

# CONSUMER LENDING IN UKRAINE: SURVEYING THE LANDSCAPE

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Kyiv, Ukraine





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# **CONSUMER LENDING IN UKRAINE: SURVEYING THE LANDSCAPE**

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## 1 Introduction

Prior to the financial crisis of 2006 – 2008, consumer lending in Ukraine developed rapidly due to two main factors:

- First, beginning in 2000, international banks started to actively enter the Ukrainian market and introduce financial consumer lending practices and products. This increased the supply side of the equation; and
- In 2003 the National Bank of Ukraine (NBU) revisited its Lending Policy and removed the prohibition of making foreign currency (FX) denominated loans to individuals. That decision opened the door to consumer loans with seemingly more attractive interest rates, and spurred the demand for such loans.

Household loans (including mortgages) more than tripled in this period. The share of loans denominated in FX increased from 63% to 72%. Overall, the level of FX-denominated loans (including both commercial and retail loans) as a percentage of total loans reached 60.3% in 2008, the highest level of any major country in the region.

**Table 1. Outstanding Loans to Households, UAH billion, End of Year**

Year	Total Household Loans	Consumer Loans			Mortgage Loans			Other Loans		
		Total	UAH	FX	Total	UAH	FX	Total	UAH	FX
2006	82,0	58,5	26,1	32,4	20,4	2,4	18,0	3,1	2,2	1,0
2007	160,4	115,0	49,1	65,9	40,8	6,1	34,7	4,6	3,2	1,3
2008	280,5	186,1	66,7	119,4	88,4	8,8	79,5	6,0	3,3	2,8
2009	241,2	137,1	52,2	84,9	98,8	11,6	87,2	5,3	2,8	2,5
2010	209,5	122,9	52,5	70,5	82,0	9,8	72,1	4,6	2,4	2,2

*(Source: National Bank of Ukraine)*

In an effort to gain market share in Ukraine's rapidly growing consumer finance sector, many banks, primarily of foreign origin, apparently relaxed credit underwriting standards. Loans became easier to obtain in terms of initial down payment, loan to value, and debt to income ratio, compared to earlier requirements.

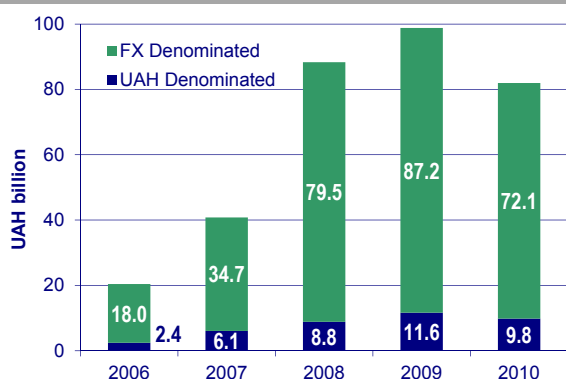
**Table 2. Weight of FX-Denominated Loans in Total Outstanding Loans, %**

Country	Year			
	2007	2008	2009	2010
Bulgaria		57,2	58,7	
Czech Republic		21,8	21,2	21,6
Latvia		89,5	92,1	92,7
Poland		35,0	33,3	
Romania	45,9	43,7	42,8	
Russia		30,2	29,9	28,5
Slovak Republic		17,4	2,0	1,5
Turkey		27,0	24,9	25,8
Ukraine	51,5	60,3	52,6	48,2

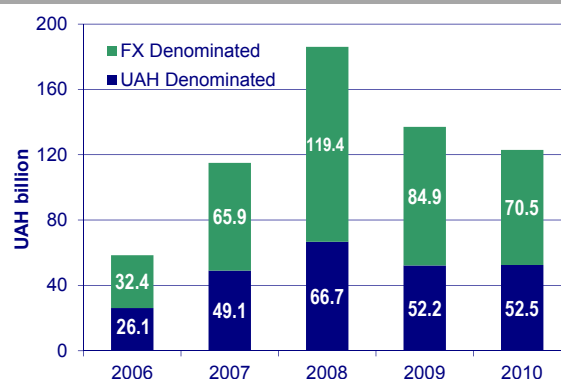
*(Source: IMF Financial Stability Indicators)*

Ukraine's stable exchange rate – from April 2005 to May 2008 the exchange rate of the Ukrainian hryvnia to the US dollar remained unchanged at UAH 5.05 for USD 1 – encouraged Ukrainians to treat US dollar denominated loans as having no foreign currency risk.

**Chart 1. Outstanding Mortgage Loans**



**Chart 2. Outstanding Consumer Loans**



(Source: National Bank of Ukraine)

**NB: Consumer loans include Cash and Retail Loans, as well as Car Loans  
End of Year balances**

The average Ukrainian borrower was unfamiliar with the idea of foreign currency risk, and in any event there were no hedging mechanisms available to individuals. Bankers surely knew of the FX risk to borrowers, but did nothing to reduce it via prudent lending practices. When the hryvnia depreciated to the US dollar by over 40% in late 2008, the majority of borrowers were confronted with unreasonable debt-to-income ratios, and became unable to service these FX loans. They were not able to close their position either, since devaluation appeared almost instantly – over a period of just two months – and no conversion or restructuring options were embedded into their loan agreements. As a result, Ukrainian banks started to experience troubles with their loan portfolio quality and had to shift their focus from expansion to damage mitigation.

**Table 3. NPL to Total Outstanding Loans, %**

Country	Year		
	2008	2009	2010
Bulgaria	2,4	6,4	
Czech Republic	2,9	4,6	5,4
Poland	2,8	3,9	
Romania	4,5	7,9	11,7
Russia	3,8	9,5	9,2
Turkey	3,4	5,0	3,5
Ukraine	3,9	13,7	15,3

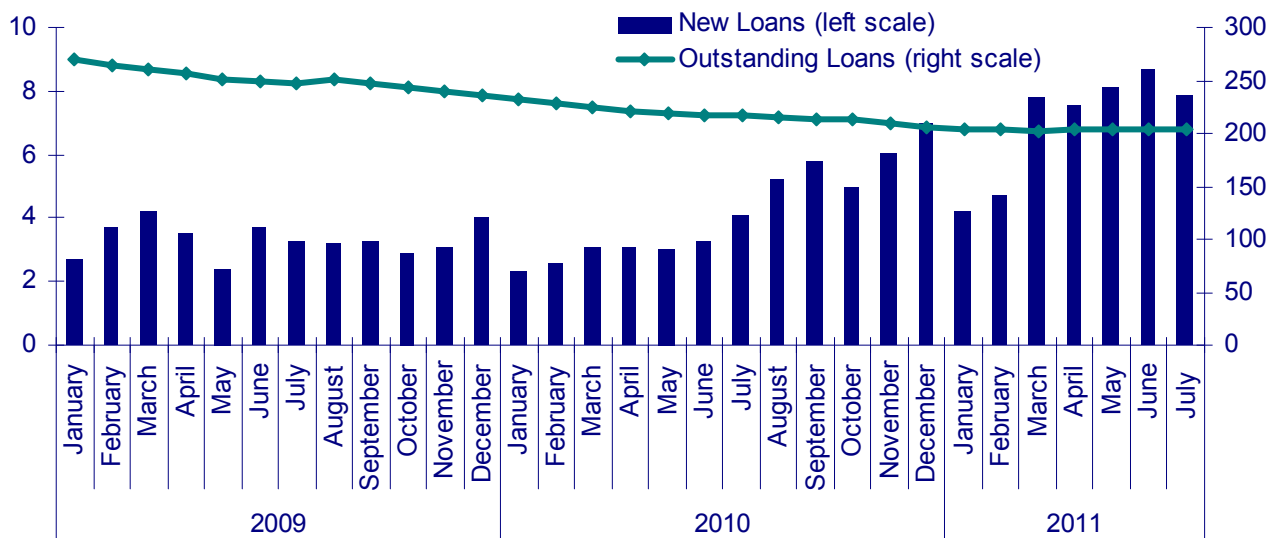
(Source: IMF Financial Stability Indicators)

During the global financial turbulence, consumer lending in Ukraine effectively collapsed. From January 2009 to June 2010, banks were only making UAH 2 – 4 billion (USD 0.2 – 0.5 billion) of new retail loans and a negligible UAH 0.2 – 0.3 billion (USD 30 –40 million) of new mortgage loans every month. Although there are no official statistics on new consumer loans issued by banks each month before the crisis, estimates suggest a monthly range of UAH 5 – 6 billion (USD 1 – 1.2 billion)<sup>1</sup>.

There were three underlying reasons for the consumer ‘credit crunch’ in Ukraine during the crisis: (1) the lenders significantly tightened credit underwriting standards to protect themselves from any additional credit risks, intentionally leaving most of the borrowers in the ‘failed’ category in order not to allow their loan officers to make any new loans; (2) potential borrowers were reluctant to take any loans; and (3) there were no massive loan restructurings, and existing borrowers had to struggle with their outstanding financial liabilities.

By the middle of 2010 there were some indications that banks wanted to resume consumer lending and official statistics show some growth in lending activity. More retail stores, car dealers, and banks started to offer consumer loans, first softly and then more and more aggressively. Since March 2011 banks were making more than UAH 8 billion of new consumer loans (USD 1 billion) every month, and the outstanding loan portfolio balance stopped declining. Although the trend is not definitive, and may not gain a significant momentum, it clearly shows both supply and demand for new consumer credit expansion.

Chart 3. New Household Loans by Ukrainian Banks (Retail and Mortgage), UAH billion



(Source: National Bank of Ukraine)

The purpose of this paper therefore is to discuss the practice of consumer lending in Ukraine in the post-crisis period. What lessons have been learned from the crisis, and has the consumer lending landscape in Ukraine changed, especially in terms of consumer protections requirements?

<sup>1</sup> USD equivalents vary due to exchange rate fluctuation

## 2 Developing Trends

### 2.1 Changing Competitive Landscape, More Unregulated Institutions

Historically, the lion's share of the consumer finance market was with commercial banks. Other lenders – like credit unions or retail sellers – were not major players in the consumer finance market. For example, as of Jan 1, 2009, banks had UAH 269.9 billion in outstanding loans, compared to only UAH 5.5 billion for credit unions. In 2011, the situation remained the same, with banks controlling UAH 209.9 billion and credit unions dropping to only UAH 3.3 billion.

**Table 4. Top 10 Ukrainian Banks by Outstanding Loans to Individuals as of July 1, 2011**

Rank	Bank Name	Outstanding Consumer Loans, UAH billion	Share in Total Consumer Loans
1	Privatbank	23,762	11,6%
2	Ukrsibbank (BNP Paribas Group)	22,917	11,2%
3	Raiffaizen Bank Aval	21,604	10,6%
4	Ukrsotsbank (UniCredit Group)	18,928	9,2%
5	Nadra	14,564	7,1%
6	OTP Bank	8,122	4,0%
7	Delta Bank	6,017	2,9%
8	Swedbank	5,330	2,6%
9	Alpha Bank	4,883	2,4%
10	State Savings Bank	4,702	2,3%

*(Source: National Bank of Ukraine)*

Consumer finance is restricted by Ukrainian legislation to regulated financial companies – banks, credit unions, and credit institutions, which can charge interest. Tax legislation<sup>2</sup> is also used to discourage interest bearing loans made by non-financial institutions. Therefore, if a consumer wanted to buy a home appliance on installment, the loan is typically offered by a bank, often associated with a particular seller.

Ukrainian consumer protection legislation has been effectively applied only to the 'lenders', but it has never been precisely clear who is the regulator for consumer protection purposes. In fact, most Ukrainians are unaware of their consumer rights, the laws on consumer protection of financial services are unclear, and there are a number of possible regulators involved. For prudential supervision purposes, however, these 'lenders' have been split into two jurisdictions: commercial banks fall under bank supervision by the National Bank of Ukraine; and other financial companies are under the jurisdiction of the Financial Services Regulator (FSR).

In 2007, at the peak of consumer lending growth, the NBU issued Regulation #168 setting forth consumer disclosure and protection requirements for banks. Unfortunately, the FSR failed to issue a similar policy for other non-bank financial institutions. In any case, the enforcement of NBU Regulation #168 both before the crisis and especially during it has been weak due to uncertainties regarding the law the regulation was based upon. That has forced many consumers to protect themselves vis-à-vis lending institutions in other ways outside the intended regulatory structure. Anecdotal examples of such 'protection'

<sup>2</sup> During 2010, Ukraine's new Tax Code came into effect, replacing numerous and controversial tax laws and regulations.

include law suits in which borrowers demanded that their loan agreements be declared null and void since a foreign currency cannot be legal tender in Ukraine without a special permission from the National Bank. However, the more commonly used practice is to explore any possible loophole and contradiction in Ukrainian legislation to stall or halt the foreclosure process.

Various, so-called 'bank partner programs' can also be found, as well as similar plans with non-bank financial institutions. These are special arrangements between a lender and a retailer or dealer that allow a client to purchase on credit or with special rates and conditions. In some cases, however, it is not possible to obtain any information on who is the ultimate lender – a bank, a financial company, or a retailer itself – and whether or not consumer disclosure requirements are applicable in this case. In many cases, the installments offered by direct sellers do not follow Ukrainian legal requirements, not to mention OECD principles that require that if a product is sold on installment, a statement of the total cash flows to be paid by the consumer has to be provided as well.

Lenders still fail to comply with the requirement to disclose the effective rate of interest to a potential borrower before entering into a contract. For this reason, we were only able to calculate estimates of an approximate effective rate of interest on newly available consumer loans, using information from printed and electronic advertisements, and phone calls to lenders with the most aggressive advertisements. We collected information from about 10 lenders that offered 'instant cash' loans during January-February of 2011. The results show that **effective interest rates remain high**, significantly above the official inflation rate of approximately 16% p.a., and in some cases amount to an annual effective interest rate of 135%. This means a client basically pays double the purchase price for any item financed by a two-year loan, and triple the price for a four year loan. In many cases, it was not even possible to estimate the implied interest rates, since we were not able to find any information on any additional fees and charges.

This practice leads to Ukraine being one of the leaders among neighboring and peer countries with respect to interest rate spreads, as evidenced by IMF data.

**Table 5. Spread between reference lending and deposit rates, basis points**

Country	Year			
	2007	2008	2009	2010
Austria	240,0	232,0	191,0	197,0
Czech Republic		478,0	481,1	485,6
Germany		273,0	342,0	347,0
Greece		577,2	522,3	548,6
Italy	401,9	413,1	336,2	301,9
Poland		434,6	364,2	
Romania	810,7	752,6	925,0	
Russia		714,7	887,6	847,0
Turkey		598,0	918,0	621,0
Ukraine	546,0	816,0	405,0	721,0

*(Source: IMF Financial Stability Indicators)*

The biggest problem, however, might not be with interest rates. Unfortunately, more and more 'lenders' that now offer consumer loans believe they are not subject to consumer protection laws since their 'financial arrangements' are not 'loans' or are 'special loans' like revolving credit lines via a bank plastic card. This allows some institutions and agencies to exempt themselves from consumer disclosure and protection practices. Most

likely, this confusion will have to be addressed through legislation. The existence of such ‘unregulated’ institutions and ‘special schemes’ further erodes the already negligible public confidence in the financial sector, and should be corrected with joint efforts from the regulators and prudent market participants.

The ‘traditional’ lenders now are trying to re-gain market share. Several banks now offer mortgage loans, as well as car and cash loans. However, due to the generally poor perception of banks among consumer borrowers, chances are that ‘alternative’ lenders (i.e. non-bank financial institutions like credit unions or leasing companies) are going to preserve their market share.

## 2.2 New Local Currency Loans Prevail, Still No Hedges Available for Existing FX Borrowers

Just like in many other countries of Eastern Europe, in Ukraine foreign currency consumer loans gained extreme popularity before the financial collapse in late 2008. Some products – e.g. mortgage loans – were almost exclusively offered in USD, EUR, or Swiss Francs (CHF). There were two major reasons for this: (1) long-term funding in local currency before the crisis was not available, and (2) many banks with foreign capital were able to fund themselves with money from their parent companies, and preferred to lend in that currency.

The banks placed foreign currency risk on the shoulders of borrowers. Moreover, the stability of UAH to USD exchange rate caused borrowers and regulators to ignore the risk of devaluation. Unfortunately, consumer borrowers had no access to any meaningful hedge instrument to protect themselves from any future adverse movement in the exchange rates.

After the crisis unfolded, the NBU issued new rules prohibiting making any new FX-denominated loans to borrowers without access to FX-denominated cash inflows. Later, the direct administrative prohibition of FX loans was replaced by prudential rules discouraging the practice. In particular, collateral haircuts for performing FX denominated loans secured by residential real estate or mortgage securities were set to levels significantly lower compared to similar loans denominated in UAH.

However, this has not removed the problem with existing FX-denominated loans. Some banks have offered restructuring options to their clients to convert their loans to local currency. But in many cases, such ‘restructurings’ have not improved borrowers’ capacity to repay, due to three major reasons: (1) conversions were only available using the post-depreciation exchange rate, i.e. with unaffordable outstanding debt, (2) conversion implied application of current UAH interest rate, which are higher than the original interest rate for the FX loan, and thus would increase monthly payments, and (3) as a precondition to restructuring, many banks required the borrowers to increase the collateral for the loan due to real estate depreciation and the increase in outstanding balances. .

Existing FX borrowers are still exposed to adverse exchange rate movements. According to official NBU statistics, as of July 1, 2011, as much as UAH 129.9 billion of consumer loans were denominated in foreign currencies, or 68% of total loans. These borrowers remain exposed to the risk of devaluation.

## 2.3 Poor Disclosure Practices, Lack of Financial Awareness

The lack of disclosure to consumers of the cost, terms, and conditions of financial services is a serious problem in Ukraine. In order to gain an understanding of the real disclosure practices exercised by Ukrainian banks and other lenders, we used the commonly recognized ‘mystery shopper’ approach, i.e. when a person pretends to be a client and the institution provides the information and disclosures as if it were a real transaction.

The results of this exercise were discouraging. Very few consumer lenders followed consumer protection and disclosure practices. In most cases, where consumer loans are offered by an unregulated company, there is effectively no consumer disclosure at all. In other cases, where the lenders happen to be regulated companies, the loan officers fail to explain the contents of disclosure items.

This poor disclosure practice becomes more pronounced because most Ukrainians have no idea about their rights and responsibilities as financial consumers. This was demonstrated overwhelmingly in FINREP's Financial Literacy Survey, performed in late 2010. The majority of Ukrainians – 81% – proved to have poor financial skills, answering correctly less than half of 15 consumer rights awareness questions. In addition, only about 16% of the population took the trouble to file complaints with either regulators or the financial companies once they believed that their consumer rights were breached. 43% of the population is convinced that once a conflict with a financial organization appears, it is going to be resolved favorably for that organization.

If the disclosure practice can be improved by imposing and enforcing stricter legal requirements, the awareness problem has to be treated in a separate way. Ukrainians are not accustomed to life in a capitalist environment. Current school and university curriculums have little or no financial literacy lessons, nor do they develop the skill sets required to interact with financial markets. In addition, the group with the lowest self-assessment for financial literacy – pensioners and those over 50 – have never been addressed by any government financial education program.

Only empowered consumers can make a difference vis-à-vis fraudulent lending practices. A law or government regulation can be effective only if the borrower understands its substance. A solution here can be the use of standardized (template) banking-industry-wide contracts, where the financial institution would only be able to enter specific information on the contract and be unable to change any substantive clauses. One of the best approaches in this regard can be for the regulator to keep on its website the templates for such standardized contracts for consumers to download and study before signing.

Three issues in consumer protection gained particular importance during the time of crisis: (1) floating interest rates, (2) collateral for foreign currency loans, and (3) collection bureaus. In all cases consumer protection is deficient and requires correction and close attention.

Pre-crisis, most retail borrowers in Ukraine ended up signing loan agreements with floating interest rates. Borrowers signed contracts that gave the bank the right to reset the applicable interest rate if market conditions changed; no list of triggering events, nor a formula for a new interest rate calculation, nor a right for the borrower to challenge the reset, were allowed. In most cases, the banks made all appropriate disclosures and calculations (including effective rate of interest) at the loan's inception, so technically they were in full compliance. But when the crisis unfolded and the banks started to experience problems with non-performing loans, they started to reset interest rates to higher levels, suggesting that the crisis was indeed a 'market condition change'. In many cases, however, the banks failed to properly justify the increases and make adequate disclosures to borrowers. However, since no redress mechanism is in place, the borrowers faced new interest rates. Only then did they realize the 'embedded option' in their loans. Some of them applied to courts and succeeded, but these cases are not known to the general public.

A good portion of consumer loans in Ukraine in 2007-2008 were denominated in foreign currency. As with interest rates, most bank lenders were fully compliant with disclosure requirements at the time they were making the loans by notifying borrowers about 'embedded foreign currency rate risk', as the legislation requires. Many of these loans were covered by tangible collateral – cars, houses, apartments, parcels of land, etc. – that according to Ukrainian legislation had to be valued and carried on the bank's books in domestic currency. When the Ukrainian hryvnia depreciated over 40% to other major

currencies, the outstanding loan amounts increased dramatically, forcing borrowers to default. But at the same time banks were able to require the borrowers to provide more collateral. This forced some borrowers into foreclosure. Ukrainian legislation allows lenders to go after a borrower's other property if the foreclosure proceeds are not adequate to cover the outstanding loan.

Prior to the crisis, the collection business was modest in Ukraine. Credit history bureaus had just begun to offer their services. Banks had little or no experience in foreclosure, and the applicable laws were mainly untested. However, as more and more borrowers started to default after 2008, credit collection became an important function – both as a creditor protection vehicle and as a business.

The rise to prominence of collection agencies revealed another deficiency of consumer protection legislation: these credit collection agencies are effectively outside the scope of consumer laws and regulations. Some of these agencies use collection techniques that imply personal threats, and breach privacy and indemnity laws. To no one's surprise, borrowers also started to use quasi-legal mechanisms to protect themselves, trying to find and use every possible bottleneck or deficiency in Ukrainian legislation to fight collection agencies. The solution to this problem is greater consumer awareness – this would make borrowers aware of legal and financial consequences of taking a consumer loan, as well as what to do in case a problem arises.

Ukrainian consumers need to understand that 'disclosure' and 'protection' are distinct from each other. While in the majority of cases the lending banks have been in compliance with disclosure requirements, consumer protection was not achieved.

### 3 Specific Consumer Loan Products

In Ukraine, there are only two categories of loans – mortgages and pure consumer.

Pre-crisis, most lenders heavily relied on collateralized loans, paying minimal attention to cash flows for repayment capacity. There were two major reasons for this: (1) real estate prices in Ukraine doubled almost every year between 2004 and 2008, thus making the real estate underlying the loan a real protection, since it was believed foreclosure would offset any loan; and (2) Ukraine's shadow economy remained large despite government attempts to reduce it. A borrower's "official income" in many cases is too low to qualify for a loan, but his real, yet undocumented, wage and other income are more than adequate. As a result, banks tended to rely on collateral rather than income (cash flow) in making loans. This could only be solved by bringing the shadow economy into the sunlight.

Anyone who owned real property in Ukraine immediately became an eligible borrower for most banks. And these banks offered 'mortgage loans' that in fact were not a mortgage, as defined by international standards. In fact, any loan secured by real estate was treated as a mortgage – no matter what the purpose of such a loan was (e.g. working capital loans to family business, as and pure consumer loans secured by apartments), what kind of real estate had been pledged (commercial or residential), and even whether or not real estate existed in reality (some banks offered 'mortgages' taking unfinished construction as the pledge). Competition also forced banks to lower eligibility criteria for 'mortgage loans' – some required extremely low borrower down payments, from 10% to even zero, compared to close to 50% of the property value in 2000. Other banks treated parcels of land as eligible collateral, even though land laws in Ukraine make land foreclosure almost impossible. The practice of making education, vacation, car and other loans collateralized by real estate became widespread in 2006-2008. This practice was encouraged by the NBU Loan Loss Provisioning Policy, which sets forth lower provisioning requirements for loans secured by real estate compared to those secured by other type of property or cash flows.

From a consumer protection standpoint, besides floating interest rates and FX denomination, there was yet another problem with mortgage loans – associated insurance. Ukrainian Insurance Law requires mandatory insurance for mortgage (only the risk of losing the mortgaged item, but some banks also tried to expand it to the borrower's life) and allows banks to select specific insurance companies. While requiring insurance is a common international practice, in Ukraine it turned out to be yet another way to squeeze money from borrowers. In many cases the selected insurance company was associated with the lending bank, and charged above-market premiums. And since the Law says it is the lender (i.e. the bank) that has to be named as the beneficiary under such insurance contracts (i.e. on a consolidated basis their claims and liabilities would be offset), a borrower had nothing to do but to make the required payments, thus inflating his or her real rate of interest.

There was also a group of banks that did not rely on collateral. Many of them entered the market late, when real estate prices were already high and most eligible borrowers had already been indebted by competitors. These new lenders developed lending products where the lender's protection came from abnormally high rates of interest. These lenders did not expect that all borrowers would pay back their loans; in some cases the embedded default rate was as high as 20%. These lenders made money because cash flows from performing borrowers offset losses from defaulted ones. For these lenders, the purpose of the loan or where the borrower would get cash flow to repay the loan did not matter. Such lenders basically distorted the market by significantly lowering loan underwriting standards, allowing non-eligible borrowers to take a loan that eventually would be repaid by good borrowers. A notable feature of the Ukrainian market was that most banks decided not to use credit card loans (where a client has to open an account with a bank, accumulate some savings and spending history, and only later receive a line of credit on

his or her card). Instead, these banks offered loans at points of sale, making loans not borrower-specific but rather item-specific. Of course, for a 'loan officer' at the point of sale it was impossible to run a comprehensive background check or credit scoring. And since different banks were present at different points of sale, bank client loyalty did not develop between these two major categories of consumer loans.

In between these two major categories of consumer loans there is a special one – car loans. In Ukrainian circumstances these loans have been special for two reasons: (1) unlike normal real estate, even well-maintained cars depreciate over time, thus reducing the value of a car as collateral; and (2) most car dealers did not offer in-house loans, making this niche very attractive for those banks who offered 'pure consumer' loans. In most cases, banks were making money from car loans indirectly – through associated insurance companies. In such cases the official nominal interest rate for a loan would be set at market levels or even slightly below, but the banks would limit the borrower's ability to buy insurance on an open market and require an insurance contract from an associated company. The rates charges by such company could be significantly above the market ones. The practice of using a list of 'accredited' insurance companies tied to banks and requiring the borrower to buy car insurance became widespread in Ukraine. Most borrowers are unaware they have a legal right to argue in such a situation. Therefore, the car loans in pre-crisis Ukraine had features from both a mortgage loan (collateral, insurance, and down payment), and pure consumer loans (offered at point of sale).

Such practices led Ukraine into credit problems, evidenced by a non-performing loans ratio significantly above its peer and neighboring countries (see Table 3 in Introduction).

### 3.1 Mortgage Products

In post-crisis Ukraine, mortgage loans are far less available than during 2006-2008, and far less affordable.

During the crisis, mortgage lending eventually halted. Not only were new loans not available, but the existing portfolio started to shrink, dropping from over UAH 102 billion as of Jan 1, 2009, to as low as UAH 78 billion on July 1, 2011.

Banks had to find ways to deal with their existing mortgage portfolios that became more and more impaired. In many banks, mortgage loan officers were converted to loan restructuring officers, and then collection officers.

As of May 2011, only about 35 banks offered mortgage loans. Most of the mortgage products are now denominated in UAH; however some loans are also available in Russian Rubles (RUR)

Notable changes from the pre-crisis period are: (1) concentration on secondary market; (2) increased down payments; (3) much shorter repayment periods; and (4) the domestic currency denomination.

#### Secondary Real Estate Market

Before the crisis, banks used to offer mortgage loans to borrowers to buy houses from both primary and secondary real estate markets. During the crisis, many primary market deals became problems – developers either failed to finish the construction or did it with significant delays, and foreclosure of property rights for uncompleted sites became a problem from a legal standpoint.

As a result, mortgage loans are now exclusively offered for secondary real estate markets, mostly in regional capital cities. Primary market mortgages are typically offered only to buy apartments and houses from developers associated with the lending bank – the banks believe they are better at controlling the risk through proper and timely construction in such cases.

An interesting observation is that banks are very reluctant to offer loans to new clients to purchase real estate foreclosed from a failed borrower of the same bank. Instead, they are seeking cash settlements. One explanation is that there can be a title risk embedded in foreclosure as the underlying legislation is still rather vague. Another explanation is that banks may seek to exit mortgage lending completely instead of improving their portfolios.

### Increased Down Payments

In pre-crisis Ukraine, mortgage loans with low down payments of 0% to 10% were not uncommon. Ukrainians were taking mortgage loans for living, renting, and speculation purposes. With the seemingly fantastic one-way upward trend in real estate prices, banks were apparently unconcerned about down payments, and clients were eager to take loans now rather than later – a typical set of conditions for real estate bubbles.

Mortgage loans with down payments less than 20% can be problematic because they do not provide adequate cushion to absorb any negative movement in real estate prices. Once the crisis unfolded and real estate prices stopped rising, and later began to decline, the low down payment on existing loans indeed became a problem. Clients started to refuse servicing their loans due to negative equity and the lenders were not ready for such actions – their products were based on assumption of real estate booms and not nonperforming loans.

The lesson from this has been learned: in May 2011, no mortgage loan is made with less than a 20% down payment. However, with average down payments now around 45% of the loan, borrowers are not lining up to purchase a depreciating property. Slowly Ukraine is returning to outright cash purchases of real estate.

### Shorter Loan Terms

In pre-crisis Ukraine, mortgages were typically for 10 to 15 years, and a few banks offered 20 years loans. Most lenders had another condition – a borrower had to be below the official retirement age<sup>3</sup> at the expected time of the loan's expiration.

However, in the post-crisis market, loan durations are much shorter. The longest maturity a borrower can find as of May 2011 is 15 years, and the average is 7 years. Partially, this is due to banks being unable to raise longer-term cash to finance new mortgage loans. However, this shorter duration significantly reduces the difficulty of assessing a borrower's capacity to repay a loan, thus lowering bank risks.

As with increased down payments, such short durations make little sense for the purpose of a 'true' mortgage. In pre-crisis mortgage loans, the largest part of borrowers' payments during the first payment periods were accrued interest. Now, principal and interest payments are almost equal from the beginning of the loan – because the principal repayments are divided over a shorter amount of time – and it becomes very hard – and close to impossible – for a borrower to service a loan.

### Domestic Currency Loans

Last but not least, most mortgage loans in 2011 are offered in domestic currency. On the one hand, this is an improvement since it removes any FX risk from both the lender and the borrower. On the other hand, with domestic currency deposits having typically short maturities and higher applicable interest rates, this makes mortgage loans less affordable now.

<sup>3</sup> Official retirement age in Ukraine before 2011 was 60 for men and 55 for women.

## Competitive Landscape for Mortgage Loans

Banks dominate the mortgage market. Credit unions historically have not been active in this market, and most developers are not financially sound enough to offer any mortgage loan. In fact, many developers now experience problems finishing their projects with construction prices going up and banks elevating credit requirements.

Besides banks, Ukrainians can take a mortgage loan from the state, provided they are eligible for government programs, “Affordable Dwelling” and “Dwelling for Young”. Both of these programs are social, rather than commercial, and target low-income and the vulnerable population. Thus, these loans are not competing with bank mortgages.

Further, the State Mortgage Institution (SMI), which was active in offering affordable mortgage loans in UAH for eligible borrowers in pre-crisis Ukraine, is no longer very active. One reason is that commercial banks are less enthusiastic about being agents for the SMI – in late 2008 it refused to refinance a large portion of eligible loans made by the banks leaving all the risks on the banks. Another reason is that there are fewer and fewer borrowers who can afford mortgages at current SMI requirements – the middle class tends to disappear.

### Box 1. State Mortgage Institution Eligibility Criteria for Borrowers

Age	18 to retirement (55 for women and 60 for men)
Real Estate Market	Primarily only, developer has to be pre-authorized by SMI
Maturity	5 – 30 years
Maximum Threshold	Depends on the location, UAH 1 million for Kyiv
Applicable Interest Rate	Depends on the servicing bank, SMI refinances 11% to the bank and encourages banks for 15% cap
Loan Service	Annuity or Standard
PTI	Less than 45%
OTI	Less than 50%
LTV	Less than 75%
Insurance	Full insurance required from the borrower
<b>(Source: State Mortgage Institution)</b>	

## 3.2 Cash and Retail Loans

Cash and retail loans – the ‘pure consumer’ loans – have always been the most problematic category of loans in terms of quality. The undeveloped credit bureau system in pre-crisis times allowed some to borrow money from different banks, effectively hiding one’s credit history. Some commentators argued that, due to kick-backs from loan applicants, many non-eligible clients were allowed to take out a loan using fake documents. In pre-crisis Ukraine, cash and retail loans used to carry an extremely high effective rate of interest – in some cases as high as 150% annually, and a rate of 80% p.a. was quite common.

Compared to 2008, cash and retail loans are indeed different in 2011. The difference mainly comes from the following areas: (1) different sales practices, and (2) new market players. However, some common features do persist, in particular high implied interest rates.

### Different Sales Practices – Credit Card Loans

Most cash and retail loans in Ukraine used to be offered at the points of sale. It created fertile ground for false documentation and imprudent underwriting. In many cases, credit agents were able to take advantage of banks by ‘fitting’ the borrowers into banks’ eligibility criteria. In addition, this sales practice was rather expensive since it implied fees to credit agents, or salary of bank personnel, at points of sales.

At the same time, before 2010 banks were not actively using such products as credit card loans. Even those bank clients with good income history from so called 'salary cards'<sup>4</sup> were rarely offered credit card loans.

In post-crisis Ukraine the situation has changed. During the crisis banks started to save on administrative costs and the large army of retail loan 'officers' were no longer needed. Therefore, when the situation changed and banks started to offer consumer loans again, they had to work out new sale channels and techniques.

In this regard, credit cards have been a solution. Credit card loans are one of the proven international sale channels for consumer lending. Such loans allow banks to better control borrower's performance, develop various client loyalty programs, and thus better control risks. It is also less expensive compared with point-of-sale loans.

Nevertheless, despite better controlled risks, the perception of 'good paying for bad' is not completely eliminated. Implied interest rates are still high. In Ukraine, there is no restriction on applicable effective rate of interest on a credit card loan. Calculations show that in many cases the real rate charged by a bank (including any additional fees that the client has to pay in addition to the interest charges), exceed 40% p.a. Typically credit card products involve step-up interest rates<sup>5</sup> that make the calculations very difficult even for a sophisticated client. In addition, credit card loans offered in the form of a revolving line of credit are eventually excluded from consumer disclosure<sup>6</sup>, putting bank borrowers in a disadvantageous position.

### New Market Players – Non-Financial Institutions

A notable difference from the pre-crisis situation is the emergence of non-bank and non-financial lenders offering consumer loans. Among these are car dealers, large department stores, and internet stores (mostly home appliance and electronic devices).

Before 2008, many of these non-bank institutions used to have various partner programs with banks aimed at client loyalty, but they were not offering loans to their clients due to regulatory and tax consequences. Some of them continue such partnerships and use banks (in some cases several banks) as end-lenders, allowing the borrower to make his or her choice. However, some of them are now offering in-kind consumer loans: various installment or save-and-buy programs.

For example, a large well-known shoe department store offers an installment option for any purchase above UAH 400. The total price would be split into five equal monthly payments, with the first one made at purchase. Another large national department store for construction materials and tools offers its clients an option to take goods now and pay in a month using a special plastic card. Similar schemes are offered by other companies, as well. All of these schemes have some similarities, as follows:

First, no company offering in-kind consumer loan discloses the ultimate lender. The client therefore develops an impression that the loan is offered by the company from which he or she buys a service or a product. We made significant efforts trying to

<sup>4</sup> A 'salary card' is a debit card issued by a bank for an employee's account so that an employer may wire an employee's wages directly to the employee's account. A large portion of the bank plastic card growth in Ukraine has been attributable to 'salary cards'.

<sup>5</sup> i.e. When an applicable interest rate for different periods varies, e.g. 12% for first 30 days, 20% for 31 to 60 days, and 35% for over 61 days. This rate technically is not 'floating' since it is known at the moment of the loan's inception, but it is not 'fixed' either since it is not the same for all the periods. Depending on the client's payments, the real rate can be significantly different – the earlier the repayment is made the lower the rate is and vice versa.

<sup>6</sup> The disclosure requirements regarding the effective rate of interest is based on the 'expected cash flow' concept. The NBU has issued an explanation that effective rate of interest has to be calculated and disclosed to a borrower only if the borrower can tell the bank about the dates and volumes of expected credit draws and repayments. Since this is not the case with the vast majority of credit card loans, the banks are using this as an excuse not to disclose the effective interest rate.

find out the details of the ultimate lender (using the mystery shopper approach) and failed – no officer of any company that offers such schemes was either willing or able to tell us who is the real lender;

Second, all of these schemes make no sense from a financial mathematics point of view. Formally, these schemes carry no nominal rate of interest; therefore the implied effective rate of interest is negative<sup>7</sup>. It could mean that the 'lenders' hide the real interest cost in the price and most likely take advantage of clients;

Third, such schemes are outside the scope of consumer disclosure requirements, since formally there is no loan agreement.

The last point – exemption from consumer disclosure – is also the case in situations where some companies select as their lending partners non-bank financial institutions. While the Consumer Protection Law does apply to these lenders, a regulation from the Financial Services Regulator to implement the law is still missing.

Such non-regulated lenders often use quite aggressive sales strategies, offering 'quick and easy' loans in various free commercial brochures and leaflets, posters, etc. In the course of preparing this document we used the mystery shopper technique and approached about ten companies that offered cash loans. All of the companies we approached appeared to be non-banks, and all of them refused to make appropriate disclosures set forth by the law, justifying this on the basis of lack of information from company managers. In many cases the conversation halted as soon as we started to ask for required disclosures.

The increased presence of unregulated institutions is not only a threat to potential clients, but it also erodes the already negligible public confidence in financial companies. Most consumers are not able to distinguish regulated financial service providers from others due to a low level of general awareness and limited experience with financial products. It therefore has to be on the agenda of both regulators and financial industry associations to make sure unregulated companies, as well as those that abuse and/or do not comply with consumer disclosure and protection legislation, are removed from the financial market.

### Implied Interest Rates

With unregulated loan providers or in-kind loans, it is almost impossible to calculate implied real interest rates. In fact, such estimations are only possible for cash and consumer loans offered by banks – the regulated institutions – and some non-banks that make appropriate disclosures.

We calculated effective rates of interest for two large cash loan lenders – a large commercial bank and a non-bank financial institution, both operating in every region of Ukraine. Admittedly, this is a small sample and may not accurately reflect market rates and conditions. We assumed several loans between UAH 5,000 and 25,000 for periods of two, four, and six years. The results, which indeed are representative of the market, are presented in the table below.

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<sup>7</sup> The time value of money concept implies that present value of five cash flows of 200 units is less than 1000 unit. Therefore, if a pair of shoes costs UAH 1000, the five installments have to be above UAH 200 to take into account the time value of money. However, if a store offers two options – cash sale for UAH 1000 and five installments of UAH 200 – as equivalent, it therefore accepts negative effective rate of interest.

**Table 6. Effective Rates at a Large Commercial Bank**

Loan Amount	Monthly Installments, UAH		
	2 years loan	4 years loan	6 years loan
UAH 5 000	315 (APR 60.3%)	211 (APR 52.6%)	181 (APR 50.1%)
UAH 10 000	617 (APR 53.0%)	414 (APR 48.7%)	356 (APR 47.2%)
UAH 25 000	1525 (APR 49.1%)	1022 (APR 46.3%)	879 (APR 45.4%)

**NB:** *Additional fees: A UAH 200 one-time origination fee and life insurance (both deducted from allotted loan)*

**NB:** *APR calculations are made by author using the provided monthly cash flows. The bank does not disclose any effective rate of interest in its ads. All rates are annualized.*

**Table 7. Effective Rates at a Non-Bank Financial Institution**

Loan Maturity, Months	Annual Nominal Interest Rate	Monthly Fee	Single Time Origination Fee	APR (Annualized)
6	0.01% on unpaid balance	3.9% on INITIAL balance	3% on INITIAL balance, CAPITALIZED	135%
9				131%
12				127%
18				119%
24				112%
30				107%
36				102%

**NB.** *Calculations are made by author using the estimated cash flows generated by financial company's online calculator. The company does not disclose any effective rate of interest.*

### 3.3 Car Loans

In pre-crisis Ukraine, car loans were very popular. Although there are no official statistics on how many cars have been sold using bank loans, experts suggest that the rate is not less than 30%, and may exceed 50% for some classes of cars. There were several types of partner programs – led by either a bank or a car dealer, depending on the situation. However, in many cases such partner programs left a client with a limited choice – either a bank would dictate from which car dealers to select, or a car dealer would dictate with which banks it operates.

In 2007 – 2008 Ukraine was an attractive market for car dealers with about 30 to 50 thousands new cars sold every month. In 2009, however, sales dropped to as low as about 10 thousand new cars sold every month. Although Ukraine has several national car producers, the vast majority of cars sold were, and still are, imported, and therefore exposed to FX rate fluctuations.

Since the drop in demand for new cars has not been just a Ukrainian phenomenon and severely impacted the entire Eastern Europe region, the international car manufacturers started to design a global solution to this. An effective approach has been to use an in-house financing company to offer car loans to clients.

In Ukraine, the first in-house car loan service was offered by Nissan-Renault Finance. The program is designed jointly with Index Bank (a member of Credit Agricole). However, the presence of in-house car finance companies in Ukraine is still relatively low compared to other countries in the region – e.g. in Russian Federation there are subsidiaries of

virtually all large international ‘car banks’ like Toyota Finance, Volkswagen Group Finanz, Mercedes Benz Finance, etc.

From a consumer standpoint, car loans in Ukraine have remained almost unchanged, unlike mortgage and consumer loans. The following issues are still present and awaiting a proper solution: (1) choices for consumers, (2) associated insurance, (3) associated fees and commissions, and (4) unregulated financial products. The rest of the loan conditions – applicable interest rates, loan duration, and down payments – essentially remained the same.

### Choice for Consumer

Historically in Ukraine, consumers were limited in their choice of lenders for car loans. That was due to so called ‘partnership programs’ present between a car dealer and a bank.

Most car dealers are exclusive dealers for a particular brand. They make their own choices as to which financial company (or companies) to partner. In some cases, these choices are dictated by the parent company, and in some cases are made domestically. Both of these situations lead to limiting the consumer’s ability to choose among lenders by limiting the number of eligible lenders. Situations where a particular car dealer operates with only one bank are widespread.

If the client does not find the offered loan acceptable, there is no other option to finance the purchase. Applying to a non-partner bank for a cash consumer loan is not a solution due to the size of loan.

This practice is a limitation of competition.

### Associated Insurance

Ukrainian Insurance Law states that property risk insurance is a voluntary type of insurance. As such, no one can require anyone to enter into an insurance contract with a particular insurance company as a pre-condition for any other civil act (e.g. sale, lease, or loan). From this standpoint, the car owners are free to choose any company to buy car insurance.

At the same time, the Collateral Law requires a collateral item to be insured from risk of damage or loss. It does not, however, clearly state whether or not the lender might dictate a particular insurance company for the borrower, except in the case of a mortgage where it indeed can dictate. From this standpoint, the new car owners may not be free to choose their own insurance.

There is a long history of disagreements between the borrowers and the lenders about car insurance. The lenders insist on their associated companies – with typically higher insurance premiums – and in most cases succeed. The borrowers, however, insist on freedom of choice – and in many cases end up being scrutinized by the lenders for non-compliance with loan terms and conditions.

The law has to be corrected to provide clear requirements, and consumers have to be educated on those requirements. It is not a prudent practice to hide the real cost of loans in insurance payments. It is also not prudent to recognize only insurance from an associated company as the only eligible one.

### Associated Fees and Commissions

Because of the “competitiveness” of automobile sales, there has always been a temptation for lenders to lower the nominal, advertised interest rate, and instead make money on associated commissions. An example of such commissions were the insurance premiums charged by insurance companies associated with the bank – technically they

were not part of the nominal interest rates, but in substance these were additional charges to the client. While this temptation is present in almost every type of loan, it has surfaced the most in car loans.

### Unregulated Financial Products

A worrisome feature of Ukrainian car loans is the rapid growth of unregulated financial schemes and products, namely the so-called 'group purchase'. This is a combination of installment loan and savings scheme: several individuals that want to purchase a car come together as a group; each member makes a monthly contribution that equals the car price divided by the number of group members (thus the larger the group, the smaller the installment); every month one car is purchased and 'randomly distributed' among the group participants; those who have already been lucky enough to get a car should still make contributions in the next month until all group members have their cars.

This scheme indeed sounds a bit like a financial pyramid and requires close oversight. However, Ukrainian financial services legislation does not recognize it as a financial product and therefore it is effectively left with no licensing, control, or supervision. In substance this is a form of credit cooperation, but with no credit union established to support it legally.

It is not possible to estimate the size of such unregulated business since technically these car purchases are not registered as a 'loan' – the lucky group member becomes the rightful owner with no recognition of his or her liability to the rest of the group members. There is also no complaint history on this scheme either, simply because there is no regulator.

## 4 Conclusions and Observations

It appears that the 'credit crunch' in Ukraine is easing somewhat, and consumer loans are now available again. Lenders are ready to make new loans, and clients may be willing to borrow. The recent financial crisis should have taught a tough lesson to both lenders and borrowers, causing them to change their approach to credit.

Obviously, the pre-crisis goal to expand market share caused the lenders to make their products as attractive to borrowers as possible. In many cases it led to a relaxation of prudent underwriting policies.

Lenders used to compete on the price of a loan (represented by the nominal rate of interest), and the time to process a loan application. The real cost of a loan (the effective rate that includes all additional fees and charges, as well as other significant terms of loan agreement) was not openly presented to borrowers, creating many problems with consumer protection.

In post-crisis Ukraine, the goal of lenders again is becoming market share. As the economy recovers, there will be more people willing to take a loan and believe they can afford it. Most likely, these are going to be new customers with no experience with loans, including young Ukrainians, whereas existing borrowers are still struggling with their debt and credit history. These new customers will probably be offered consumer loans that are somewhat different from what was offered pre-crisis:

First, the focus will be on domestic currency loans. If pre-crisis it was difficult to find a consumer loan denominated in domestic currency, now the situation has completely reversed – new loans are predominantly offered in domestic currency. Obviously, we can conclude that this is significant improvement in the risk environment as it eliminates any FX risk component from both the lenders and the borrowers;

Second, loan costs are higher than pre-crisis, even if measured by nominal rates. By itself this is not a problem, since loan rates are tied to macroeconomic conditions. However, in this case consumer disclosures come to the front – borrowers have to know the real price of a loan before the contract is signed, and lenders are absolutely obliged to provide such information. This issue becomes more important if we remember that expected new consumers might not have or only possess basic financial skills and abilities; and

Third, new lenders – non-bank financial institutions – have entered the market and are actively offering consumer loans. This difference might not be seen by an average financial consumer, since the loans are offered at the same places they were offered before the crisis – at points of sale. However, if previously loans were offered by either a bank or a bank agent, they are now being offered by retailers and dealers. Again, by itself this is not a problem – in many developed economies non-bank lenders play a significant role in consumer lending. Unfortunately, in Ukraine their involvement makes financial consumer disclosure problematic. Since non-bank financial institutions are non-regulated, clients have to work hard to make sure their rights are observed

Additionally, some problems that contributed to the velocity of the consumer lending crisis in Ukraine are still in place and create challenges for lenders:

First, retail lending in many developed economies is heavily based on outsourced, independent credit scoring and credit bureaus. These agencies lower the costs and risks for lenders. However, now credit histories are basically ignored by new lenders in Ukraine, especially by non-bank institutions. Thus, lenders are still confronted with credit assessment problems;

Second, willing lenders have to adjust their internal credit approval practices (or loan underwriting standards) to recognize the presence of the shadow economy. For potential borrowers it is still difficult to prove their cash flows. For lenders to rely merely on real estate or any other type of 'hard' collateral is no longer appropriate due to problems with foreclosure practices; and

Third, banks that require their clients to buy insurance as a precondition for consumer lending (from an associated insurer) may skew their credit approval process.

The overall conclusion is not positive – it seems that Ukraine's financial system has not been able to use the crisis as an opportunity to improve lending practices. There is still significant room for improving the disclosure regime, credit underwriting standards, lending market infrastructure, and regulatory oversight. These problems have to be approached and corrected promptly, before they have an adverse effect on future financial sector resilience.

## 5 Recommendations

The situation with regard to consumer lending in Ukraine requires reform. Some lessons from the financial crisis have not been completely absorbed with regard to consumer finance, and appropriate policies and regulations have not been put in place. One major source of the problem – just like before the crisis – is poor consumer awareness and lack of proper disclosure and consumer protection.

The analysis of existing practices, however, suggests that a standard Ukrainian refrain, ‘Pass a new law,’ is not a workable solution. Ukraine to a great degree has not used properly the existing Consumer Protection Law, which in fact gives the consumers fairly broad powers to protect themselves. The two missing components are implementing regulations and the consumers’ awareness of their legal rights.

Several immediate steps are appropriate:

- Introduce an implementing regulation by the FSR to ensure a level playing field for financial institutions, and eliminate any regulatory arbitrage that exists now. This would restore the competitive landscape and put all the financial companies under equal disclosure and conduct requirements.
- Launch a public awareness campaign to explain to average Ukrainians what rights they have vis-à-vis financial service providers, and what to do to ensure that these rights are respected. This might include establishing a department in several state agencies that would be responsible for consumer complaints.
- Re-visit the existing NBU Real Rate and Cost of Credit Disclosure Policy to ensure banks can no longer use artificial excuses to avoid proper consumer disclosure, and invigorate NBU enforcement.

Besides the cost of borrowing, the asymmetry of bargaining powers has been a significant problem for consumer finance in Ukraine. Some immediate remedies could include: unified, or standardized, legal texts for most popular types of loans, e.g. mortgage, car, or consumer loan. These templates could be developed by professional lawyers and made effective through the consumer protection legislation. The financial institution would only be allowed to enter borrower’s name and other specific loan details in the preprinted form, and no other amendments to legal clauses would be possible. This would reduce the most imprudent lending practices and protect the consumers not through education (which is still preferred, but an expensive and time-consuming effort), but through administrative and legal measures.

In addition, the regulators have to start taking serious actions against those institutions that breach consumer protection requirements. This would demonstrate to the market that consumer protection is not a mere notion, and has to be considered seriously by all parties involved.