" dating from 1992. In June 2003, Verkhovna Rada adopted in second reading the Law "On mortgage". This law defines the main terms, including first of all "mortgage" itself, sets requirements for the object of mortgage, insurance, establishes obligatory parts of mortgage contract and clarifies the procedure of selling property. Also, the law introduces the "mortgage deed", a security which certifies the rights for the object of a mortgage loan. The mortgage of agricultural land is provided by the law, but banned until 2005. In general, the law "On mortgage" provides vital preconditions for the establishment of housing finance and mortgage lending market in Ukraine, although it is by far not complete. For instance, it does not include regulation concerning mortgage bonds.

3. Should the state create specialised mortgage bank institutions?

In many countries such as Germany the state has established a system of specialised mortgage banks. According to this system, only specialised mortgage banks are allowed to conduct several activities related to mortgage lending, such as the issuance of mortgage bonds. Other activities of specialised mortgage banks are highly restricted. In particular, they are not allowed to attract deposits from clients.

The strong feature of the system of specialised mortgage banks is supervision. Because of their limited field of activities, these banks can be supervised in an effective manner, even when banking supervision capabilities are quite limited, as is the case in many transition economies including Ukraine. Notwithstanding this strong feature, we are convinced that a universal banking system is much more preferable for Ukraine than a specialised one.

The main argument for this assertion has to do with the importance of deposits as a source of refinance. Long-term credits require long term refinancing. But at least to some extent, financial intermediaries are able to transform short-term deposits into long-term credits (transformation of maturities). Thus, it is crucial that banks involved in mortgage lending are allowed to take deposits from clients, which can be used to refinance part of the long-term mortgage loans.

But at least two further arguments can be put forward in favour of an universal and against a specialised mortgage banking system. First, the risk management and the financial stability of specialised banks might be rather poor. As shown by international experience, property markets are quite volatile and have a tendency to develop so-called bubbles. Consequently, specialised banks have an non-diversified risk structure and are likely to go bust in the event of a property market bubble bursting, even if they are effectively supervised. Second, a specialised system is very expensive. Under a specialised system, existing commercial banks, which want to develop the mortgage lending business, might have to found a new mortgage bank. This requires a lot of time, work and capital. Needless to say, these costs will be passed to borrowers, making mortgage loans expensive and for many potential clients unaffordable.

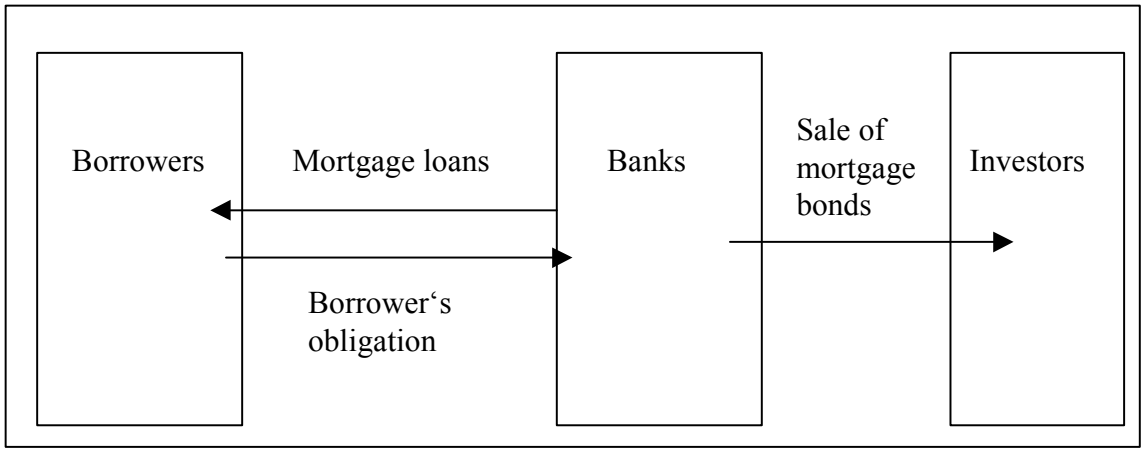
For all these reasons, we strongly advise the Ukrainian policy makers to retain the existing universal banking system and not to introduce a specialised mortgage bank system.

4. Should the state favour mortgage bonds or mortgage backed securities?

The capital market should become a very importance source of refinance for mortgage lenders in Ukraine. For this to happen, mortgage loans have to be "repackaged" (securitised) into bonds, which can afterwards be sold to investors on the capital market. Broadly speaking, there are two main systems on how to securitise mortgage loans: the mortgage bond system and the mortgage backed securities system. The mortgage bond system is used in many European countries such as Germany and consists of three participants: mortgage borrowers, mortgage lenders and investors. First, mortgage lenders provide loans to mortgage borrowers. These mortgage loans are afterwards securitised and the resulting mortgage bonds („Pfandbriefe") are sold to investors (see chart 1).[1]

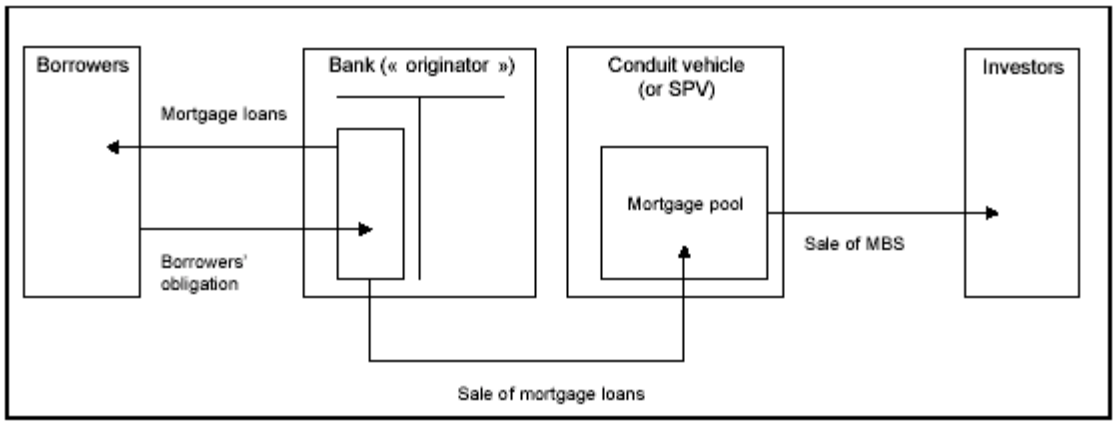
1 As of end of 2001, total outstanding German mortgage bonds (Pfandbriefe) amounted to more than € 1.1 trillion. The Pfandbrief market is Europe's biggest bond market. Thus, it even outsizes the markets for Italian and German government bonds.

Chart 1: The Mortgage Bond System



The mortgage backed securities (MBS) system is widely used in the USA and features a fourth participant, the so-called special purpose vehicle (SPV) or conduit vehicle. The SPV buys mortgage loans from the banks, securitises them into MBS and sells the resulting securities to investors. Banks are thus able to free equity capital and use it for further loans. The MBS system is depicted in chart 2.[2]

Chart 2: The Mortgage Backed Securities (MBS) System



Source: Based on Spremann/Kränzlein (1996).

Both systems do not exclude each other. For example, the market for MBS is starting to develop in Germany, notwithstanding the strong dominance of mortgage bonds. Thus, in the long run, both systems could also co-exist in Ukraine, and the government does not have to take a final decision on which system to establish in the long run. Having said that, we think that in the short run resources should be concentrated on the establishment of the system, which is likely to work best in Ukraine in the coming years. Thus, it is necessary to decide on which of both systems to concentrate in the short run. In order to prepare this decision, we should look at the advantages and disadvantages of both systems.

The main *advantage* of a MBS system vis-à-vis a system based on mortgage bonds is the possibility of selling the loan and thus freeing equity capital for new loans. But a MBS system has the great *disadvantage* of being rather complex and requiring highly developed legal and financial institutions. In a mortgage bond based system, the credit risk remains all the time with the same institution, which originated the loan. This ensures

[2] A detailed analysis of the mortgage systems in Germany and in other countries is given in our recent policy paper S 36.

a very thorough proof of the creditworthiness of the borrower, a very intense monitoring of the creditor after signing the contract and leaves little room for moral hazard. In a MBS system, the loan (including its risk) is sold to the special purpose vehicle (SPV). Thus, the loan originator (the bank) might not be as careful as in the alternative system when it comes to the assessment of the creditworthiness of a borrower. Also, the information about delays in payments or non-compliance of the borrower might be hidden or not reported in time to the SPV.3 Besides, the possibilities for fraud are much higher in a MBS system. Furthermore, the inclusion of a fourth participant (the SPV) into the system significantly increases the number and the complexity of the necessary legal contracts to run the system. Also, it requires strong rating agencies to exclude the possibility that only mortgages with a bad risk-profile are sold to the SPV and eventually to investors, whereas more favourable mortgages are kept on the bank's balance sheet. Last not least, the complexity of MBS will put off a large number of potential private investors. MBS are much more difficult to understand than mortgage bonds. Whereas mortgage bonds in Germany are often bought by retail investors, MBS are almost exclusively held by institutional investors or very large private investors.

A further major *disadvantage* of a MBS system in Ukraine relates to the SPV, which has the function of buying mortgage loans from the banks, securitising them and selling the resulting MBS to investors. According to current plans, the NBU is supposed to establish a SPV to intermediate between banks and investors. The argument put forward in favour of this plan is that only the NBU enjoys the necessary reputation among investors to be able to place the MBS on the capital market. It is certainly true that the NBU is a highly credible institution and that it enjoys a high degree of trust among commercial banks and the public in general. But a crucial drawback of this plan concerns supervision. Financial institutions in general and a SPV in particular must be properly supervised. But a proper supervision cannot be guaranteed, if the NBU (as the Ukrainian banking supervisor) has to control its own activities or the activities of an organisation which is dependent from the NBU. To put it bluntly: You just cannot supervise yourself! Another problem with a SPV established by the Ukrainian state (government or NBU) will be its foreseeable lack of independence from the government and the presidential administration. The SPV decides as a monopolist which mortgage loans are worth buying. This opens the way for political influence on mortgage loan decision and on which mortgage loan are used for securitisation. As a consequence, the quality and the safety of the MBS issued by the state-dominated SPV will be rather poor and the mortgage business will not develop in a sustainable way.

A comparison of the advantages and disadvantages of both systems shows clearly, that a system based on mortgage bonds is more appropriate and much more likely to be successful in the foreseeable future in Ukraine than a MBS system. *Consequently, we strongly favour the establishment of a system based on mortgage bonds, in which the role of the state is limited to regulation and supervision, and the possibilities of negative political interference are minimised. This does not exclude the possibility of establishing a MBS system in the future, once the necessary preconditions are fulfilled.*

5. Which legal safety requirements should be fulfilled by mortgage bonds?

Investors base their decisions on whether to buy or not to buy bonds on information. But the acquisition of information as well its processing is very costly. These high information costs have a negative effect on the bond market by reducing demand and/or reducing the yield. The state can contribute to reduce these information costs by creating (in the sense of defining) a special instrument called „mortgage bond" which must fulfil several safety requirements. An investor considering the possibility of buying a mortgage bond will know that this is a rather safe security and this will facilitate his decision.

[3] The SPV has in general a legal right to sell back (repo) the loan to the bank if some irregularities take place.

In order to make this instrument safe, only bonds featuring specific safety mechanism should be allowed to be offered and sold as mortgage bonds. The main safety mechanism is the „cover principle". Mortgage bonds should be covered at all times by mortgage loans at least equal to the nominal value of all outstanding issues and yielding at least an equal interest yield. Furthermore, cover assets should be first-charge mortgages.[4]

A further important aspect for the safety of mortgage bonds is the so-called „loan-to-asset ratio". The lower this ratio is, the safer is the mortgage loan and consequently the mortgage bond secured by this loan. On the other hand, low loan-to-asset ratios mean that the borrower has to finance a major part of the asset (house, apartment, etc.) from his own savings and makes it more difficult to bring borrowers and lenders together. In order to decide how to deal with this trade-off between safety and profitability, one should recall the main problem at the Ukrainian bond market, namely the lack of *safe* bonds. The priority for the state should be the legal creation of safe bonds. Otherwise investors will not buy mortgage bonds and banks will not be able to collect long term refinancing from the capital market. Consequently, we recommend to limit the loan-to-asset ratio for mortgage loans which are used for backing mortgage bonds to 60%.[5] Besides, it must be ensured that the mortgage lending value is carefully assessed.[6]

The new, safe mortgage bonds should be an interesting instrument of investment for many private and state institutions. In order to not artificially reduce demand, all restrictions by state institutions on the purchase of these „private" bonds should be abolished. In particular, the pension fund, life insurers and the deposit insurance fund should be allowed to purchase mortgage bonds. Also, the NBU should allow commercial bank to use mortgage bonds as collateral for credits from the NBU to commercial banks.

To summarise, we strongly recommend the Ukrainian government and the NBU to legally create a special instrument called „mortgage bond". This instrument should fulfil high safety requirements, and state institutions should be allowed to invest in them.

6. Conclusions

Each country faces at some stage in time a strategic question concerning mortgage lending: should the state legally define special institutions and/or special instruments to promote a sustainable development of mortgage lending or not? In our view, Ukraine should not legally define special mortgage institutions such as specialised mortgage banks. These highly regulated and restricted institutions are not allowed to accept deposits from clients and are thus barred from an important source of refinance for mortgage loans. But Ukraine should legally define a special mortgage instrument which fulfils strict safety requirements. Only safe mortgage instruments can ensure a sustainable development of mortgage lending. Furthermore, priority should be given to the legal definition and to the promotion of mortgage bonds and not of mortgage backed securities (MBS). A system based on MBS is not likely to be successful and sustainable in Ukraine in the foreseeable future, because of it's high requirements on the legal and financial institutions of the country.

R.G., I.E., Lector: F.P.

Kiev, July 2003

[4] A lender who has a first legal charge over a property will have the first call on any funds raised from the property sale.

[5] This recommendation is based on the positive German experience of a 60% loan-to-asset ratio for mortgage loans, which are used to secure mortgage bonds.

[6] According to the Association of German Mortgage Banks, the mortgage lending value in Germany is regularly about 10% to 15% less than the market value.