Improving the conditions for residential mortgages in Ukraine: An analysis of mortgage lending opportunities and selected interventions – A case study

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1. Introduction

The purpose of the article is two fold: firstly to describe how to analyze mortgage lending opportunities in an emerging country with Ukraine as an example, and secondly as a case study to elaborate on approaches to intervention and how the intervention in three selected areas is currently being carried out in a project supported by the European Union.

2. Project description

"Establishment of Mortgage Market Rules and Legislation - Ukraine" is a project funded by the European Union . The overall objective of the project is : "Develop an appropriate regulatory framework that assists the mortgage loan market to come into being through creating a platform of dialogue between the private sector and authorities on regulation of the now evolving market, and to contribute to the transfer of know-how of mortgage markets in other countries to private and public stake holders in Ukraine"

The end beneficiary is : "the citizens of Ukraine who through the increased availability of affordable financing opportunities can maintain and refurbish their existing accommodation and hereby both improve their living conditions and reduce the energy used for heating."

The Project has the following five main components:

1. Institutional development of The Ukrainian National Mortgage Association (UNIA)
A powerful and sustainable mortgage association is crucial to ensure the development of a sound, efficient and reliable Ukrainian mortgage system. Moreover, this is also vital for the technical assistance provided under the current EU funded Project for the below components to be as productive and effective as possible.

2. Strengthening the Ukrainian mortgage structure.
The project will facilitate an analysis of mortgage market development among local stakeholders and support them in developing the most appropriate structure for Ukraine.

3.Development of rules, regulations and mortgage standards for the Ukrainian mortgage system.
A sound legal environment, consistency and a systematic approach to rules and standards form a basis for effective mortgage market structure development.

4.Development and implementation of training programmes on mortgage related topics.
Training sessions, seminars and workshops constitute an integral part of several components of the Project. To a large extent, the success of the Project will depend on the transfer of knowledge and increase in capability within a large number of Ukrainian beneficiaries.

5.Market information on the Ukrainian mortgage lending system.
Public awareness about mortgages is quite an important issue. It will be difficult to improve access to credit unless the public is educated properly.

The project started effectively in January 2005, and will come to an end in December 2006.

[1] INTERPROJECTS GmbH, Frankfurt, Germany, is a member of the consortium carrying out the project

[2] According to the Tor as of 2002

[3] ToR, op.cit.

3. Mortgage lending opportunities[4]

In analyzing the mortgage lending opportunities, the Project used the model outlined in chart 1, the individual components of which will be explained in the following:

Chart 1. Factors affecting mortgage lending opportunities

We will briefly summarize the current situation:

3.1 Key macroeconomic factors[5]

With a population of 47 million inhabitants, the situation is as follows:
- GDP growth is expected to decelerate to 2.2% in 2006 against the background of a sharp rise in imported gas prices.
- In 2007 the real GDP growth is forecast to be 3.7%.
- Key driving force of GDP growth remains final households' consumption both in 2006 and 2007.
- Investment activity remained sluggish in the beginning of 2006 but is expected to intensify later in the year. In 2007 investments are expected to restore a high growth pace.
- Growth rate of imports is expected to continue to surpass export growth.
- Consumer inflation is forecasted to stay at around 12% in the next two years.

3.2 Legal framework

From a Ukrainian creditor's perspective there are major obstacles to an expansion into mortgage lending:

1)
An appropriate real estate register is not in place.

Registration of real property rights allows a creditor to assess the ownership as well as to ascertain any third party's rights to the property. The current registers are not centralized and are not publicly available. The consequence for a potential creditor is that the above information can not be verified.

2)
Enforcement of rights in mortgage collateral is complicated and lengthy (foreclosure) The court proceeding and execution procedures are highly uncertain and time and cost consuming. In practice legal enforcement may last from six months up to a few years. It may cost up to 30% of a debt value for numerous fees, legal expenses, etc.

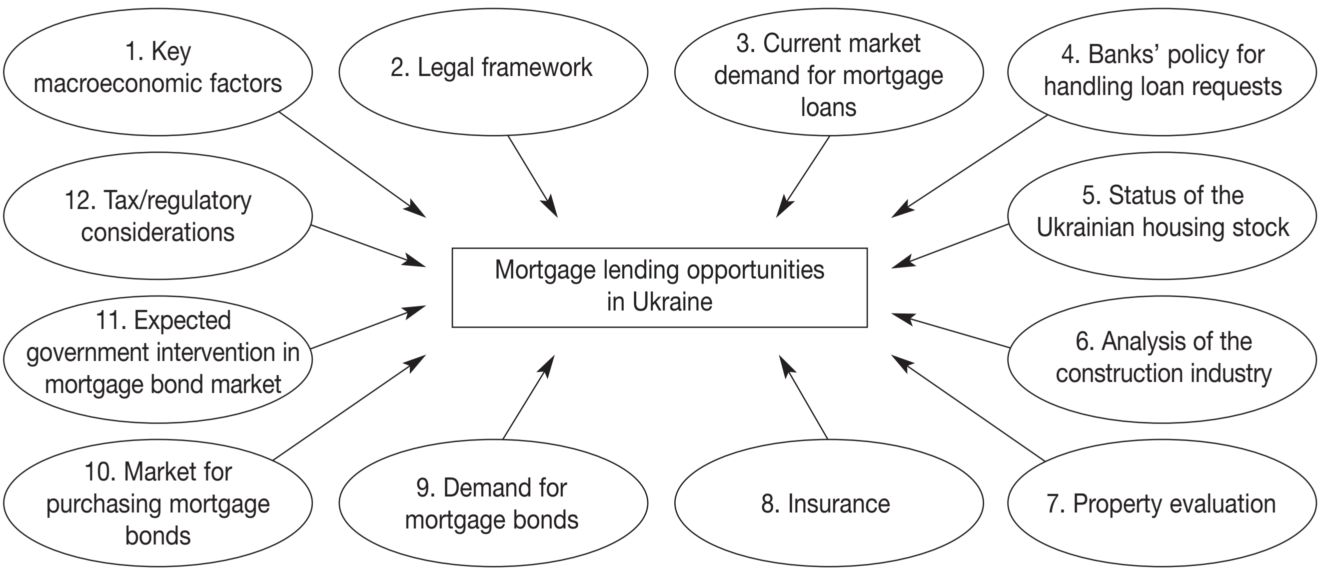
With respect to enforced auction, the only body which is authorized to operate such auctions is "Ukrspetsjust" which is a subsidiary of the Ministry of Justice. The consequence of this highly monopolized situation is that prices are significantly below the market.

Finally, eviction procedures do not work in practice.

3)
Lack of consistency between the Law on Mortgage and other laws.

There are number of conflicts between Law on Mortgage and other laws. In addition various ambiguities, discrepancies and irregularities exist in definitions. All in all this can lead to malpractices, market disruptions and losses to creditors.

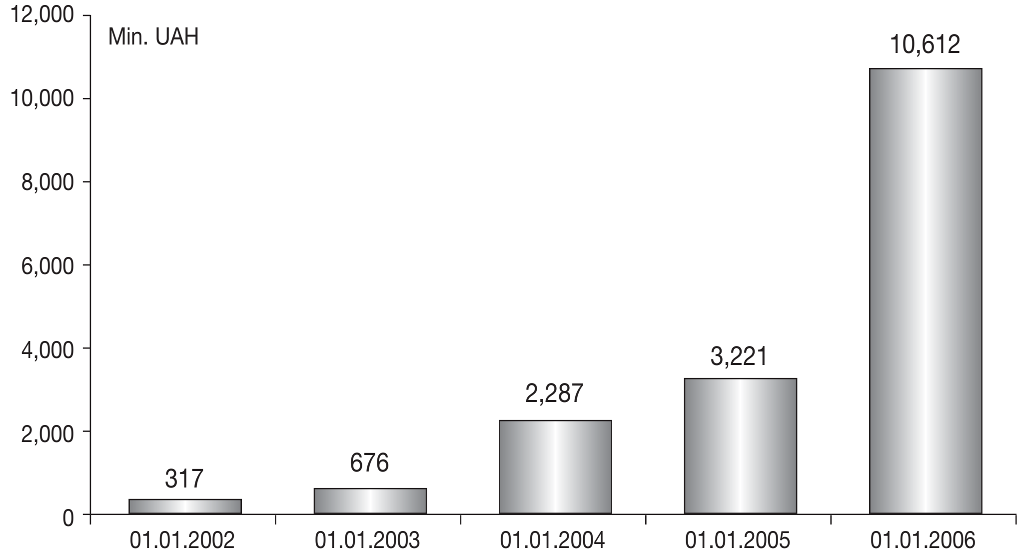
Chart 1. Factors affecting mortgage lending opportunities



[4] EU Project: "Establishment of Mortgage Market Rules and Legislation – Ukraine": Working Paper No 1: Strengthening The Ukrainian Mortgage Structure" (Authors: Leif Andersen, Olena Prokopovych, Anton Sergeev)

[5] Institute for Economic Research and Policy Consulting: "Macroeconomic Forecast Ukraine", No. 1 May 2006.

Chart 2: Outstanding debt under mortgage loans, 2002-2005, UAH million[6]



Currently the government is considering changes to legislation to improve the legal framework for mortgage lending, for instance in setting up a unified registration system of real estate.

3.3 Current market demand for mortgage loans

As chart 2 illustrates, mortgage lending has increased considerably over the last few years, and particularly from 2005 to 2006. The growth was even higher in the second half of the year than in the first half, which is noticeable as the economy generally slowed down. The share of mortgage lending grew from one percent of GDP to 2.5 per cent during 2005. The importance of mortgage lending for the banks is also illustrated by the fact that the portion of mortgage loans in the overall lending portfolio grew from 3.6 percent at the beginning of 2005 to 7.4 percent at year end. By the end of 2005, 82.7 percent of the mortgage portfolio was denominated in hard currencies, mainly USD but also EUR, thus only 17.3 percent were UAH-denominated loans.

The leading banks in driving this growth are Ukrsotsbank, UkrSibbank, Aval Bank, Privatbank, Raiffeisenbank, Finance & Credit Bank, Nadra Bank and Pravex Bank. A number of these banks are fully or partly owned by Western European banks.

3.4 Banks' policy for handling loan requests[7]

Distribution channels:

Obviously the traditional branch network is used as a distribution channel. However, some banks used only their regional branches or special dedicated branches for processing the loans whereas the smaller branches and outlets were mainly used as points of sale. Some banks had established or were in the process of establishing so called "Mortgage Centers" where all service providers needed for mortgage clients are located in the same building, e.g. the banks, insurance companies, notary, and real estate agents. Some banks used real estate agents, construction companies (primary market) and to a lesser extent insurance companies as distribution channels. One bank processed 90% of its underwriting based on real estate agents as distribution channel.

Loan products:

Several banks did not finance construction projects. However, all financed new residential property as well as property related to the secondary market. In fact all legal loan purposes including refurbishments and acquisition of consumer goods are eligible for finance as long as adequate collateral is in place and the customer's credit worthiness is deemed acceptable. In other words, it is entirely the value of collateral and the financial standing of the borrower to which the bank refers in its approval decision. According to UNIA, a large number of loans are taken by existing owners of flats with the purpose of buying a new flat, and these are usually paid to the construction company even before the building activities have started.

[6] Ukrainian National Mortgage Association: "Ukrainian Housing Mortgage Market – Analytical review for 2005"7 Source: The Project's interview of twelve banks during February-March 2005 and UNIA's research conducted in early January 2006.6 Ukrainian National Mortgage Association: "Ukrainian Housing Mortgage Market – Analytical review for 2005"

[7] Source: The Project's interview of twelve banks during February-March 2005 and UNIA's research conducted in early January 2006.

Another quite common loan purpose is to borrow in order to buy a small flat for a family's children which they can use while they study.

The terms and conditions obviously vary from bank to bank. Loans are offered in UAH as well as in USD, and also in Euro. However, finance in USD is by far the most common, and the Euro is rarely used. Loan repayment is usually monthly based on the annuity principle, and interest is usually fixed throughout the life time of the loan. The loan durations vary from 1-30 years depending on loan purpose and the bank's internal policy, however prepayment is frequent, and it is not uncommon that a 10-20 year loan is paid within 3-5 years. The median interest rate was 16-17 percent on UAH denominated loans, 12.5-13 percent on USD denominated loans, and 11.5-12.5 percent on EUR denominated loans as of beginning of 2006 . The interest rate has generally been lowered over the last years due to a more fierce competition. From beginning of 2005 to 2006, the interest rate was reduced between 2.5-4 percent dependent on currency and the banks. In addition to the interest, many banks charge a monthly fee, between 0.1-0.2 percent of either principal or outstanding balance. Such a fee de facto increases the effective interest paid by the borrower. Many banks do not have maximum loan amounts, however, the typical loan size, depending on the location and whether the real estate relates to the primary or secondary market, varies between USD 10 – 80 thousand. Average loan sizes in Kiev and other major cities are considerably higher. The loan to value percentage is between 70-85 percent. Some banks may extend loans without a down payment against additional collateral.

Loan origination procedures:

The main procedures followed are almost the same for all banks: Based on the loan application, which include data on income, fixed costs, family size, net assets, etc. the maximum loan size is calculated. Usually the monthly payment on loans should not exceed 40 – 80% of disposable income (documented income after tax and all fixed costs). In some banks the "security service" is tracing the potential borrowers' previous willingness and ability to pay by using a microfinance credit methodology .

Hereafter the potential borrower identifies a property which he wants to buy and the property is valued either by an independent appraiser or an appraiser employed by the bank . The client and the property are usually then assessed through a manual scoring system, and if the client is eligible for a loan, a loan and mortgage agreement is signed, and at the same time the borrower takes out an insurance policy. Hereafter, the loan will be disbursed after the down payment has been paid.

In all cases, property insurance needs to be taken out, and some banks require in addition legal title insurance, and insurance against the insured death or loss of work ability.

3.5 Status of the Ukrainian housing stock

Ukraine started its residential privatization in 1993, allowing the current tenants to transfer the occupied residential housing stock into their private ownership. Currently, around 85% of the total residential housing stock is in private ownership, which is quite high compared with the average in Western Europe (especially Germany).

As of beginning of 2006 the housing stock was approximately 19.08 million with an average of 22 sqm living space per person. Almost one third of the population resides in housing of unsatisfactory quality. A third of the population lives in conditions where there are less than 14 sqm per person. Of living space, almost 70 percent of the housing stock is more than 35 years old, and 20 percent of 4-person families live in 2-room apartments[12]. Despite yearly increases in construction since 2000, the level of new residential construction, at some 8,000 units, is still only 37 percent of what it was at its peak in 1987. The pricing development of the secondary housing apartment market per sqm in Kiev for 2005 in USD[13] is shown in chart 3 opposite:

As illustrated, the prices increased approximately 50 percent depending on apartment size. A similar trend can be noted in the primary housing market, with approximately 35-40 percent increases. The same trend exists in fast growing cities such as Dnipropetrovsk, Kharkiv, Donetsk, Lviv, Odessa, Sevastopol and Yalta whereas cities in more remote areas as Rivne, Ternopil, Vinnytsia, Sumy, Zhytomyr, and Chernigiv encountered increases between 20 and 25 percent. The prices of residential property per sqm exceed those of for instance Warsaw and Budapest.

The key driver of house prices in Ukraine seems to be developer 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 percent upward – with the Kiev average in the range of 500-700 percent. For Kiev, one interviewed lender for example suggested typical construction costs of 300 USD per sqm in contrast to sales prices of 1000 USD per sqm. These

[8] Ukrainian National Mortgage Association, op. cit.

[9] For instance by interviewing persons with a knowledge of the potential borrower' s willingness to pay.

[10] Sometimes the property is selected by the client prior to the customer application.

[12] According to Mr. Yuri Blaschuk, chairman of the board of International Mortgage Bank

[13] Ukrainian National Mortgage Association, op. cit. 2005

[14] The Project's Working Paper No 2: "Consumer Protection Issues in Mortgage Lending in Ukraine: Case, Scope and Implementation Strategy for Regulation". Authors: Hans-Joachim Dubel and Gennadiy Shemshuchenko (draft).

numbers are extremely high in regional comparison – for example in perspective of typical margins of approximately 35 percent in neighbouring Romania[14].

3.6 Role of the construction industry

The Ukrainian construction industry is proving to be a highly lucrative business sector, with the soaring demand for all types of real estate and increasing property prices. Around 80% of the activity on the market is new construction, renovation being the secondary factor.

Unfortunately this sector of the economy is not transparent. The growing construction markets of major urban areas are divided between the companies with close links to city administrations. These links distort the market and significantly reduce competition among construction companies. Furthermore, the imperfect land allocation system allows construction companies to obtain valuable construction sites in long-term lease in exchange for promises of future investments into their development (which might never crystallize). The land sale tenders are virtually non-existent. These factors allow for the rise of corruption and growing dissatisfaction of the urban population with the construction practices.

3.7 Property evaluation

Property evaluation procedures in Ukraine are well regulated. All of the rules correspond to International Evaluation Standards and to EU Standards of Real Estate Evaluation.

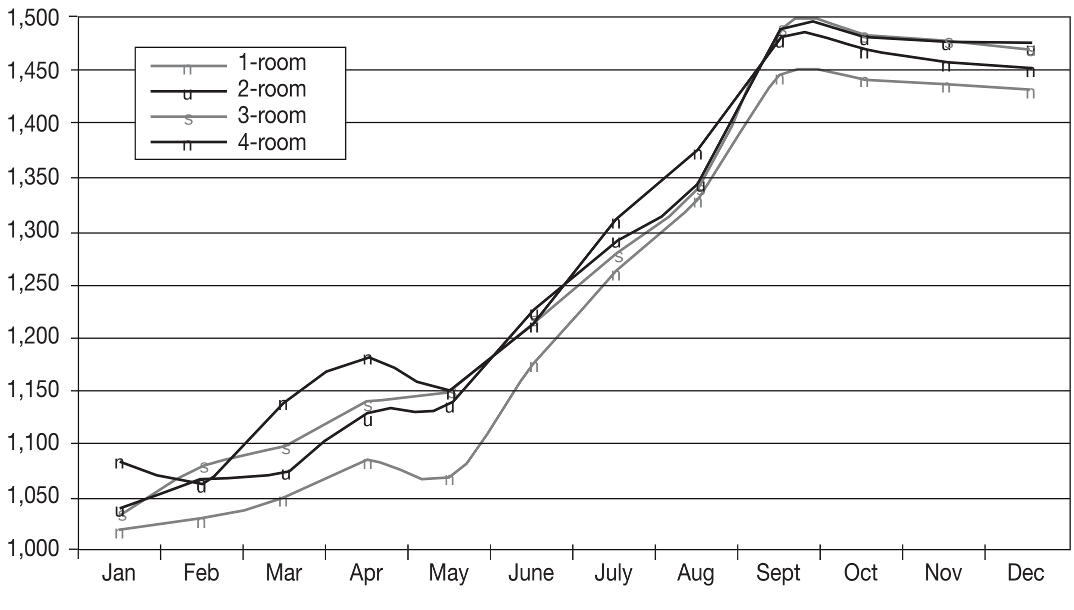
All of the physical or legal entities conducting evaluation are required to be certified. The certification requirements are standardized and correspond to the EU guidelines. There is strong competition on the Ukrainian real estate evaluation market. Property evaluators are largely independent. Many of them are members of the Ukrainian Real Estate Evaluation (Realtor) Association as well as its regional branches.

3.8 Insurance

The Ukrainian insurance industry is still relatively small and undeveloped, however developing dynamically.

The practices of insuring risks of banks are very rare due to the overall low sophistication of the Ukrainian financial sector. However, this situation is likely to change in the near future. Currently, the banks are interested to insure their consumer lending risks. Since most of the banks are using some type of collateral, which is usually the item purchased by the client, they are interested that their clients insure the collateral. Present National Bank regulations unfortunately do not stimulate wide usage of insurance as the key instrument of banking sector risk

Chart 3 – Price development in the secondary housing apartment market in Kiev, 2005 (in USD)



[14] The Project's Working Paper No 2: "Consumer Protection Issues in Mortgage Lending in Ukraine: Case, Scope and Implementation Strategy for Regulation". Authors: Hans-Joachim Dubel and Gennadiy Shemshuchenko (draft).

management. A number of banks have their subsidiary insurance companies through which they insure all their risks.

In mortgage loan transactions, banks usually require their clients to have the following types of insurance[15]:

- real estate property insurance
- legal title to the real estate property insurance, and
- Accident insurance and in some instances insurance against death of the borrower

3.9 Demand for mortgage bonds

The experience from other countries clearly suggests that the main buyers of mortgage bonds are investment funds, pension funds, insurance companies, banks, corporate investors and private individuals. In some countries, foreign investors are market players as well.

The insurance industry as previously mentioned is in a very early stage of development as described in the previous section and the Ukrainian economy is under-insured[16]. In this respect, it is important to note that the insurance sector is expanding rapidly albeit from a small base. The Law on Insurance was adopted by the parliament in 2001[17]. The insurance companies mostly invest in deposits, foreign currency, and real estate. However, they may in future invest in bonds, corporate and government as well as mortgage bonds. There are examples that insurance companies have invested in corporate bonds, however, not on a regular basis.

According to Benfield's study[18], the economic upturn in the last years has brought into existence a definable and growing middle class with money to spend on luxury goods. The spending power of this small group of the population is increasing. It has stimulated markets in property and consumer goods and created demand for insurances and consumer credit. Income has increased significantly and is also expected to do so in the future as other economic and structural reforms take place, however at a slower pace.

As regards pension funds, the key legislation was passed in 2003. The scheme consists of three pillars and the third pillar scheme is under the Law on Non-State Pensions which came into effect at the beginning of 2004. The law permits three types of schemes, one of which is funds run by the financial services industry such as banks and insurance companies[19]. In June 2004, the first four non-state pension funds were registered, and they include two banks, Aval Bank and VA Bank[20]. According to the chairman of the State Commission for Regulation of Financial Services Markets in Ukraine, 23 non-state pension funds were registered as of 01.04.2005. The chairman further mentioned that there is a huge interest in establishment of non-state pension funds and that almost all banks either have already applied or are preparing documents for registration.

There have not been any private individuals who have invested in corporate bonds. Foreign investors are not in the market yet.

Regarding *investment* funds, the law "On Collective Investment Institutions"[21] was put into force in 2001, and establishes comprehensive rules for setting up, operating and liquidating investment funds and asset management companies in Ukraine. In addition it provides substantial tax incentives for portfolio investment through the funds. According to the information from the "Ukrainian Association of Investment Business", 105 investment funds and 88 assets management companies were active in Ukraine as of 01.01.2005. The funds available are primarily invested into shares of companies with substantial assets primarily in real estate, and less than 1 percent in corporate bonds.

Based on the above, it is not likely that mortgage bonds will be a major object for investments in the future, if the prospect for increasing real estate prices remains unchanged, as the alternative investment opportunities will be deemed more lucrative.

3.10 Market for purchasing mortgage bonds

The only experience with issuing papers similar to mortgage bonds in Ukraine is a specialised bank based on a special "experimental" law that directly applies to one bank. A market is not yet in place, since mortgage bonds are not issued. The bond market encompasses the trading of corporate bonds which is the largest part of the bond market covering a variety of industries including banking. Although the non-government bond market is growing, it is still relatively small compared to the loan portfolio of commercial banks, and amounts to less than 3 percent of the total loan portfolio of the commercial banks.

Government bonds are the second largest part of the bond market after corporate bonds. The market is very imperfect with limited monthly turnover. 2003 was the year for the re-launching of municipal bonds offering by the city of Kyiv after municipal

[15] According to Raiffeisenbank Ukraine.

[16] "Insurance Market in Ukraine", Institute For Economic Research and Policy Consulting, March 2004.

[17] The following is based on: "Ukraine Debt Market Assessment", May 2003, Deloitte Touche Tohmatsu.

[18] "Ukraine Insurance Market Review", June 2003.

[19] "Pension Reform in Ukraine", May 2004.

[20] "Pension Reform in Ukraine", June 2004.

[21] Under "collective investment institutions" are meant the investment vehicles with varying levels of risk for investing in the stock, bond or money markets. The Ukrainian legislation foresees the establishment of venture funds, corporate and unit funds.

bond issuance faded away in the late 1990s when the city of Odessa defaulted on its bonds.

3.11 Expected government intervention in the mortgage bond market

The Government has created a financial institution, called the State Mortgage Institution (SMI), which should refinance residential mortgage loans. Institutions such as the SMI are usually referred to as "liquidity facilities", and describe the service they offer, ie providing liquidity to lenders based on refinancing long-term mortgages. Liquidity facilities primarily serve a role of a supplementary funder, being tapped on an as-needed basis by lenders who usually acquire the bulk of their funding from shorter-term sources, primarily bank deposits. The funding allows the lender to extend the average term of the funding, but not to eliminate all funding risks. The SMI will thus make loans to qualified mortgage lenders based on qualified mortgage collateral, and use the issuance of corporate bonds as its primary mode of raising funds. The loans would primarily be for a period of 3 to 5 years, although shorter periods could be made available, as could longer periods, if the bond market in Ukraine begins to support issuance of bonds for longer terms.

Although the SMI was established early 2005 it is hardly functioning, and has become a political football. It is the authors' assessment that due to political considerations it may never fully function.

3.12 Tax and regulatory considerations

The Cabinet of Ministers of the Ukraine has approved a resolution in which it is mentioned "To ensure implementation…., it is necessary to enhance tax legislation envisioning introduction of tax deductions for revenues received as interest or yield on investments into mortgage securities issued by residents of Ukraine".

4. Approach to intervention

The project's Terms of Reference was the most important guiding document in the planning of the technical assistance. However, for various reasons since the ToR was finalized after two years had elapsed, and in the meantime a number of other donors were already active in delivering technical assistance. A key objective of our project was obviously to avoid duplicating other donors' interventions, and we therefore undertook a number of initiatives to coordinate activities with all major donors. It was agreed that our Project should concentrate on further development of the primary market as a sound primary market is a prerequisite for a well functioning secondary market. Another major donor would focus on the secondary market. This decision was also based on the fact that the other donor's intervention has a duration of five years which is often a minimum requirement for secondary market development. Furthermore, as several other donors were highly involved in improving the regulatory and legal environment for all major aspects of mortgage lending the resources for this component were reallocated to other project components for the purpose of a higher benefit to the country.

An important input to our final project design was also interviews of the 12 most important mortgage market players, covering 75 percent of the mortgage portfolio at that time. One of the purposes of the interviews was to get the "clients'" opinion on their needs and requirements.

In relation to strengthening of the primary market development some of the priority areas are risk management, training of mortgage credit officers, support to product development and alternative distribution channels, dissemination of other countries' mortgage market structure aiming at providing inspiration for the further development and design of the Ukrainian mortgage structure, and consumer protection. In order to fulfill those wishes, study tours to three countries were also organized.

Another key aspect of our project design and approach is related to make the programme as tailor-made as possible to the Ukrainian environment. Ukraine is unique as far as culture, economic and legal environment, etc are concerned, and all solutions suggested should be tailor made. Obviously inspiration from other countries is important but should be used as a "tool box", not pure duplication. In order to pursue this working approach we decided to select two pilot banks for capacitating of the banking sector in risk management and development of new mortgage products and distribution channels. In working with banks directly, and subsequently posting the deliverables, such as manuals, workshop presentations, forms, etc. on UNIA's website and thus making them available for all major mortgage providers, we are able to ensure that our results are not only academically correct but also adapted to the Ukrainian banking environment.

In fine tuning the program, the Project was well aware of the need to establish synergy between the various deliverables and components. Here are some examples:

1. As mentioned above, risk management and product and distribution channels development were deemed important by the banks. Consequently, we ensured that those topics were well covered in the study tours to the three countries the Project visited with senior Ukrainian bankers;

2. We invited some senior bankers involved in our "train-the-trainer" program as trainers, cf. below, to the study tours so that they in turn could provide the trainees with experience from other countries;

3. For the study tours, we invited two journalists to participate so that they in turn could disseminate important issues through the press regarding "best practice" of our Project;

4. Our deliverables for the pilot bank in risk management relating to credit scoring methodology were incorporated in the training of mortgage credit risk officers;

5. We initiated a Code of Conduct aiming at introducing consumer protection to the Ukrainian mortgage environment. At

the same time we included the topic in our training of mortgage credit officers.

6. A working paper is being issued on consumer protection in order to further broaden the knowledge of the Code of Conduct and the applicability for banks as well as for the consumers.

Last but not least, in all our interventions we are whenever possible channelling those through UNIA in order to increase the sustainability of the organisation. An increase in the services offered by UNIA quantitatively as well as qualitatively channelled through UNIA has so far led to an increase in the number of members as well as a general lift in membership fees.

5. Examples of intervention

The project consists of a number of areas of intervention and deliverables which can not all be described in a relatively short article. The authors have therefore decided to select three main areas, and describe these in some detail. The selected areas are training of mortgage credit officers, a risk management pilot project, and market information on the mortgage lending system.

5.1 Training of mortgage credit officers

Introduction

During our interviews with 12 banks, it became obvious that one of the key constraints to further outreach of mortgage lending was the lack of trained mortgage credit officers. In order to substantiate the needs, our Project in liaison with UNIA conducted a survey among banks, insurance companies, and various state institutions related to the mortgage market development. The outcome was that the total needs exceeded 3,600 professional staff.

Obviously we could not train such a huge number directly, and we decided to launch a “train-the-trainers” program whereby 80 high calibre staff were taken through a six day training course, and enabled to train 2,000 employees. The aim was to establish a “turn-key” training, so that the final trainees would be able to perform their tasks in the banks in the areas of loan origination, monitoring and delinquency management. Exceptions were obviously training in the banks’ internal procedures and IT systems. Also from a sustainability perspective, it makes sense to train selected staff of banks and other institutions so that they in turn can transfer knowledge to employees of their own institutions.

Needless to say, high quality training is always essential but in this case very critical. If sub-standard training was provided to 2,000 employees it may have a detrimental effect on the whole mortgage lending environment. The project took therefore a very conservative approach (as outlined below) to the training development.

The training had two major components, obviously the mortgage lending but also in training methodologies for adults as learners. Many of the selected trainers were quite strong in retail lending but inexperienced in training and others were bank trainers without retail credit experience. The third group, the non-bankers, was generally without either of the two skill sets. The “art” in the design and in conducting training was therefore to take into account the lack of homogeneity of the group. Fortunately this “blend” of professionals with different backgrounds turned out to be ideal, as interesting discussions facilitated our aim of having a high degree of interactive training.

Preparation of the training and the training materials

The programme in mortgage lending necessitates careful planning and high involvement of stakeholders to ensure commitment and sustainability. Therefore, right at the outset of the planning we initiated a “training committee” consisting of senior representatives from the sector to be trained, and from the Project. The members encompassed representatives from a number of larger and smaller providers of mortgage loans. This was deemed necessary to ensure that the training needs were fully understood and that all Ukrainian specific issues were taken into consideration in the design of the training. In addition the committee also helped to create commitment and ownership. The purpose was that the committee should sign off on all major deliverables, i.e. the training curriculum and all training materials, which finally exceed 800 pages.

Two days were dedicated to training methodologies, the first day where theory was presented, and on the sixth day where the attendees performed their own training based on what was achieved during the whole training session.
In addition to the sections on trainer/adult training, the mortgage lending methodologies consisted of the following components:

1. Elements and stages of the mortgage lending process;
2. Basic mortgage lending risks;
3. Mortgage instruments;
4. Regulatory and legal aspects;
5. Legal aspects of mortgage origination and delinquency management;
6. Prequalification assessment of borrowers;
7. Underwriting procedures, including scorecards, financial calculations of mortgage loans, assessment of borrowers’ debt capacity;
8. Insurance issues;
9. Housing market dynamics;
10. Methodological approach to property appraisal;
11. Housing construction issues;
12. Business game;
13. Loan monitoring and delinquency management; and
14. Consumer protection.

In addition to the above off-site training, the attendees participated in a one day on-site training with an appraiser or realtor, and accompanied the appraiser in visiting and appraising selected residential objects. The completion of the on-site training was the responsibility of the participating financial institutions.

The training material should ideally be designed by the same persons who are subsequently going to execute the training. The Project identified twelve local experts, each of them with a deep knowledge of the topics they were supposed to cover. In doing so, it became clear that most of them had no or limited experience in performing training and designing first class training materials, for the latter including business games, case studies, exercises, etc. Therefore, all short term experts went through a training course covering training methodologies as well as design of training materials. Afterwards they were tested to ensure that minimum requirements were in place.

The development of the training materials proved, as expected, to be a complicated process with up 9-10 drafts before final version was reached. The Project had announced high standards for the material with no room for compromise.

When the Project had assessed that the material could be accepted, it was then reviewed by an experienced mortgage banker for consistency and for compliance with the Ukrainian financial and regulatory environment as well as for consistency with "best banking practise" in Ukraine.

Apart from hard copies of the training material, soft copies were provided as well. In addition, all training sessions were recorded on a DVD so that the trainers can use the media as preparation for their own training sessions.

5.2 Risk management pilot project

As mentioned above, the purpose of the pilot project was not only to assist the selected bank but in addition to disseminate the results and experience gained from the programme through adding them to UNIA's web-site so that all member banks would have access to the information.

Seven banks were short listed for the pilot project based on pre-determined criteria[22], the banks were asked to fill in a risk management questionnaire, and based on the response to the questionnaire and subsequent interviews, the pilot bank was selected. The deliverables from the pilot project will thus be beneficial for the many banks which are currently preparing to enter into this business line.

After signing a memorandum of understanding to protect the confidentiality of the bank while allowing broad dissemination of the main deliverables, a risk management due diligence was performed, and a working group on mortgage business development was established. The main purpose of the working group is to increase the efficiency of the pilot project. The bank's representatives are key professionals from different departments related to retail business development, such as IT, legal, sales, security, methodology, risk management and client service department. From the Project, the risk management consultants participate.

It is worthwhile mentioning that the Project deemed it very important to have the right "blend" between international and local consultants in place in order to enhance the sustainability of the pilot project. Risk management staff is a scarce resource in Ukraine, and the Project therefore decided to recruit young, talented staff with a strong willingness to learn, with an attitude of delivering high quality deliverables, and either with a mortgage background or an engineering background. They were, and still are, being intensively trained by the international consultants.

The concrete deliverables, discussed and agreed with the bank are listed below. Some of the deliverables are in place; others are still in progress as the consultants will continue to work until mid December 2006.

Main deliverables are:

1. *Risk management organization recommendations.* It needs to be very clear which departments are responsible for which tasks. Our pilot bank is quite conservative with the risk management function more influential than the business lines. This may be quite sensible in a very volatile environment; however, sound and profitable business should not be prevented. We see it as an important task to build bridge between the risk management function and the business lines so that sound business can be generated in accordance with the bank's risk appetite.

2. *Scoring systems*. Based on the bank's current profile and strategy, we are providing recommendations on best practices in scoring systems and in their implementation. We are developing a manual for scoring model application, which includes scoring card adjustment procedures, implementation plan and resource allocation. Finally, we will train personnel including local experts.

3. *Operational risks.* Operational risk is quite high in Ukrainian banks in general. We are providing the bank with specific recommendations on human resource development in mortgage lending; especially people risk (fraud) and possible mitigation measures. Further, we are delivering a general guide covering operational policy on mortgage lending including all operational risks (people, process, system, external), and closely linked hereto, we are delivering a loan administration/monitoring manual covering operational risks. As a part of the deliverables, training sessions and workshops are integrated. We will qualify and quantify risks for a specific organizational unit within the bank, namely the retail banking credit scoring.

[22] They were: the bank must have implementation of mortgage lending as a strategic goal, have a strong IT department in place, have a solid legal department, and should already have a relative strong risk management system in place. In addition, it should have an interest in working with the Project, and finally there should be no evidence that the bank is currently considered as a privatization candidate.

4. *Asset/liability risks.* The bank is relatively advanced in market risk management, for instance is using Value-at-Risk. However, the nature of mortgage lending, ie long term lending, and in Ukraine primarily in foreign currencies makes it applicable to review the liquidity, interest and foreign exchange risk management vis-à-vis the new business line, and provide appropriate recommendations, for instance in matching assets and liabilities.

5. *Regulatory risks.* We are assessing the risks in mortgage lending vis-à-vis the Ukrainian legal system and NBU regulatory framework, and we will provide recommendations for mitigating these risks.

6. *Insurance in mortgage lending.* We will assess the mortgage property, title, life and accident insurance procedures, and make specific recommendations for improvement and conduct the necessary training.

7. *Mortgage lending IT package.* We will evaluate IT packages, including underwriting module and MIS, and make specific recommendations to assist the bank in preparing specifications to fulfill its IT requirements for mortgage lending. Linked to that we will suggest amendments to existing information technology regulations, including IT security, related to mortgage lending.

5.3 Market information on the mortgage lending system

This component has proven to be very important. Public education is a key issue for dissemination of knowledge of mortgage. It became very clear for the Project at the outset that the public knew very little about mortgage, and public awareness became an important issue as without that, it is difficult to improve access to credit.

The first step was to develop a comprehensive communication strategy, outlining the vision for the Project's public information actions and focusing on the implementation of a number of consistent and well planned actions. Examples of actions implemented based on the communication strategy[23] are listed below.

1. *Agreement with a leading, nationwide, news agency.* The agency is specialized in providing accurate political and business news. The agreement obliges the agency to provide the Project and UNIA with several services, for instance to provide information on all mortgage and real estate related issues, regularly to publish Project/UNIA materials, such as news reports and press-releases.

2. *Press-club meeting.* A cascade national press-club meeting, "Mortgage Lending: Its Role and Importance in Ukraine's Economy" was arranged in Kiev. It attracted more than 60 national and regional media representatives, and involved Members of Parliament, government officials, specialists from the country's leading commercial banks, and real estate organizations. The outcome was extensive coverage of both mortgage developments issues and Project activities. The number of press publications, TV and radio programmes amounted to more than 30 reports. Similar meetings have been held in other cities.

3. *Mortgage workshop for journalists.* The Project has held a 6-hour long 'workshop' entitled 'Mortgage Market Development Coverage in the Media'. The workshop attracted around 50 journalists from 10 regions of Ukraine; several speakers were heads of retail departments from some leading commercial banks. The main goals were to help the participating journalists specialized in writing on economic development issues get rid of some common misconceptions surrounding mortgage market and mortgage lending; have a deeper understanding of how mortgages work, in particular, and why mortgages are significantly important for the national economy development, in general. In addition they had a chance to learn the intricacies of reporting economic news and writing features on mortgage lending and housing market developments.

4. *"UNIA's Tuesday Breakfasts".* To increase the number of UNIA members, the Project has launched a series of breakfast meetings with representatives of senior management of banks. The meetings have been successful as a number of new members signed up, which has improved the sustainability of UNIA.

5. *Booklet: "What is a mortgage?"* The aim is a comprehensive consumer guide, Ukraine's first independent guide to mortgages, available for public distribution nationwide via various channels. A focus-group has been viewed as a significant tool in improving the general value of the guide. The panel's recommendations have been carefully analyzed and where applicable, taken into account. The circulation is planned to be 12,000.

6. *Series of radio programmes.* The series has been planned as a valuable information source and will focus on key mortgage issues, mortgage lending conditions, consumer protection and international cooperation in mortgage market development in Ukraine. These individual radio programmes will be aired on one of the country's leading FM radio stations, as well as on selected radio stations in Ukraine's regions.

7. *Televised episode for national TV.* The televised episode will be produced in the remainder of the Project. It is planned to compare Ukraine's mortgage market developments to the experience of the country's closest neighbours. It will be produced in close cooperation with UNIA's foreign

[23] Defined by the local expert of the Project, Sergiy Grytsenko.

partners in Poland, Slovakia and Germany. The goal is to have episodes that could be aired on the National UT1 TV Channel on a weekly basis, as well as submitted for free airing on TV channels in the regions.

Conclusion

Despite the numerous external and sector-specific challenges, the mortgage market in Ukraine is developing rapidly and attracting considerable international attention, including donor organizations. While this can have a salutary effect, particularly in supporting the growth and further strengthening of the primary and secondary markets, the experience of the project has shown that to continue to channel the growth in a positive direction, a number of aspects should be taken into consideration.

For one, it is important to take a broad approach and support the simultaneous development of the legal and regulatory framework, issues concerning risk, consumer protection and banking sector development, housing, construction and real estate, primary and secondary market players, and the role of government. The better the various interventions can be coordinated, the more impact they will have with the result that the sector growth is promoted in a competent and professional way.

The Project is attaining its particular success in adopting an approach which is both individual and holistic. We are working closely with individual players in the market, adapting and tailoring international norms to Ukrainian requirements and helping to generate a national best practice standard. At the same time, we are targeting broad areas of the Ukrainian mortgage market so that the disparate elements can work together as appropriate and develop simultaneously. We are working to ensure sustainability, both in the institutional support provided to UNIA and in the professional forums created for dialog and exchange on important mortgage issues.

Secondly, particularly in light of the large number of interventions by Donor organizations from countries with different legal, regulatory and banking system configurations, it is essential that recommendations be filtered and sorted to ensure that they are really appropriate for the Ukrainian market. Only in this way can consistency be ensured.

Last but not least, it should be noted that there is a pressing need for further training and information dissemination, both within the general population and among the stakeholders and players in the mortgage market. All training and widely disseminated information materials should be subject to the highest quality control standards and carefully checked for their relevance to the situation in Ukraine.

It can be safely assumed that the Ukrainian mortgage market will continue to grow and develop strongly over the next 5-10 years. A solid foundation for the further development of the market has been laid through the concerted efforts of government, the banks, UNIA and a number of other organizations and institutions. If growth can be managed as it has up to now, then the mortgage sector will be in a position to make a significant contribution to GDP growth of the Ukraine.

List of Acronyms

GDP	Gross Domestic Product
NBU	National Bank of Ukraine
SMI	State Mortgage Institution
ToR	Terms of Reference
UAH	Hryvna, Ukrainian currency (1 USD = 5.05 UAH)
UNIA	The Ukrainian National Mortgage Association