Part III

FINANCIAL FRAMEWORK FOR THE HOUSING AND LAND SECTORS

A. AVAILABILITY OF HOUSING FINANCE

Increased financial instability in 2009 has undermined the ability of households to finance their housing. Both mortgage payments and construction costs increased while households' disposable income decreased. To address the issue of shrinking investment in residential construction and support the construction industry, the Government adopted the Law "On Prevention of the Impact of the Global Financial Crisis on the Development of the Construction Industry and Residential Construction". This allows the Government to stimulate demand for housing through subsidies and cheap loans and to financially support the construction of unfinished residential buildings directly or through state banks and mortgage institutions.

Investment in construction

During the financial crisis in 2009, housing construction investment declined by 50% and total investment dropped by 35%. Public investment in housing at the national and local levels still does not exceed 3.5% of total investment.[87] The lack of mechanisms to facilitate the construction of affordable housing, including the availability of housing finance, has resulted in only a small increase in the housing stock in recent years.

Residential construction was concentrated in economically developed cities. In 2011, residential construction was 27% of total construction in the Kyiv area and residential construction in rural areas was less than 26% of the total. In this situation, building one's own home becomes the easiest and most affordable way to improve one's housing situation, especially for the rural population. In 2011, individual housing built by owners made up 55% of the total housing output.[88]

Based on market price dynamics and experts' estimates on supply and demand for multi-family housing, the demand for new and affordable multi-story housing is overwhelming. The supply is insufficient due to a lack of financial mechanisms to support construction companies. Residential construction is financed mainly from proceeds from the pre-construction sale of housing units.

According to legislation, non-government investment in residential construction can be done through only one of four options: residential construction investment funds; funds for real estate operations; institutions of joint investment; and the creation of housing bonds.[89] The first two schemes are regulated by the law "On the Financial and Credit Mechanisms and Management of Property for Housing and Real Estate Transactions" (law No. 978 of 19 June 2003) and are supervised by the State Commission for Regulation of Financial Services. The two other schemes are supervised by the National Securities and Stock Market Commission. The most common of these schemes are residential construction investment funds and housing bonds, especially for non-professional investors, because they are focused on purchasing residential real estate rather than generating profit from investments.

Residential construction investment funds provide additional external control over the finances of developers to ensure timely fulfilment of obligations.[90] The fund issues a certificate that gives ownership rights to the bearer for a specific flat in the building to be constructed. The certificates are subject to registration at the supervising agency and are transferable. Although this scheme protects the rights of the investor, the risk of failure for the developer remains high. With this scheme, the developer is required to disclose to the investor information on the financial activities of the fund before the investor signs the investment agreement. As of the end of September 2011, there were 12,200 investors investing UAH 7.6 billion (USD 950 million) in residential investment funds. Moreover, 10,400 units have already been constructed under this scheme with a household financial input of UAH 5.5 billion (USD 687.5 million).

Housing bonds also certify ownership rights but only for a specified area of the dwelling. There is no specific flat assigned to the bonds but they may be

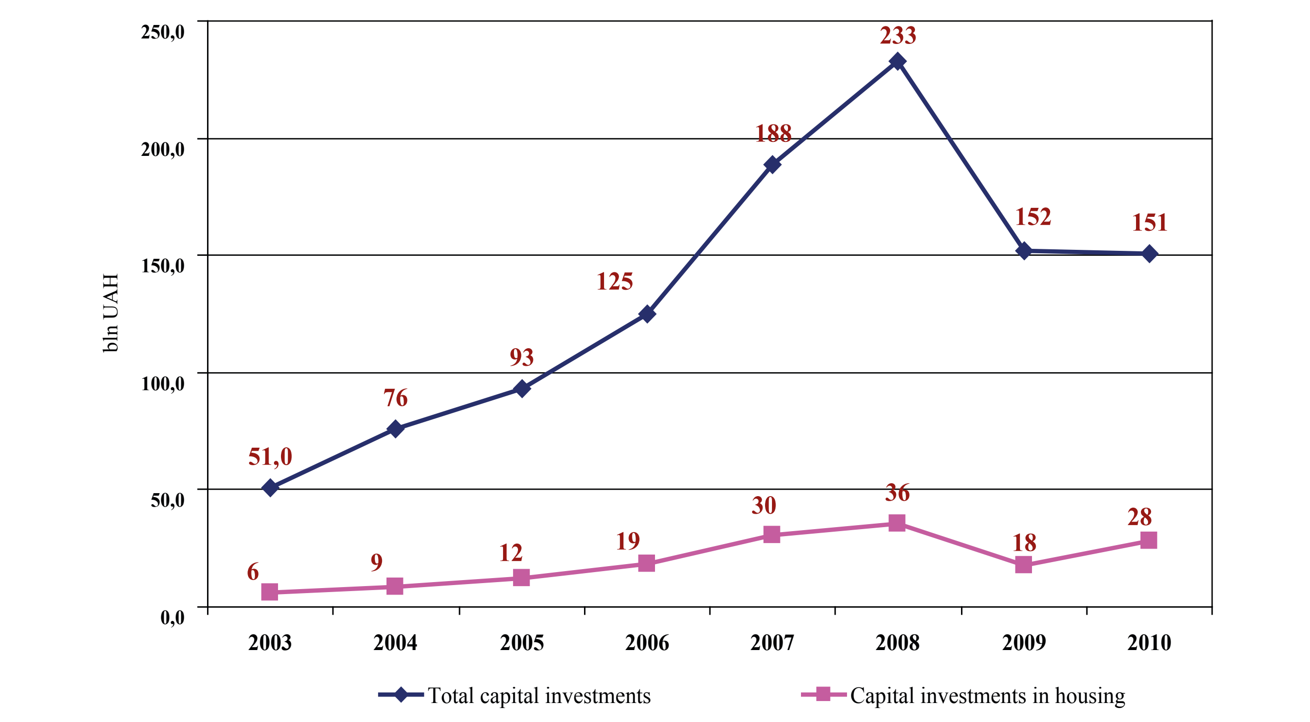
[87] MinRegion, *"Housing Construction",* 15 December 2011, Presentation.

[88] SSSU, *Commissioning of Dwellings in Ukraine in 2012* (Kyiv, 2012).

[89] Article 4 of the law "On Investment Activities" №1561 dated 18 September 1991.

[90] Control could be performed by the bank or other financial organization, who must obtain a special license from a supervising agency.

Figure 14. Annual capital investments and investments in housing at current prices



Source: MinRegion, "Housing Construction", 15 December 2011, Presentation.

exchanged for a dwelling that is equivalent in size to that indicated in the bonds.

Commercial banks do not consider housing construction loans as important components of their business, mainly due to non-transparent financial accounting, the absence of reliable data in the construction industry and a lack of knowledge and experience in residential construction underwriting. Outstanding loans to residential construction companies amounted to UAH 43.4 billion (USD 5.4 billion) in January 2012, representing 7.6% of total outstanding loans, of which 15.2% are delinquent.[91] The loans were mainly provided by banks to associated or controlled construction firms.

The cost of purchasing housing units at the beginning of construction is usually 30 to 50% less than buying them once they are completed. For this reason, buyers tend to purchase at the beginning of construction despite the fact that their rights are not well protected.

Funding for the improvement of existing housing stock

The mass privatization of residential dwellings in the 1990s resulted in significant underinvestment in housing maintenance. The Government's obligation ceased and most apartment owners cannot afford to maintain their units; moreover, even if flats are privatized, the Government generally still owns the building (including the roof, walls and common places) and therefore the new owners do not recognize their responsibility to maintain common spaces. This prevents the development of competition among maintenance companies as well as preventing the creation of HOAs. The experience of housing cooperatives in the maintenance of common areas of multi-family dwellings is still limited. Such coops are generally created for new housing construction and their development is limited by legislation (please see Chapter III for more discussion).

To stimulate the process of renovation of residential units, the Government drafted a law "On the First Capital Repair of Multifamily Buildings after Privatization" which provides financial support to HOAs. Moreover, in 2011, the Government spent UAH 35 million (USD 4.4 million) for this purpose. However, limited budgetary resources prevent the widespread implementation of this scheme; in the 2012 budget there is no money for the support of HOAs. Renovations are financed mainly by international donors through energy efficiency and utility modernization projects and by households themselves for privately owned flats within multifamily buildings, but some banks, like ProCredit Bank, offer loans for renovation. In 2012, the Government has reserved UAH 40 million (USD 5 million) to fund housing renovation and plans to provide loans for the technical modernization of housing through the State Fund for the Assistance

[91] Based on data from the National Bank of Ukraine.

of Youth Housing Construction. These loans will be payable in 10 years at 3% annual interest.

B. AFFORDABILITY OF HOUSING

Primary and secondary housing (real estate) markets

As mentioned above, the Ukrainian real estate market was seriously affected by the world financial crisis; the number of real estate sales dropped by 35% from 346,600 in 2007 to 224,900 in 2010. In 2011, the market showed some recovery as the number of real estate transactions increased to 255,000;[92] this growth represented a housing mobility rate of approximately 1.3%. Of this, an estimated 26% are primary real estate market transactions 26%.[93] The most active housing markets are Kyiv, with 9% of total transactions, and the Donetsk (13%), Kharkiv (9%) and Odessa (5%) oblasts. Less than 7% of the housing purchased in 2010 and 2011 was through mortgages.[94] The development of the housing market is influenced by ongoing government reforms[95] aimed at increasing transparency in the real estate market.

The Ukrainian housing boom from 2005 to 2008 was fueled by strong economic growth (7% GDP growth per annum), relatively low interest rates and, partly, by Ukraine's wealthy elite and foreign buyers. From 2002 to 2007, house prices in Kyiv skyrocketed by 562%.[96]

Speculative pressure on the housing market declined due to the financial crisis and prices started to adjust to real demand but, for the most part, only high-income households can afford to buy a home. In large cities, housing prices steadily declined and demand shifted towards moderately-priced flats (one and two-room apartments), which are financed by the simultaneous sale of existing flats (this also referred to as "upgrade with cash payment"). With a loss of confidence in developers and the lack of supply of new, affordable housing, demand in the secondary housing market increased, especially outside Kyiv.

High housing prices have also made the rental sector more attractive for investment; rents increased in Ukraine's largest cities in 2011. The expected return on investment (ROI) in real estate for leasing in Kyiv is 7 to 11.5% per annum (the rent is about USD 500 to 750 per month), while the ROI for United States dollar deposits is 7.7%.[97] However, existing legislation limits the development of the private rental sector, failing to provide sufficient protection for either the landlord or the renter. Currently, the private rental sector is dominated by individuals who generally avoid the 15 to 17% tax on rental income specified by the Tax Code. In Kyiv, landlords who evade the rental income tax could recoup their investment in eight to nine years.

C. ROLE OF CENTRAL AND LOCAL EXECUTIVE BODIES IN HOUSING FINANCING

The relationship between housing policy and housing finance

The Government does not view housing as one of its priorities in socioeconomic development;[98] despite this, about 15 housing programmes were developed to meet the housing needs of vulnerable people through free dwellings and assistance in home construction or purchase. A limited state budget, coupled with government spending on more prioritized social services, has left little to fund general housing-related programmes. In 2011, less than 1.5% of total government expenditure went to investments in the infrastructure for utilities used by residential housing and actual financing for these housing state programmes was below that budgeted.[99] Actual financing from the state budget for the three largest state housing construction programmes, "Affordable Housing",[100]

[92] UNIAN, "Мін'юст: у 2011 році ринок житлової нерухомості в Україні зупинив падіння" (Ministry of Justice: In 2011, the Residential Real Estate Market in Ukraine Stopped Falling), 6 April 2012. Available from http://economics.unian.net/rus/detail/124537.

[93] Calculated under the assumption that the number of transactions on primary market is equal to the number of housing units constructed in the urban areas (66,200 in 2011).

[94] Dengi.ua, "В Киеве стали активно раскупать недвижимость" (In Kyiv, They Begin to Actively Buy Up Property), 6 March 2012. Available from http://dengi.ua/clauses/95056_V_Kieve_stali_aktivno_raskupat_nedvizhimost.html.

[95] Recent reforms include the transfer of some functions related to registration of transactions from BTI to the State Registration Service, new regulation of real estate appraisals, adoption of new Tax code and discussion about new regulation of realtor activities.

[96] Royal Town Planning Institute, A new vision for planning. Delivering sustainable communities, settlements and places. Mediating space - creating place. The need for action (London, 2001). Available from http://www.rtpi.org.uk/media/9321/RTPI-New-Vision-for-Planning.pdf (accessed 5 February 2014).

[97] Dengi, "Недвижимость: закрыто на переоценку" (Real Estate: Closed for Revaluation), no.5 (224), 22 March - 4 April 2012.

[98] The Annual Message of the President of Ukraine to the Verkhovna Rada of Ukraine in 2011 cited the five socioeconomic development priorities of the government: increased national competitiveness; macroeconomic stability and growth-oriented economy; land reform; modern social policy; and growth of regional economies.

[99] In 2011, only 90% of scheduled state funding for housing, utility and construction programmes were actually financed (information published on the website of MinRegion).

[100] Decree of CMU "On Approval of the State Target Social-Economic Programme on Construction/Purchase of Affordable Housing for 2010-2017" No. 1249 of 11 November 2009.

Table 13. Average prices for secondary-market apartments in Ukraine's largest cities in 2012

City	1-room apartment, USD per per m²	Change per year (%)	2-room apartment, USD per per m²	Change per year	3-room apartment, USD per per m²	Change per year (%)
Donetsk	**1,249**	2.3	**999**	-18	**1,128**	-12
Dnepropetrovsk	**864**	-22	**941**	-22	**978**	-20
Odessa	**1,346**	-7	**1,323**	-17	**1,402**	-11
Kharkov	**977**	-4	**1,022**	-11	**1,179**	5.9
Lviv	**1,390**	11.7	**1,308**	-2	**1,434**	-1
Kyiv	**1,868**	-16	**1,967**	-14	**2,079**	-7

Source: Dengi, "Недвижимость: закрыто на переоценку" (Real Estate: Closed for Revaluation), no.5 (224), 22 March - 4 April 2012.

"Subsidized Mortgages for Youth"[101] and "Your Own House",[102] was UAH 211.2 million (USD 26.4 million), taking about 21% of the total budget for housing construction programmes in 2011. In 2012, less than 6% of the required state expenditure on housing, utility and construction as estimated by the Government will be financed. There is a lack of cooperation between ministries and departments dealing with housing issues during the budget process and as a result, the Ministry of Finance does not receive the consolidated costs of housing programmes in time to allow for them in the budget.

To increase the number of households that they could serve, these three programmes require financial input from participants, which prevents low-income households in need from participating.

To attract private investment, particularly in the housing sector, the Government established a framework for PPPs.[103] However, the law limits the possible forms of PPP, making it less attractive for private investors.[104] Moreover, the high risks associated with the Ukrainian economy prevent the spread of PPP projects in the country despite potentially high demand, especially in housing and the renovation of utilities.

State, Local governments and possibilities for generating housing finance

Local governments share the responsibility with local executive authorities for designing and implementing housing policies. Many state programmes require local budget participation, but financial resources at the local level are very tight. Local budgets are dependent on transfers from the state budget to cover budget deficits. According to Ministry of Finance estimates, about 70 to 75% of total local expenditures are for public services (such as education and health) and functions delegated by the state to local authorities. However, the formula for calculating the value of the transfers is complex and unclear. Property and sales taxes are the main sources of revenue for the local budgets, especially land sales which contribute up to 15% of local budget revenues.[105] These are accumulated in the local development budget, a special part of the local budget, which is used to finance development programmes; however, local government does not have to use this income for housing purposes. Local authorities could finance their development programmes by external borrowing[106] but, since 2005, only 30 cities have so far issued debt securities because of the complexity of the procedure and the high risks of investment projects.

According to legislation, allocation of land must be done through public tender except for land intended for redevelopment projects and the construction of affordable housing. However, the complexity of tender procedures and lack, by potential bidders, of human and financial resources to prepare documentation, results in a limited supply of land plots for construction.

To increase the soundness and predictability of state and local budgets, in 2012, the Government introduced a mid-term budgeting procedure whereby in addition to the annual budget, the forecast for the next 2 years is also prepared. To increase the efficiency of

[101] Decree of CMU "On Approval of the State Programme on Provision of Housing for the Youth for 2002-2012" No. 1089 of 29 July 2002.

[102] Decree of the President "On Approval of the State Programme on Development of Ukraine Rural Areas till 2015" No. 1158 of 19 September 2007.

[103] The legislative framework includes the law "On Public-Private Partnership" No. 2404 of 1 July 2010 and supporting legislation.

[104] Wolfram Rehbock and Olena Chubukina, "An Overview of Public Private Partnerships in Ukraine". Available from www.arzinger.ua.

[105] National Institute for Strategic Studies, *Reforms of the System of Public Finance in Ukraine: First Results and Further Perspectives* (Kyiv, 2011) (in Ukrainian).

[106] According to the Budget Code, external borrowing is allowed for cities with populations of more than 300,000 and are subject to approval by the Ministry of Finance. Borrowing should not exceed 10% of local budget expenditures. Funding from international donors is allowed for all local authorities.

government spending, the programme-target method for drafting state budgets was recently introduced; however it is yet to be implemented at the local level.

According to the Law "On Regulation of Construction Activities", the developer is obliged to participate financially in the development of the city's social, transport and utility infrastructure, except in specific instances such as the construction of affordable housing. Local authorities determine a fee, which cannot exceed 4% of the total construction cost for residential buildings and 10% for other types of buildings, as well as the schedule of payments for the fee. Under the same law, any other types of encumbrance for the developers are illegal. Although the fee is intended to provide financial resources for the balanced development of the area around the construction plot, in practice, there is a lack of transparency in spending. Developers often complain that they have to fully finance infrastructure development and that the costs, including the fee and construction of off-site utility networks can be up to 40% of total construction costs.

Overview of the banking sector

The Ukrainian banking system consists of 176 commercial banks, of which 22 have 100% of the foreign capital. About 42% of the authorized capital of the banks is foreign and about 25% of that is from the Russian Federation.[107] The country has a sovereign rating from international agencies; the rating is unfavourable. A number of leading banks have ratings from international agencies as well. Since 2012, the financial sector has been legally obliged to fully implement International Financing Reporting Standards principles. The banking sector is recovering from the financial crisis in 2009 and total assets increased from UAH 340 billion (USD 42.5 billion) in 2006 to UAH 1,054 billion (USD 131.8 billion) in 2011 (see Table 14). State-run banks control 20% of all assets and 40% of bank-owned capital and mortgage loans currently comprise approximately 7.7% of total banking assets.[108] Ukraine's banking sector is undercapitalized, vulnerable to even minor shocks from the world economy and liable to a further increase in non-performing loans.[109] The profitability of the banking sector has become highly volatile after the crisis; the average return on equity ranged from -33% in 2009 to 4.8% at the beginning of 2012.[110]

At the same time, the economic importance of the banking sector has increased; banking sector assets as a percentage of GDP increased from 62.5% in 2006 to 80.1% in 2011. The share of total bank deposits to GDP has been fairly stable over the last six years, while the share of deposits in foreign currency increased from 34% in 2006 to 43% in 2011. The share of long-term (more than one year) deposits decreased from 66% in 2006 to 33% in 2012, but the state deposit insurance system was created in 2001 and performed quite well during the financial crisis. Without sources of long-term capital, mortgages will have high interest rates related to the need to finance long-term credits with short-term deposits.

In 2011, the average interest rate on bank loans for households was 25.6% for local currency loans and 12% for foreign currency loans.[111] The total volume of credit to households is about 25% of total loans and 15% of GDP. Due to the financial crisis and high interest rates, the volume of credit to households declined by 30% in 2011 (compared to the maximum value of UAH 280.5 billion or USD 35 billion in 2008). The interest rate on deposits was 18.5% for local currencies and 7.2% for foreign currencies. The ban on lending in foreign currencies to borrowers who do not have stable incomes in foreign currencies was helpful in overcoming the consequences of the financial crisis; however, this now seriously limits the ability to lend using foreign capital. The lack of hedging instruments to decrease currency exchange risks also prevents international investors from investing inside Ukraine.

There are about 610 credit unions and many pawnshops operating in the country,[112] supervised by Ukraine's State Commission for Regulation of Financial Services Markets. Unlike banks, credit unions generally do not have the right to accept deposits, so they refinance loans through shareholders' equity or refinancing programmes offered by international donors. Furthermore, microfinance institutions (MFIs) lack the special legislative environment which could create a more effective framework for their operations. MFIs had about 18,600 active borrowers in 2010 with an outstanding loan portfolio of USD 255,800.[113]

One of the oldest MFIs in Ukraine, "Nadezda" (Hope), was established by Hope International in 1998. Since its establishment, it has provided microcredit for

[107] As of 1 April 2012, based on data from the National Bank of Ukraine.

[108] Calculated using data from the National Bank of Ukraine and the Ukraine National Mortgage Association.

[109] World Bank, *Strategic Choices to Accelerate and Sustain Growth in Ukraine. Country Economic Memorandum*, Report No. 55895-UA, 31 August 2010. Available from http://www.undg.org/docs/RCAR/2010/UKR/World-Bank_Country-Economic-Memorandum_2010-Ukraine.pdf.

[110] Based on data from the National Bank of Ukraine.

[111] Based on data from the National Bank of Ukraine. Available from www.bank.gov.ua.

[112] Data for the 3rd quarter of 2011 of the State Commission for Regulation of Financial Services Markets of Ukraine. Credit unions provided UAH 2.3 billion or USD 287.5 of loans (outstanding balance) to its 263,700 clients.

[113] MixMarket, "Ukrainian Market Profile". Available from http://www.mixmarket.org/mfi/country/Ukraine (accessed 5 February 2014).

Table 14. Assets and deposits of the Ukrainian banking sector

City	2006	2007	2008	2009	2010	2011
Assets, billion UAH	340	599	926	880	942	1,054
% GDP	63	83	98	96	87	80
Deposits, billion UAH	186	284	360	335	417	492
% GDP	34	39	38	37	38	37
Share of deposits in foreign currency (%)	38	32	44	48	43	43

Source: Based on data from the National Bank of Ukraine. Available from www.bank.gov.ua.

the development of small business, agriculture and improved living conditions. By the end of 2011, it had issued 100,000 loans. In 2007, it cooperated with Habitat for Humanity to offer the poorest segment of the population a loan for housing improvement with a two-year repayment period. A larger MFI, the ProCredit Bank, operates as a commercial bank and also provides home improvement loans up to UAH 25,000 (USD 3,125), payable in 2 years, mainly for energy-saving technologies. The bank does not require collateral for the loans, but the borrower must provide a detailed renovation plan. Most borrowers are middle-age workers whose income exceeds UAH 1,500-2,000 (USD 187-250) per month, which less than a third of the income of a typical mortgage borrower. By March 2012, 15,600 loans amounting of UAH 213.2 million (USD 26.6 million) were provided, with a default rate of less than 3%.

Mortgage market and participants

The mortgage market started development in 2003 when the law “On Mortgages” (No. 898 of 5 June 2003) was adopted, establishing a legal framework for mortgage lending, including the possibility to use unfinished buildings as collateral. The “Concept of the Development of the National System of Mortgage Lending” (resolution of CMU No. 559-p of 10 August 2004) which establishes the two-tier mortgage lending model as the most effective and outlines the main features of the national mortgage lending system, defines the requirements for successful development of mortgage systems and creates a state mortgage refinancing facility, the State Mortgage Institution (SMI). Law of CMU No. 1330 of 8 October 2004 established SMI.

Before the 2009 crisis, the mortgage market had been growing actively from a low base. The amount of outstanding mortgage loans from banks has been steadily declining since 2009 according to the Ukrainian National Mortgage Association (UNIA) (1 January 2012) and currently amounts to approximately UAH 72.1 billion (USD 9 billion), which is about 5.5% of GDP and 36.8% of the total loan portfolio. However, about 40 to 45% of the total mortgages are loans for non-housing purposes secured by a real estate. There were approximately 20,000 mortgages issued in 2011, which is about 4% of total housing unit turnover.[114]

A state-supported mortgage programme launched by SMI created prerequisites for the development of primary and secondary mortgage markets. Under the programme, SMI purchases mortgages that match specified standards from commercial banks and issues mortgage bonds. SMI charges an interest rate of up to 15% to the borrower and pays the banks, in turn, a refinancing rate of 11%. The terms of a mortgage include the five- to 30-year payment period and a loan-to-value ratio of up to 75%. Mortgages are refinanced mainly through SMI’s chartered capital of UAH 2.2 billion (USD 275 million) and are later secured through state-guaranteed mortgage bonds. Due to this limited funding, by January 2012, SMI managed to refinance only 1% of the outstanding mortgages (equivalent to UAH 746 million) and issue UAH 200 million (USD 25 million) of mortgage-backed securities (MBS) and UAH 3 billion (USD 375 million) of corporate bonds. In 2010, the Government authorized SMI to provide funding to overcome the consequences of the financial crisis and the completion of stalled or unfinished residential construction. As of January 2012, 23 construction sites across Ukraine, consisting of 4,000 apartments, were provided funding by SMI.

SMI operates in the mortgage market with state support and, based on international best practices, has implemented consistent procedures for granting, refinancing and servicing mortgages, establishing requirements to borrowers and key creditworthiness ratios (SMI Standards). This allowed it to refinance mortgage banks and creditors with funds generated from mortgage bonds and MBS. Its primary mortgage programme is the acquisition of mortgage loans from partner banks under SMI Standards. In this way, the partner banks obtain from SMI long-term financial assets (up to 30 years) which they then use to grant mortgages. Such mortgages for housing (apartments or individual houses) have five to 30 years terms with at least a 75% loan-to-value ratio and mandatory mortgage insurance. The reference interest rate on such a mortgage, recently 15%, is now 18% due to the increase by SMI of its refinancing rate from 11% to 15.3%. Also eligible for refinancing or acquisition by SMI are mortgage loans to citizens issued under SMI standards to improve housing conditions, that

[114] Based on data from the National Bank of Ukraine. Available from www.bank.gov.ua.

is, for the modernization, retrofit and rehabilitation of housing, or to construct housing (both apartments and individual houses).

After the acquisition of a mortgage by SMI, the servicing of the mortgage (collection of payments from borrowers, periodic review of the mortgage and other functions) are carried out by a bank for a fee. The bank's fee for servicing the mortgage loan is the difference between the loan rate and rate of refinancing at 11% per annum. Today, the rate of refinancing is 15.3% per annum due to increased costs of borrowings for SMI.

To achieve its primary operational objective, SMI runs mortgage programmes aimed at financing partner banks to create a portfolio of mortgage loans (for a period up to 180 days) and finance the completion of construction of residential facilities (for a period of up to 2.5 years). The Government anticipated that the outcome of these mortgage programmes would be improved access to and lower interest rates on mortgages for the public. In order to pay SMI for the housing purchased under the 2009 Government programme to provide free housing to certain categories of population, the Government increased SMI's share capital in October 2010 by UAH 2.0 billion to UAH 2.2 billion. As the apartments were handed over from SMI to the citizens, this share capital was adjusted. As a result, SMI's share capital was UAH 0.95 billion in January 2013and UAH 0.76 billion in June 2013.

Due to government financial crisis measures leading to slowdowns and limited funding in mortgage markets, SMI was able to refinance only 1% of all outstanding mortgages (equivalent to UAH 746 million) and to issue MBS worth only UAH 200 million (USD 25 million) and corporate bonds worth UAH 3 billion (USD 375 million). However, as of January 2013, SMI's portfolio of refinanced mortgage loans amounted to over 5,300 loans worth UAH 904.9 million (USD 113.2 million). It also issued corporate bonds worth UAH 2.0 billion (USD 250.3 million) and mortgage bonds worth UAH 0.5 billion (USD 62.6 million).

In 2010, in order to deal with the effects of the international financial crisis, the Government authorized SMI to complete "frozen" or unfinished construction in the residential sector. As of January 2012, 23 construction sites building a total of 4,000 apartments across Ukraine have received such funding from SMI through partner banks. By 2013, a total of 26 construction sites had received UAH 654 million (USD 81.8 million) in funding, which enabled the finishing of 395,000 m2 of housing. Since the beginning of this mortgage programme, 16 houses with a total area of 253,900 m2 have been completed. Thus, as a two-tier mortgage market institution, SMI operates sustainably without reliance on money from the State or local governments.

Today, 42 commercial banks have their own mortgage programmes and another 106 are involved in the SMI mortgage programme. The terms of participation of commercial bank programmes are more complicated compared to the SMI programme: they have an average interest rate of 18.3% in hryvnia (16.0% in United States dollars and 15.7% in Euros), an average tenure of 15 years and an average loan-to-value ratio of 0.65.[115] As before, the mortgage is affordable for high income households, although UNIA estimates that since 2008 mortgages have become much more affordable and the 2011 UNIA housing affordability index has doubled compared to 2008. Mortgage market concentration is high; according to the UNIA, 54.7% of outstanding mortgages are concentrated in five major banks and 75.5% are concentrated in 10 banks.

The development of the Ukrainian mortgage sector is hampered by several problems, including high liquidity risk caused by the general condition of the banking sector. The lack of cheap long-term capital and a short-term deposit base creates a situation where the banks have mismatch between the maturities of their assets and liabilities; this leads to high interest rates and medium terms.

Another problem is the lack of predictability and trust in the stability of the Ukrainian economy. Despite recent macroeconomic stability and a significant decline in inflation, interest rates on loans in local currency remain unchanged, which suggests an expectation of future devaluation of the local currency.

In addition, further growth of the mortgage sector is affected by the legacy of rapid pre-crisis development of the mortgage market, which was fueled by foreign financial resources. A high proportion of non-performing loans, originating mainly in foreign currency before devaluation in 2008 and 2009, continue to poison banks' balances. According to UNIA, 16.7% of outstanding mortgages have been restructured due to financial problems of the borrowers. In addition, the National Bank of Ukraine estimates the share of doubtful and non-performing loans at 14% of the total outstanding balance of all loans in Ukraine. Despite the ban on foreign currency lending introduced by the Government to protect borrowers from foreign exchange risk, the proportion of mortgages in foreign currencies is still very high and reaches 77% of the total amount of outstanding mortgages.[116]

[115] UNIA, Available from http://www.unia.com.ua/.
[116] Ibid.

Another problem is the borrowers' financial illiteracy and the lack of generally accepted reliable industry standards from realtors and appraisals. There have been several attempts to run public awareness programmes and to raise the level of social responsibility within the banking sector (including UNIA activities and a joint project with USAID and Ukraine's Financial Services Authority), but they were not very successful, largely because banks and supervisory authorities were reluctant to participate in them. USAID noted that full development of Ukrainian integrated financial services markets is significantly impeded by a combination of financial illiteracy and a lack of trust.

Legally, in cases of late payment by borrowers, the bank may demand eviction via a judicial or non-judicial procedure. In theory, the extra-judicial eviction procedure is faster and cheaper, but, in practice, all creditors who attempt extra-judicial procedures still have to go through court hearings because of the vague decision-making processes of notaries responsible for foreclosure. This still constitutes a major legal problem.

Evaluation activities are regulated by a special law ("On Evaluation of Property, Property Rights and Professional Appraisal Services in Ukraine" No. 2658 of 12 July 2001) and supervised by the State Property Fund and the self-regulatory organization of appraisers. Under the current law, evaluations must be performed by licensed professionals (appraisers), but the bill that is currently being debated in Parliament delegates the licensing process to a self-regulating organization of appraisers, which does not have uniform skills and standards, leading to varying quality of evaluation services. Moreover, financial responsibility for appraisers' errors and discrepancies is vague in the assessment report. For these reasons, banks prefer to rely on internal estimates or accept evaluation reports selectively.

While realtors are very active in the housing market, banks do not cooperate to promote mortgages, mainly due to realtors' lack of credibility. Ukraine still has no specific law regulating realtors' activity and, although there were several attempts to pass one, all of them failed. Some realtors offer clients advice on mortgages, but at the expense of the customer.

Most banks do not actively use insurance as a tool to mitigate risks of mortgage. The insurance sector is also undercapitalized[117] and is unconnected to the nascent residential mortgage industry. Insurance companies working with banks and engaged in mortgage lending primarily offer property insurance, which is mandatory. However, as a rule, borrowers cannot select an insurance company, as banks impose their own choice of insurers.

Debt collectors' activities are expanding due to the increase in non-performing loans, however, there no regulations for collection or a single supervision institution. This creates problems for all market participants, because according to the law "On Banks and Banking Activity", credit agreements are considered commercial secrets and cannot be disclosed to third parties without the written consent of the borrower.

The law "On Organization of Formation and Circulation of Credit Histories" No. 2704 of 23 June 2005 set up a legal framework for institutions such as credit bureaus. Of the six companies registered today as credit bureaus, three are most active. The leader among them is "First Credit Bureau of Ukraine" (FCBU), founded with support of the National Bank of Ukraine, Ministry of Finance, World Bank, USAID and the Union of Ukrainian Banks. While banks are not required to provide information about loans to credit bureaus, most leading Ukrainian banks cooperate with them. In 2011, the number of inquiries handled by FCBU reached 3 million. The law authorizes credit bureaus to ask for information such as income tax data from public registers, but, in practice, this information is still impossible to obtain.

Financial markets of the country are underdeveloped. The undiversified sector of non-banking financial institutions leaves average Ukrainians with only three savings options: cash, bank deposits and real estate.[118] Thus, banks account for almost 96% of the total assets of the financial sector.

Nevertheless, the mortgage market demonstrates quite decent growth potential despite limitations caused by lack of financing on acceptable terms. Currently short-term deposits represent the main source of funding for mortgage transactions. However, some international organizations, such as the International Finance Corporation, are seeking opportunities to provide funding for the implementation of programmes related to the housing sector (e.g., residential energy efficiency programme and the modernization of buildings), but a lack of available tools to minimize associated risks significantly increases the cost of such funding.

Meanwhile, although there is a solid legal basis for MBS (law "On Mortgage-Backed Securities" No. 3273 of 22 December 2005), this market was hit hard by the financial crisis of 2008-2009. Under the law,

[117] As of October, 2011, the aggregate reserves of insurance companies were about UAH 11.2 billion.

[118] US AID FINREP Project, *Financial Literacy and Awareness in Ukraine: Facts and Findings* (Kyiv, 2010), 2nd edition, revised and corrected.

institutions may issue two types of MBS (mortgage bonds and mortgage notes). In 2008, SMI issued UAH 200 million (USD 25 million) in MBS and secured bonds, which were completely repaid in 2011. Two other issuances of MBS (UAH 120 million) totaling UAH 120 million were executed by commercial banks in 2008 and were repaid in 2009-2010. Thus, the MBS market in Ukraine is nonexistent, although SMI is considering issuing mortgage bonds. A few commercial banks have recently established a non-governmental agency on mortgage refinancing, which is currently preparing to issue UAH 400 to 500 million (USD 50 to 62.5 million) in MBS. It is anticipated though that these MBS will be purchased by Oschadbank to clear up its balance of the mortgage, which will be used as collateral.