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MORTGAGE LENDING IN UKRAINE: PROBLEMS AND THE WAYS OF THEIR SOLVING

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. 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. 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. In terms of financial funds shortage we can propose several solutions of the problem. Firstly, we propose to keep the existing universal banking system and not to introduce a specialized system. Secondly, we recommend to favour the establishment of a system based on mortgage bonds, rather than on mortgage backed securities. 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.

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

The strong feature of the system of specialized 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 specialized 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

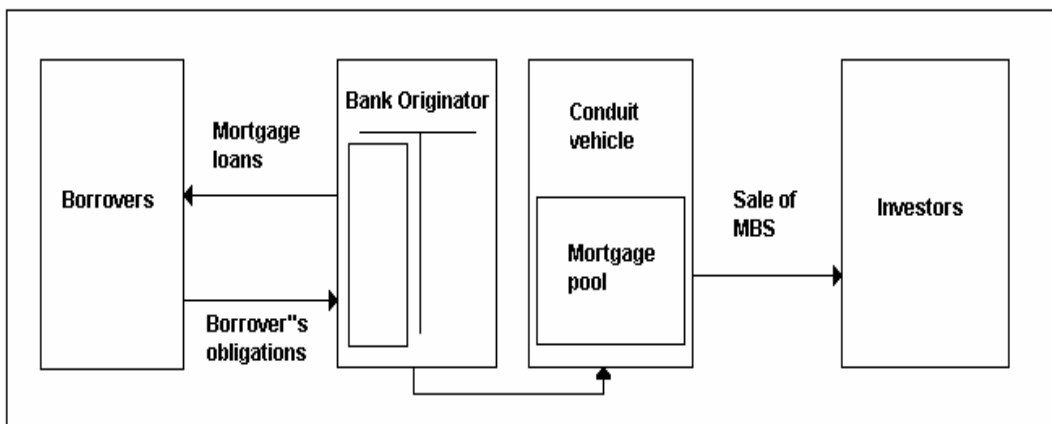
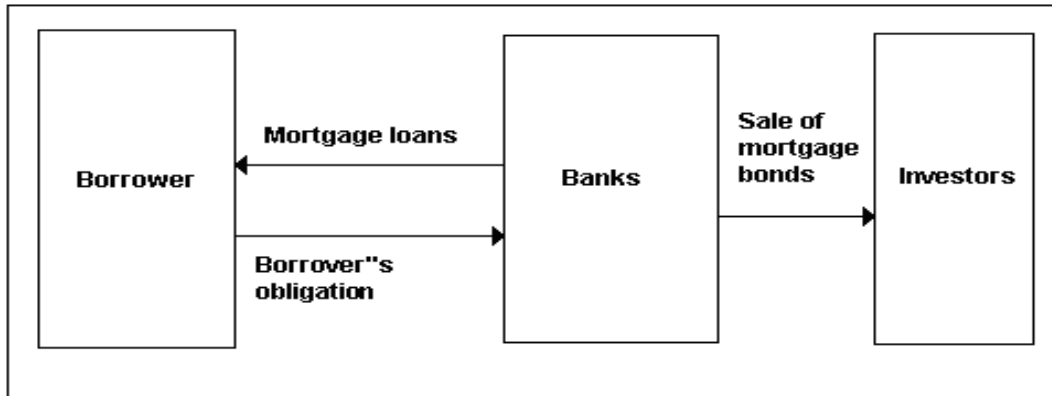
lending are allowed to take deposits from clients, which can be used to refinance part of the long-term mortgage loans.

But at least two further arguments can be put forward in favor of a universal and against a specialized mortgage banking system. First, the risk management and the financial stability of specialized 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, specialized banks have a 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 specialized system is very expensive. Under a specialized 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 it is better for Ukraine to retain the existing universal banking system and not to introduce a specialized mortgage bank system.

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” (securitized) into bonds, which can afterwards be sold to investors on the capital market. Broadly speaking, there are two main systems on how to securitize 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 securitized and the resulting mortgage bonds (“Pfandbriefe”) are sold to investors. 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, securitizes them into MBS and sells the resulting securities to investors. Banks are thus able to free equity capital and use it for further loans.

Mortgage bond system



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.

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 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. Besides, the possibilities for fraud are much higher in a MBS system. 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, securitizing 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. 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.

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 fulfill 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. 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. The new, safe mortgage bonds should be an interesting instrument of investment for many private and state institutions.

To summarize, it is desirable for the Ukrainian government and the NBU to legally create a special instrument called, “mortgage bond”. This instrument should fulfill high safety requirements, and state institutions should be allowed to invest in them. The stage of development of this market depends on the appropriateness of legislation. The year 2003 turned out to be very fruitful in terms of progress in legislation regarding mortgage lending regulation. The long-existing legislative vacuum in this sphere has been finally filled. Despite the progress the legal base is still imperfect.

At present, there is no centralized and publicly available system for registration of real estate property rights and encumbrance. As long as there is no centralized registration of real estate property rights and encumbrances, there is no system for mortgage registration. Thus, if the borrower defaults to repay the mortgage loan, the creditor cannot be sure of the priority of his claim on the mortgage object. In fact, the creditor is not able to find out encumbrances of the mortgage object, which directly affects liquidity and the selling price of the mortgage object.

Creation of a state system for registration of real estate property rights will first of all contribute to:

1. Supporting guaranteed rights on real estate and determining its encumbrances;
2. Creating the information base for taxation of real estate provided the proper legislation for taxation is in place;
3. Additional safety of loans and development of investment activity;
4. Efficient recording of real estate and transparency in signing contracts dealing with this property.

The existing procedure of satisfying claims on mortgage object through court decision or by notary executive inscription is extremely inefficient, lengthy, and costly for the creditor. It is necessary to introduce new quickly operating

mechanisms of decisions making in cases of loan non-payment and when claims on mortgage object are raised.

That's why it is essential to develop and adopt special provisions in legislation that would regulate details of extra judicial decision-making regarding foreclosure of mortgage object and would foresee possibility and procedures of forced management of real estate or its forced sale through public auction.

The success of the mortgage market will depend on the development of the stock market and activity of its agents. As for now, Ukraine does not have a developed institutional structure of the stock market. Attraction of long-term funds for mortgage lending remains the major problem in Ukraine. Considering the aforesaid, we can conclude that for development of mortgage market in Ukraine it is necessary to create a proper legislative base, which would be in line with international standards and would include positive experience of other countries. The banks' support to enterprises, entrepreneurs and citizens will become noticeable if there are reliable guarantees that bank loans are repaid on time. These very guarantees are provided by mortgage.

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 specialized mortgage banks. 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).

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