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LEGISLATION MONITORING: FINANCIAL SERVICES CONSUMERS PROTECTION

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News Flash

On **November 4, 2010** the **Draft Law "On Amending Article 6 of the Law "On Arbitral Tribunals" # 6670-1** passed the first reading in the Verkhovna Rada. The Draft Law excludes consumer protection-related matters from arbitral tribunals' jurisdiction. If the Law is adopted, all disputable matters will have to be decided exclusively by state courts. Currently, there is a possibility for financial or any other institution to include a provision into an agreement with a consumer that all disputable matters will be decided by a particular arbitral tribunal. Very often such arbitral tribunals are created under certain institutions (so called "pocket" tribunals) and are likely to decide matters in favour of such institutions. A consumer is usually not able to influence such "typical" reservations in an agreement. Moreover, in such a case a consumer is deprived of the right to apply to a state court, as well as to appeal the arbitral tribunal's resolution (unless there were evident procedural violations in arbitration). Also, a consumer is required to pay an arbitration fee whereas application to a state court is free of charge in consumer-related matters. Therefore, adoption of the Draft # 6670-1 is likely to enhance consumers' rights protection.

Also, on **November 10, 2010** the **Draft Law "On Amendments to Certain Laws of Ukraine in Relation to Protection of Creditors' and Financial Services Consumers' Rights" # 7351** (hereinafter referred to as "**Draft # 7351"**) was registered with the Verkhovna Rada. The Draft # 7351 is supported and pushed by banking industry. It has undergone a number of discussions and approval with relevant ministries.

The title of the Draft Law has changed several times and now it is supposed to refer not only to creditors' rights protection, but to consumers' ones as well. See below overview of Draft # 7351.

Overview of Draft # 7351

As indicated in the Explanatory Note to the Draft Law, the draft is aimed at improvement of creditors' rights, as well as bank depositors' and financial services consumers' rights in order to reduce risks in financial sector and decrease the amount of non-performing assets in banks' portfolios. However, it would be fair to say that the Draft Law addresses creditors' rights protection (mainly banks' rights) far better than the consumers' ones. Very often, due to ambiguous or inconsistent provisions, good intentions of a lawmaker resulted in detriment for the consumer. In some cases, positive changes are so minor that they do not influence the situation substantially.

Besides, the structure of the Draft Law is misleading. It consists of the body of the Draft Law and Transitional Provisions, which however, also contain very critical and controversial provisions. Under general legal drafting rules, such provisions should be incorporated in the body of the Draft, not in the Transitional Provisions.

The Draft Law contains technical errors. The current Civil Code indicates the possibility of granting a loan by a bank or another financial institution. However, the words "another financial institution" are lost through the text of the Draft Law.

For the purpose of this memorandum, changes suggested by the Draft Law with respect to consumers' rights protection have been arranged into three groups:

- Positive changes
- Changes positive by nature but not implemented properly
- Negative changes

Positive changes:

1. "Consumer" and "consumer loan" notions will be clarified in the Law "On Protection of Consumers' Rights" (hereinafter referred to as "**Consumer Protection Law"**), so that there will be no ambiguity as to whether "mortgage loans" are covered by "consumer loans". A consumer loan will be defined as "funds (money) granted by a creditor (bank or other financial institution) to a consumer for purchase of goods, **real-estate** or services". The Draft Law

clearly states that consumer loans include loans for purchase of real-estate, that is mortgage loans. It is a positive clarification since all consumers[1] which have mortgage loans will undoubtedly fall under Consumer Protection Law.[2]

2. The Draft Law introduces amendment to the Civil Code of Ukraine that provisions of contracts with natural persons-consumers, including consumer loans, shall comply with the consumers' rights protection legislation, herewith referring to the Consumer Protection Law. Currently, there is a reference in the Civil Code to consumers' rights protection only with respect to retail purchase-sale contracts. In general, this is a minor step forward since consumer loans fall under Consumer Protection Law anyway, even without a special provision mandating it in the Civil Code.

3. According to amendments suggested to Consumer Protection Law, before entering into a contract with a consumer, a creditor will have to inform a consumer of the estimated total loan cost including interest rate and cost of all the services (registrar, notary, insurance, valuation etc.) related to obtaining a loan and entering into a contract. A loan contract itself has to contain total loan cost with all the details as described above. It is also a minor change expanding current norms and making them more explicit. This is not a novelty because the same expanded provisions have already been envisaged in the NBU Resolution #168 of May 10, 2007 "On approval of Rules of Providing the Consumer with Information on Loan Conditions and Total Loan Cost by Banks of Ukraine". The only positive result is that legal force of such provisions will be higher that that of NBU resolution (which does not necessarily mean they will be followed more strictly) and that it might be easier for a consumer to find them gathered in the law than in NBU acts.

Besides, it will be forbidden to make it harder for the consumer to read a total loan amount indication in the contract by typing it in small print, on indistinct background etc. This is merely a formal, not a substantive change.

4. The non-performance period for the consumer mortgage loan will be increased from 1 to 3 months. Only after a 3-month period expires, a creditor will have the right to demand the early repayment of the loan. A consumer will have to pay the loan within 60 calendar days starting from receipt of the creditor's demand (compared to 30 calendar days in current version).

5. A creditor will have to inform the consumer of transfer of its rights under loan contract to third parties (e.g., collection agencies). This is a positive step forward allowing consumers to be well informed of the new creditor.

Changes positive by nature but not implemented properly:

1. A creditor will not be able to establish any fees and payments for the actions which are not considered "service" in terms of the Consumer Protection Law. "Service" is "any activities of a bank which will result in providing of a consumer with a material or non-material weal requested by a consumer for his/her individual needs". By making such a change a lawmaker must have intended to say that any action for which a bank intends to charge fee, shall have a clear and definite subject. (Such a requirement was previously stated in NBU letters of 6/16/2007 and 7/16/2007). But there is not a big deal for a bank to overcome the above provision since almost any bank's activity (opening an account, servicing a loan, cash processing etc.) can be treated as a "material or non-material weal" for a consumer, and signing a loan contract can be treated as confirmation of the consumer's request and consent for such additional services. Also, the suggested provision can be understood as giving a bank the right to establish fees that are not included into total loan amount.

Instead, we would suggest the wording from the NBU Resolution #168 and Kyiv Commercial Court Resolution # 18/363-a of 11/22/2007 that "a bank may not charge fee for actions which a bank exercises for its own benefit, or actions which a consumer exercises for the bank's benefit, or actions which a bank or a consumer exercise to establish, change or cease credit relationships". That is, a bank should not be allowed to offer a consumer a number of services related to loan receipt instead of one explicit service. Any costs deriving from the loan that are compulsory in order to obtain a loan must be included into total loan cost. Any costs which are optional shall be explicitly stated in the contract.

2. The Draft Law provides for loan restructuring mechanisms. However, these restructuring mechanisms are the right, not the obligation of a bank**,** and there are no any incentives for banks to do so. Under the Draft Law a creditor will have the right, with a consumer's consent, to make debt restructuring under the consumer loan contract by way of:

- Postponing payment of the principal of the loan for a period of 3 years;
- Prolongation of the consumer loan contract, taking into account limitations effective within a bank and financial conditions of a borrower;
- Amending the mechanism of accruing interest so that monthly payment does not exceed 35 percent of monthly profit of a family;

[1] Please note that a consumer is always a natural person under Ukrainian legislation.

[2] Unless otherwise indicated in this paper, terms "consumer loan", "loan", "consumer loan contract" cover also loans secured with mortgage.

- Division of liabilities in foreign currency to:
  - Liabilities secured with mortgage in the amount of remainder at the moment of restructuring expressed in gryvnya (UAH) at the exchange rate effective on the date of loan receipt;
  - Liabilities not secured with mortgage in the amount of difference between the remainder in UAH at the exchange rate on the date of restructuring and remainder in UAH at the exchange rate on the date of receipt of the loan which shall be performed in the end of the contract term.

The first three restructuring mechanisms are the same as envisaged in the Law of Ukraine "On Amendments to Certain Laws of Ukraine with the Purpose of Overcoming Results of Financial Crisis" No 1533-VI (hereinafter – Law # 1533). The analyzed Draft introduces restructuring mechanisms on a permanent basis instead of "by 31 December 2010" as it is under the Law 1533.

The last restructuring mechanism - restructuring of mortgage loans in foreign currency - means that a bank will have the right to calculate, and a customer will make recurring payments, based upon the cost of the remainder of the mortgage loan at the exchange rate effective on the date of loan receipt, and the difference in the cost of the loan which arose because of exchange rate difference will be paid in the end of the loan term. In fact, substantial amount of the debt, which is exchange difference that arouse during financial crisis, shall be paid by the borrower anyway. Also, the fact that exchange difference amount is not secured with collateral, will not deprive the bank of possibility to foreclosure other borrower's property on a general basis.

The Draft Law also introduces a new taxation rule as a result of restructuring: if a borrower performs obligations in full and on time under the restructured loan agreement within three years since the debt restructuring, a bank will be entitled to an annual decrease by 0.5 percent of the outstanding principal debt during next five years, and this amount shall be included into deductible expenses of the bank.

This provision has a positive intention but non-effective implementation (due to wording). First of all, a bank's tax incentive depends on the borrower's execution of liabilities, and it is obvious that a bank cannot control the borrower's behaviour effectively. There will also be a substantial time gap between the restructuring and tax incentive. Moreover, such incentive might cause taxation of the amount decreased on the borrower's side, and a bank may be considered a tax agent for the purpose of accrual and payment of the personal income tax. This will have negative impact on the bank's cash flow. In terms of legal drafting, suggested amendments have to be incorporated as amendments to tax laws because any changes to taxation must be done via amendments to tax laws.

3. The division of interest rates into fixed and floating (variable – under the Draft Law) shall be introduced. Suggested provisions on application of fixed and variable rates have serious drawbacks and need to be improved.

Fixed interest rate is the one which might not be changed during the term of the loan agreements ***unless otherwise agreed upon by the parties.*** The phrase in bold levels the purpose of the fixed rate. As previously, banks will use all possible means of drafting loan contracts in a way that will constitute the borrower's consent to the bank's unilateral change of the rate. Fixed interest rate should provide for no possibility to be changed by a bank unilaterally. A borrower's consent hereto shall be confirmed in writing, and a corresponding addendum to the loan agreement should be signed.

The Draft Law provides for certain **peculiarities of variable interest rate** application:

- when using variable interest rate, a creditor will have the right, without a borrower's consent, to make periodic changes to interest rate under the conditions and procedures established by a loan contract;
- a loan contract will have to provide for the procedure of variable interest rate calculation, including application of index agreed upon by the parties;
- the procedure for variable interest rate calculation must ensure determination of the exact interest rate on the loan at any time during the term of the loan contract;
- a creditor will have no right to amend the procedure for variable interest rate calculation without a borrower's consent;
- maximum interest rate increase will have to be determined in the loan contract.

The following drawbacks of the suggested provisions of the Draft Law should be pointed out:

- the term "variable" is controversial; the term "floating" is more widely used in practice;
- a creditor has the right, not the obligation to change the rate. In cases when appropriate index will change in favor of a borrower, the creditor will have the possibility not to reduce the interest rate;
- instead of the phrase "a creditor has the right without a borrower's consent to make periodic changes to interest rate" it would be more appropriate to say that "both a creditor and a borrower agree that the interest rate shall be variable";
- the provision that "maximum interest rate increase shall be determined in the loan contract" is lifeless since a bank or another financial institution may suggest that maximum interest rate increase is 100 000% of the initially defined.

Additional arguable requirements are set up for determination of **index value** used in the formula for variable interest rate calculation:

- current value of the index will have to be periodically, but not less than once a month, published in the media or made public through other public sources of regular information. The loan contract will have to include the reference to source of information about the index;
- the index shall be based on objective indicators of financial sector allowing to determine the market value of the loan;
- the index shall be established by an independent institution with a recognized reputation in the financial services market.

It is obvious that requirements for index value are not clear and definite. It is not clear how the criteria "a recognized reputation in the financial services market" will be determined. "Other public sources of information:" might not be easily accessible. This could lead to abuses by banks and financial institutions.

In our view, methods of variable rates calculation and maximum interest rate increase should be established by the National Bank of Ukraine Resolution.

4. Consequences of early repayment of a loan will be clarified. In case of early repayment a consumer will have to pay interest rate and cost of loan-related services only for the actual period of the use of loan. The creditor will not be entitled to charge any fees in case of early repayment of the loan. However, another provision of the Consumer Protection Law seems to deviate from the above since it requires that a creditor shall inform a consumer about "conditions of early repayment of the loan". Since the right of early repayment is unconditional and all the consequences are determined in the law, a creditor shall only inform a consumer about the "procedure for early repayment" without any specific provisions of early repayment initiated by a creditor.

5. Automatic eviction of residents from dwelling in case the apartments are foreclosed will be introduced. It means that with the same resolution the court will have to order to foreclose the dwelling, as well as to evict the residents. The court shall also indicate another permanent dwelling where the evicted person(s) shall be moved.

Current laws are contradictory but the procedure seems to be the following. The court has the right, not the obligation to evict residents with the same court resolution which established foreclosure on the dwelling. If the court does not take a decision on eviction, the residents must leave the premises at the mortgagee's request within one month from the receipt of such a request or another period agreed upon with the mortgagee. If they do not obey, than mortgagee can apply to the court and ask for eviction.

In general, we support the idea that the procedure for eviction should be improved. But the law cannot mandate the court to take a particular decision since, under the Constitution, all branches of power (lawmaking, executive and judicial) are independent, and the court should always have the possibility to consider the issue. Also, it is not clear what "another permanent dwelling" for moving the evicted means and where the state is going to take it. So, the analyzed provision might be lifeless.

6. In case of death or category 1 disability of one or both parents during the term of the mortgage agreement, it will be forbidden to foreclose the housing that is subject to the mortgage and in which a child resides until the child reaches adulthood. Obviously, a lawmaker must have had good intentions to introduce such a norm. But one should keep in mind that it may lead to certain corrupted actions aimed at obtaining false disability certificates to escape loan liabilities.

Negative changes:

1. It will be forbidden to provide (obtain) foreign currency denominated consumer loans within the territory of Ukraine. This provision is quite a controversial issue. The borrower's rights should be protected by increasing the level of financial literacy not by prohibition of foreign currency denominated loans. Firstly, some people receive incomes in foreign currency. General rule is that it is better to borrow in the currency of income receipts. Secondly, majority of banks are borrowing abroad in foreign currency, so foreign currency risks will be included into the value of hryvnya denominated loans anyway.

2. The necessity to obtain the consent of the guardianship and care-taking authorities for the transactions with real estate property owned or used by children, as well as disposal of the mortgaged property, will be cancelled. According to current legislation, parents of minor children are not allowed to perform transactions with real estate property owned or used by children without the consent of the guardianship and care-taking authorities.

Very often the guardianship and care-taking authorities refuse to provide consent to relevant mortgage contracts, so previously banks and lenders tended to ignore the specified provision of the Law. With the onset of the crisis and

inability to pay back loans and substantial interest, parents who had mortgages started using the absence of consent of the guardianship and care-taking authorities as the basis for recognition of mortgage agreements void.

However, bad practice should not be the reason to cancel the necessity of such a consent at the law level. Instead, the procedure and the mechanism of consent receipt, as well as grounds for guardianship and care-taking authorities' refusal to provide consent should be improved.

3. The possibility to foreclose pledged property based upon a notary's executive writ shall be introduced. Foreclosure based upon a notary's executive writ is a far more simple procedure than upon a court's decision. It is not a secret that most banks have their "pocket" notaries. Under the suggested amendment, all important actions will be performed within a notary office: entering into a pledge and foreclosure. A consumer will be, therefore, deprived of consideration his/her case by a court.

Summary of Recent Developments

Draft Law # 7351 is rather controversial. Unlike previous versions which addressed the issue of creditors' rights protection only, this Draft is supposed to refer to consumers' ones as well. However, whereas the Draft contains certain timely provisions aimed at improvement of the creditors' rights protection mechanism (for example, in bankruptcy and enforcement proceedings), protection of consumers' rights is merely a declaration. Some of the suggested provisions have already existed on the level of NBU regulations or even on a law level (on a temporarily basis). Some of the provisions are so poorly drafted that good intentions are brought to nothing. In many cases positive changes are too minor: they clarify certain rules, but do not change the situation substantially.

FINREP has been involved in discussion of the Draft Law through participation in AmCham Banking and Finance Committee. Since the Draft Law is supposed to address consumers' rights, which is the area of FINREP's great concern, it would be expedient to prepare our comments and suggestions to the Draft Law and submit them to the Verkhovna Rada Committee on Finance and Banking Activities before it's scheduled for the first reading and to AmCham.

History and Process

The Draft Law was prepared by NBU in co-operation with Association of Ukrainian Banks (AUB). AmCham is also commenting the Draft Law, and if there is agreement within the Banking and Finance Committee, AmCham will support it.

June 7, 2010. Draft Law was discussed at the Financial Press Club Meeting.

June 22, 2010. Cabinet of Ministries hold a consultation with NBU, Ministries and AUB dedicated to this Draft Law. The Meeting was chaired by Mr. Sergiy Tigipko, Vice-Prime Minister of Ukraine. It was decided to agree the Draft within the relevant Ministries and finally approve the Draft. Mr. Tigipko said that the balance of creditors' and debtors' rights protection should be achieved. In case of foreclosure on the mortgage, dwellers (borrowers and their families) shall not be evicted without being provided with another dwelling. Mr. Tigipko also proposed to oblige banks to make restructuring of non-performing loans.

As the result of the consultation, the Draft Law was submitted to the V.M.Koretsky Institute of State and Law of National Academy of Sciences of Ukraine.

June 30, 2010. The V.M. Koretsky Institute of State and Law of National Academy of Sciences of Ukraine issued the legal opinion on the Law.

In general, the Institute supported all the provisions of the Draft Law. The Institute confirmed the Draft Law is in accordance with Ukrainian legislation and is aimed at elimination of legislative gaps and inconsistencies in current legislation. It was also stated that, from the substantive point of view, the Draft Law is aimed at protection of creditors' rights. The only concern which was expressed by the Institute relates to cancellation of necessity to obtain the approval of the guardianship and care-taking authorities for the transactions with real estate property owned or used by children. In the opinion of the Institute, such approval shall be cancelled only for cases where mortgage agreements are concluded for the purpose of getting loans for dwelling, and not for other goods.

July 1, 2010. The World Bank provided AmCham with their comments regarding the said Draft Law. In general, WB supported only part of provisions of the Draft Law regarding:

- Improvement of mechanisms aimed at protection of secured creditors in bankruptcy and judicial enforcement proceedings;

- Possibility to foreclose pledged property (movable property) based upon a notary's executive writ;
- Automatic eviction of residents from dwelling in case the apartments are foreclosed;
- Criminal responsibility of a natural person for providing false financial information to the bank;
- Cancellation of necessity to obtain the consent of the guardianship and care-taking authorities for the transactions with real estate property owned or used by children was generally supported provided that the state has no other vital interest that could justify the necessity of such consent. Therefore, WB cannot evaluate results of such amendments. Also, according to WB, rights of guardianship and care-taking authorities shall be clearly foreseen in the law or another regulation.

At the same time, WB did not fully support and suggested to review the following items:

- Even though liabilities of a natural person as such and of a natural person-private entrepreneur for the purpose of bankruptcy shall be separated, a person shall be allowed to use the part of property which is necessary to support vital needs;
- Debt problems of natural persons as consumers, entrepreneurs, shareholders etc. should be well regulated in legislation;
- Notions of secured and unsecured creditors shall be introduced; where it is necessary to grant certain groups of creditors with special rights (tax authorities, employees), such rights and privileges should be clearly indicated in the law;
- Creditors shall be informed of the bankruptcy procedure initiation not only via Highest Commercial Court web-site (as foreseen in the Draft Law) but via printed media as well because ordinary creditors do not necessarily review the said web-site.

No comments were provided by WB regarding restriction of the right of a borrower-natural person to demand the deposit back at its first request.

See below the chart which summarizes the comments of the Institute of State and Law of National Academy of Sciences of Ukraine and World Bank.

№	Provisions of the Draft Law	Institute of State and Law	WB
1.	The possibility to foreclose pledged property (movable property) based upon a notary's executive writ shall be introduced	Supported	Supported
2.	Liabilities of a natural person as such and of a natural person-private entrepreneur for the purpose of bankruptcy procedures shall be separated.	Supported	Should be reviewed
3.	Automatic eviction of residents from dwelling in case the apartments are seized shall be introduced.	Supported	Supported
4.	The necessity to obtain the consent of the guardianship and care-taking authorities for the transactions with real estate property owned or used by children, as well as disposal of the mortgaged property, shall be cancelled.	Supported only with respect to mortgages for dwelling	Supported provided that the state does not have vital interest to justify the opposite
5.	Criminal responsibility for providing false financial information to the bank with the aim to get a loan and for illegal disposal of pledged property shall be introduced	Supported	Supported
6.	The conscientious (honest) pledge shall be protected. It means that if the property was transferred to the pledgee by a person who did not have such a right, the transferred property cannot be withdrawn from the pledgee	Supported	No comments provided
7.	The right of a borrower-natural person to demand the deposit back at its first request shall be restricted.	Supported	No comments provided