

Ukraine 2010:

Timely Mortgage Modification and Sharing of the Burden

May 26, 2010

UNIA FINREP Mortgage Round Table

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The Status Quo is Unsustainable

- Payment Holidays Are Temporary
- Crisis Law Expires
- Forex Vulnerability Remains

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Key Stakeholder Needs

- Borrower: Certainty of Cost in Hryvnia
- Borrower: Stay in Home
- Banks : No Immediate Capital Charge
- Banks : Conducive Provision & Tax
- GoU : No Budget Outlay
- GoU : No Contingent Liability

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Modification Elements

- Conversion USD to Hryvnia Terms
- Lock in Bank Forex Gains To Date
- Separate Original Note from Forex Gain
- Original Note Same Amortization Term
- Forex Gain Note Ballooned
- Effectively a Forex Conversion with Prolongation Option

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Obstacles

- Provisioning Issues
- Tax Issues
- Legal Issues
- Foreclosure Speed and Fairness
- Borrower Incentives / Crisis Law

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Action Steps to Take

- Banking Community Agreement on General Terms of Modification
- Unified Proposal by Banks to NBU
- Unified Proposal by Banks to Tax Authority
- Unified Proposal by Banks to Rada
- FINREP Can Provide Assistance

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Timely Mortgage Modification and Sharing of the Burden

By now it is clear that dollar-denominated mortgage loans have become a problem in Ukraine. In the face of this difficulty, the banks have taken remedial actions, mobilizing collection efforts, securing additional collateral pledges and employing numerous modification methods. Principally, though, the modification schemes to date have deferred customer payments to the near future through payment holidays and capitalized costs, remedying the problem only temporarily. The following proposal is a more permanent solution to the problem. It represents only one of many possible approaches, but it does meet certain key criteria that make acceptance by all parties involved more palatable. Those criteria are:

1. It keeps homeowners in their homes, with certainty as to their fixed hryvnia monthly payments
2. It eliminates the impact on the mortgage of future movements of dollar/hryvnia exchange rate, effective the day of modification
3. It separates the customer liability for the mortgage servicing (in hryvnia) incurred as the result of loan origination from the liability incurred to date due to the exchange rate effect
4. It results in no initial capital write down by the banks, and reflects concessions in reduced future income rather than in principal write down
5. It includes reasonable provisioning and tax treatment, reflecting the reduction in default risk and the deferred nature of certain returns on investment
6. For the Government of Ukraine, it does not exact funds from the general budget nor create any contingent government liability
7. Using the tail-risk option, it protects the borrower from extreme loss if extreme but unlikely economic outcomes (severe inflation or severe deflation) occur

How does the scheme work?

At the time of modification, the existing mortgage instrument (fixed rate dollar-denominated secured mortgage) is replaced with two instruments. The first instrument is a hryvnia denominated fixed rate mortgage instrument set at the original dollar-based mortgage amount and rate. That would be the new mortgage.

The second instrument would substitute for the anticipated payment stream from the foreign exchange agreement that was part of the original instrument. The obligation would be valued at the differential of the original mortgage amount and the obligation existing at the date of modification. This effectively locks in the foreign exchange gains the lender has obtained.

The sum of the two instruments would equal the book value of the present indebtedness; hence no write down in the value of the transaction would be needed at the bank. The maturity term of these two instruments would mimic the original borrowing term.

The payment on the first instrument would be simple, and follow the usual mortgage amortization, monthly installment method. The payout on the second instrument, which carries a similar interest to the first note, would be ballooned at the end of the mortgage amortization period. Valuation of the instrument through the period would continue at book value, as there is no reliable market valuation for a long term monthly-amortizing dollar/hryvnia forward contract on which to price. At terminus, the borrower would be obliged to pay, or refinance the cost of the second instrument. Due to the delayed timing of the payment, the likelihood that a more stable real estate market, and hence more appropriate real estate prices, will have emerged is greatly increased.

In effect, with this modification the banks will have locked in the partial windfall of the 2009 hryvnia / dollar movement, foregoing future gains or losses that occur on the exchange contract, while significantly reducing the default risk of the loan.

The benefit for the borrower would be to provide *certainty* of cost on the mortgage. Hryvnia denomination eliminates the borrower's foreign exchange risk.

The societal cost of mass foreclosure, or continued uncertainty as to ownership and occupancy of property will be removed. Anti crisis protections, which may have inadvertently led to moral hazard and refusal to pay by even financially secure borrowers, will become unneeded.

Applicability

This scheme would hold true only in the case where the original (or their beneficiary in the event of death) borrower remains. Any earlier sale would revert to terms of the original contract. This eliminates the possibility of speculators "gaming" the system for the lower initial financing cost.

I. Additional Options

Insuring Against Tail Risk

An additional benefit to borrowers can be offered in the form of a repayment option on the second, forex related, balloon loan. The option to use either the above detailed payback/refinance of the residual amount (i.e. the second instrument created at the date of modification by the forex conversion of the loan) OR an additional new option of the borrower surrendering one half of the property's residual value in lieu would eliminate the borrower's potential "tail" risk. That is, if hyperinflation occurs and the hryvnia value of property soars, the borrower need only pay back the second loan amount...greatly reduced in real value by inflation and price appreciation. If alternately deflation and housing price declines remain, the borrower need only repay one-half the dwelling's appreciation, if any. Neither extreme outcome is likely, and such an additional accommodation by the banks provides significant borrower peace of mind at little cost.

Providing Additional Bank Liquidity^[1]

A local academic suggested a variant on the proposal, though it was one that involved deeper government involvement. He suggests it would be perfectly logical to pass a law making it possible to convert foreign currency mortgage loans into UAH loans at the pre-crisis exchange rate, with the exchange rate difference in the value of loans (about UAH 6-7 billion) being documented as debt securities with 7-10 years maturity. Based on the above law, banks would be permitted to use said securities, just as government bonds, as security for NBU refinancing, and to keep them on their balance sheet. What are the benefits of this measure? Borrowers will be able to repay their mortgage loans at the pre-crisis exchange rate. They will compensate the exchange rate difference, paying by installments over a ten-year period. Banks will be able to cut down on their provisions for bad mortgage loans and will release funds for new lending. And the Government of Ukraine will be freed from one more social problem, although initially it will have to use State budget funds to buy out said securities from financial institutions via NBU.

[1] Source : UNIAN News Agency, Olexander Okhrimenko, PhD, 30 March 2010