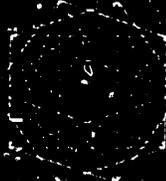
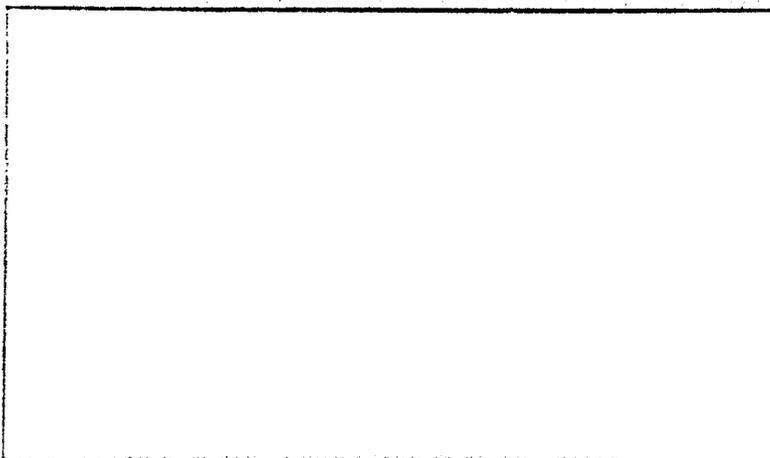


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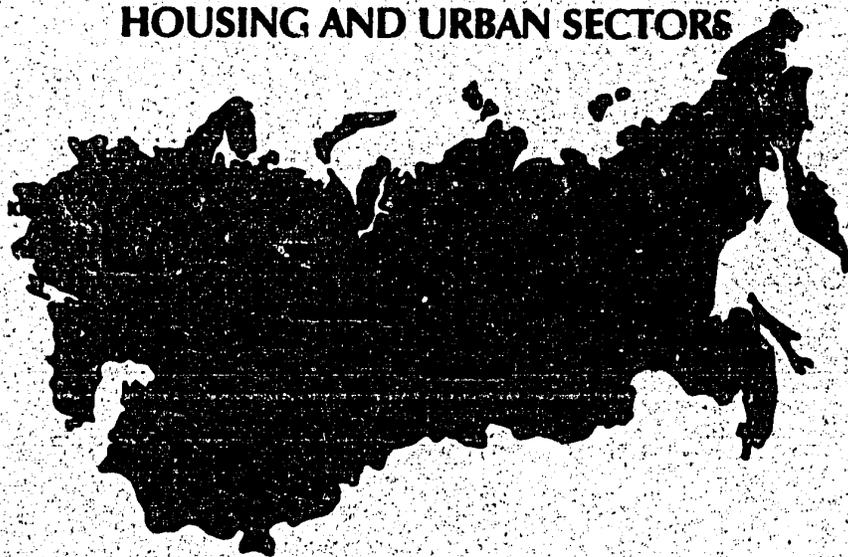


P A D C O

PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL



**STRUCTURAL REFORM OF THE NIS
HOUSING AND URBAN SECTORS**



Working Paper Series

Prepared for the Office of Housing and Urban Programs (A.I.D.)

FINAL REPORT

UKRAINE: CAPITAL MARKETS & BANKING HOUSING FINANCE & DEVELOPMENT STUDY

Working Paper No. 3

Prepared for:

**Office of Housing and Urban Programs
Agency for International Development
Washington, DC 20523**

Prepared by:

**C. Mark Williams
PADCO, Inc.
1012 N Street, NW
Washington, DC 20001**

CCS-0008-C-00-2057-00, T.O. 1

March 1993

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EXECUTIVE SUMMARY

CURRENT CONDITIONS

The disintegration of the Soviet Union has resulted in a severe deterioration of the economy of Ukraine. Economic instability, including spiraling inflation (presently 400 percent and increasing rapidly), high interest rates (approximately 50 percent—*although highly negative in real terms*), excessive monetary growth, rapidly increasing unemployment and a steep decline in the nation's Gross Domestic Product (GDP) has exacerbated the housing problem and created conditions under which the present housing finance system cannot effectively operate. The legal framework for housing finance in Ukraine must be substantially overhauled and new institutions created in order to lay the foundation for a market-oriented housing finance system.

BANKING SECTOR

The state banking system in Ukraine is currently experiencing a major crisis. Many state enterprises are unable to repay short- and long-term loans and need additional credits to meet operating expense requirements. The state banking system is insolvent and depends upon the central bank for credits to meet financing demands and maintain liquidity. In other words, the entire state banking sector is wholly dependent upon a continuing series of government-approved bailouts.

Commercial banks are allowed under Ukrainian law and many new private banks have begun operations, but most citizens remain skeptical about their viability. Banks have not been able to attract many deposits from citizens and are forced to make loans entirely from capital and retained earnings. Lending activity is also constrained by the severe lack of collateral available to secure loans. As long as consumer confidence in the commercial banking industry is lacking, this sector will be unable to function as a viable alternative to the state banking sector. Although commercial banking has considerable potential, it is still a minor factor in the banking sector.

The development of a housing finance system designed to provide wide-ranging ownership opportunities will require a major overhaul of the Ukrainian banking system along with stable economic conditions through sound macroeconomic policies. Without such comprehensive changes, a fully functioning private housing industry will be severely constrained and economic growth will be diminished. Bank lending for the housing sector can only be made on a short-term basis until structural and macroeconomic changes are in place.

HOUSING FINANCE SECTOR

The housing finance system established before the disintegration of the Soviet Union is not operating, primarily because of inflation. The existing program can only fund about 8 percent of the average cost of a house, which has risen to almost 1,000,000 rubles. Until the state banking system operates on free market principles, it will not be a practicable mechanism for housing finance.

Although the commercial and merchant banking sector is small and rudimentary, it offers a real long-range opportunity for the development of a market-driven housing finance system. All commercial bankers interviewed for this report feel that mortgage lending is not practical in the current interest rate environment. Current conditions would require an annual interest cost that would exceed average salaries by several times. But the same bankers also feel that in time lending for housing construction will have significant profit potential.

The deficiency of securable collateral in Ukraine is another significant problem, but more amenable to short-term solutions. The only potential source of collateral for individuals for housing finance consists of land and existing housing, most of which is still owned by the state. Unless the privatization of land and housing proceeds rapidly, the lack of property for collateral will present a major restraining factor to growth of lending in the housing finance sector.

OTHER ISSUES RELATED TO HOUSING FINANCE

Land. Near-total government control and ownership of land makes it very difficult for private residents or business owners to obtain land for new housing or business development. Constraints imposed by government control have severely retarded growth of a private housing sector. Many business and government officials concede that the limited availability of land is the major (but by no means the only) stumbling block to growth of the housing sector. Until the government implements a wide-ranging privatization program for land, growth of this sector will continue to be seriously restrained. Ukraine has passed a law that permits the privatization of housing, but it has not been implemented. *The implementation of the law is of paramount importance.*

Housing Construction. The housing construction industry is dominated by large state-owned construction conglomerates. Although these corporations are separate legal entities, it is hard to distinguish them from the ministries that oversee them since their managerial and financial affairs are interlinked and operating and budget authority is devolved from the central ministries responsible for construction. Unless the construction industry is privatized, the free market housing sector will be constrained by bureaucratic inefficiency and low productivity inherent in the state owned and operated housing construction industry.

Municipal Services. Local governments, including municipal governments such as Kiev and Kharkov, provide a wide spectrum of public services to residents of public and cooperative housing, including maintenance and repair of housing, water supplies, sanitation, electricity and heat. The occupant of each housing unit has little authority over the buildings where they live, and contributes only a very small portion of the cost of maintenance and utility services. Local governments should be restructured so that housing services are privatized and municipal services and utility providers are funded from local taxes and user fees.

CONCLUSIONS

The housing finance system in Ukraine remains undeveloped. Both the present economic crisis in the country and the primitive nature of the banking system inherited from the Soviet Union do not currently provide an environment in which an extensive and sophisticated housing finance industry could mobilize resources for housing development. A broader problem in Ukraine is the lack of availability of collateral, an essential component of lending programs for residential development. Since land and existing housing are the only prospective sources of collateral for most of the population, a land and housing privatization program needs to be undertaken to resolve this deficiency.

The dominant state banking system is insolvent and new commercial banks are not yet in a position to develop long-term lending programs for housing construction and renovation. The entire state banking system, with a large percentage of its assets consisting of unpayable debts to state enterprises, is increasingly dependent on the central bank for a series of government bailouts to stay afloat. While the developing commercial banking industry offers opportunity for creation of a market-driven housing finance system in the long term, currently the sector has limited technological capability and suffers from inadequate funds clearance procedures. Together with prevalent economic instability, Ukraine, these conditions do not provide the environment needed for introduction of modern financial instruments or for bank lending for housing construction and renovation. Only short-term commercial bank lending is viable under the present circumstances.

The establishment of private markets for land and housing through privatization are necessary for the successful introduction of a housing finance system. Land needs to be made available to the general public without unreasonable restrictions.

RECOMMENDATIONS

Housing Finance

Conduct a study to determine the feasibility of a Housing Finance Bank. There is a need for the development of an institutional mechanism for the housing finance sector that could serve as an instrument for mobilizing capital to promote new housing construction and rehabilitation.

Develop a mortgage law. The law should define the rights of mortgage holders and property owners. The law will permit foreclosure on defaulted mortgages and must make provisions for the development of legal systems and processes (including courts) for adjudication of claims and disputes.

Housing Financial Instruments

Consider financing mechanisms such as a housing loan guarantee program. A program designed to provide guarantees of partial principal repayment (70-80 percent) of housing mortgages should be considered as part of a long range program to allocate funds to the housing sector, once economic stabilization is achieved. Guarantees represent enormous potential liabilities and should only be employed if substantial risk reduction measures are employed. These measures include factors such as fair market property valuations, substantial homeowner equity requirements and loss prevention programs with substantial reserves.

Banking

Implement financial reforms on a systematic and rapid basis. These reforms include an overhaul of the central bank, the reform and privatization of the state owned banks, and the development of a regulatory program consistent with banking and insurance practices (including policies that adopt procedures for the Bank for International Settlements) for the commercial banking and insurance sectors. A regulatory framework for the monitoring and supervision of banks should also be developed.

Related Housing Sector Issues

Privatize land as rapidly as possible. Land must be made readily available for private construction. Land is also needed to serve as collateralization for housing loans. A land privatization program should be incorporated into the economic restructuring agreement being negotiated between the IMF and the government of Ukraine and should be a major priority of USAID housing and urban development policy toward Ukraine.

Existing housing should be fully privatized as rapidly and as completely as possible. Housing privatization should be included as part of an economic reform package for

Ukraine and should be a major priority of USAID housing and urban development policy toward Ukraine. Private housing is necessary to foster a free market in housing.

Privatize the construction industry. Existing state-owned construction conglomerates should be broken into smaller and more manageable enterprises. Small private construction concerns should be encouraged and given equal opportunity to compete on all construction projects with state owned enterprises.

Restructure local governments so that housing services are privatized and municipal services and utility providers are funded from local taxes and user fees. A new system for municipal finance and local taxing should be developed and implemented. Central government subsidies to service and utility providers should be reduced or eliminated and salaries of employees should be increased by an amount commensurate with the level of subsidy reduction.

Consideration should be given to a program whereby privatized and newly formed Ukrainian building materials companies could associate with US companies through intermediaries such as the National Association of Homebuilders to form numerous low cost joint ventures of capital and technology. A linkage program could help to increase the manufacturing capacity of the building materials industry in Ukraine and provide US businesses with opportunities to invest and sell in Ukraine and elsewhere in the former Soviet Union.

Develop new laws, regulations and legal institutions in order to set in place a legal foundation and a legal process for the governmental and economic reforms that are being implemented. A law governing *condominiums* and *private ownership of property* should be developed and implemented rapidly.

- 1 -

UKRAINE: CAPITAL MARKETS & BANKING HOUSING FINANCE & DEVELOPMENT STUDY

1 INTRODUCTION

Transformation of a planned economy to a market-driven economy necessitates that governments eliminate impediments that restrict free markets and create an environment where commerce can flourish. Private markets provide the delivery of goods and services more cheaply and efficiently than government-controlled providers. The role of government should be limited to establishing a financial and legal infrastructure where market competition is maintained and efficient production is rewarded by successful participation in the marketplace.

The role of government in the transformation is complicated. Government must institute and enforce progressive laws and policies relative to *taxes, tariffs, private ownership of property, ownership of businesses, rules of commerce, free market foreign exchange rates, sound central and commercial banking policies, prudent monetary and fiscal controls, and market rate pricing of goods and services* in order to give birth to a climate where commerce and economic growth can prosper and individual initiative can be rewarded. Government actions to restrict commerce and impose unnecessary regulatory burdens, even with the best intentions, lead to unexpected results that impact adversely on economic growth, the production of goods and services and job creation.

2 PURPOSE OF THE STUDY

The purpose of this report is to provide an analysis of the housing finance sector for Ukraine and to develop suggestions and recommendations on actions where a technical assistance program could be provided to help facilitate the successful transformation of the Ukrainian housing finance sector to a system based on free market principles. This study includes a description of the previous housing finance and development activities that had been employed when Ukraine was part of the Soviet Union. Substantive changes to the housing sector that have occurred since Ukraine declared independence are further noted.

The report provides an assessment of the Ukrainian capital markets, the central banking system, the emerging commercial banking and insurance sectors, and discusses important economic trends and their impact on the economy. An appraisal is also made of the dominant government housing construction industry and of emerging private construction enterprises. Included in this analysis is a description of local conditions governing housing ownership, maintenance, land ownership, municipal finance, and the system of financing both single family (dachas) and multifamily housing.

All of the factors discussed herein are interlocking mechanisms that dominate the existing housing sector and which will fundamentally influence the direction of this industry as it evolves into a system based on market principles. Each of these factors must be analyzed carefully in order to assess the changes needed to implement a comprehensive free market housing program involving land, buildings, construction, building materials and financing.

The housing industry is inextricably linked to the past system of government ownership and control. In order to restructure this industry to accommodate market-driven forces, major changes will be needed in government laws and policy toward the housing sector at the national and local levels. In addition, the development of a housing finance system designed to provide wide-ranging ownership opportunities and promote significant economic growth will require a major overhaul of the Ukrainian financial system and the imposition of stable economic conditions through a sound structural adjustment program. Without major comprehensive changes, a fully functioning private housing economy will continue to be severely constrained and economic growth will be diminished. This study attempts to put forth a rationale and a systematic strategy for transformation.

2.1 Organization of this Report

This report provides an analysis of the housing industry of Ukraine, with special emphasis on the housing finance sector. Other sectors such as banking¹ and municipal government are covered in order to provide an understanding of their relationship and impact on the housing sector.

In addition to housing finance, this report focuses on a range of topics, including macroeconomic conditions, the commercial and state banking sector, bank lending practices, financing sources, the housing construction industry, construction materials industries, land availability, property ownership, housing market demand, and municipal services. *Although the scope of this study was directed primarily at housing finance, the importance of related issues such as land and property privatization, banking sector conditions and the economic climate are also included to provide an accurate picture of the depth of the problems for housing and housing finance.*

The report concludes by summarizing the findings of the study and by offering recommendations for reform of the housing and housing finance sector as well as the

¹The banking and financial system are a critical component of the housing finance sector. An in-depth understanding of the present banking sector is essential in order to understand housing finance needs and to develop recommendations for technical assistance.

housing and banking industry. Section 7 lists specific suggestions for short-term priority technical assistance and for medium-term and longer range priority needs.²

3 ECONOMIC CONDITIONS IN UKRAINE

The government and economy of Ukraine have been administered under a policy of highly centralized planning and control. Government policies have resulted in an economy that was, in many respects, isolated from the world economic and financial system. Prices and wages were controlled by government and products were produced in accordance with central planning targets instead of market demands. The Soviet system brought about economic stability and low inflation, but was unable to provide an adequate supply of basic necessities and brought about a very low standard of living. Among other things, central planning resulted in inadequate and low quality housing and a seriously underdeveloped service industry.

3.1 Existing Conditions

The breakup of the Soviet Union has resulted in a further deterioration of the economy of Ukraine. The production of commodities has decreased and scarce goods and services are more expensive. This phenomenon has brought about economic instability, spiraling inflation (presently 400 percent and increasing rapidly), high interest rates (approximately 50 percent—*although real interest rates are minus 350 percent*), excessive monetary growth, rapidly increasing unemployment and underemployment and a near catastrophic decline in the nation's Gross Domestic Product (GDP).

The old Soviet industrial system was designed so that republics were dependent on each other for major inputs. This system has collapsed with the movement toward political independence and cannot sustain previous levels of industrial production without inputs from other former Soviet Block countries. Imported inputs such as energy (gas and oil) and lumber will soon be priced at world market levels, resulting in substantial price increases and increased expenditures of scarce foreign currency reserves. These events will be very inflationary and can only serve to accelerate the contraction in GDP.

Ukraine is at a crossroads. *It is urgent that economic reforms that can serve as a foundation to build a self-sustaining economy be implemented promptly.* Reform measures will permit the dynamics of the market economy to be mobilized in order to more effectively manage the considerable resources of Ukraine and to increase the productive capacity of the economy. If reforms are not implemented and the economy continues its deterioration, it is likely that shortages of food staples and other vital commodities will accelerate. This process could lead to a wave of political instability that would pose a serious threat to the immediate future of the country.

²All of the conclusions of the report impact either directly or indirectly on housing finance.

4 BANKING SECTOR ANALYSIS

The Ukrainian banking sector is similar to the banking system that was employed throughout the former Soviet Union and in the former Soviet satellites. The banking and financial sectors differ greatly from western financial systems and are not able to provide many minimal services that would be expected of a modern banking and financial system. Each government-owned bank has one or more branches located in the 24 regions (oblasts) of Ukraine in addition to Crimea and Kiev, which are special administrative regions.

The banking sector is presently structured as follows:

4.1 Ukrainian Banking System

Central Bank. The primary function of the Central Bank of Ukraine is to provide liquidity to the financial sector by disbursing funds or credits to lower tier banks in order to meet industrial, commercial, social and governmental financial requirements. These credits are provided in accordance with planned budget expenditures and can be extended as either loans or grants. In essence, the Central Bank serves as a treasury disbursing agent for financial needs.

The Central Bank is also responsible for circulating currency. Prior to 1992, the ruble was the currency used in Ukraine and throughout the entire USSR and was controlled by the USSR Central Bank located in Moscow. Because of a severe shortage of rubles (due to inflation), the Russian republic discontinued its supply of currency to Ukraine after Ukraine declared independence. In order to avert a shortage of currency, Ukraine developed an intermediary Ukrainian currency known as the "Coupon" to provide for short-term currency and liquidity needs. The Coupon will be redeemable for the new Ukrainian currency expected to be introduced next year. The new currency will be known as the *grivna*.³

The Central Bank also is responsible for all foreign currency operations. All foreign currency selling and buying transactions must be processed through the Central Bank in accordance with government policies. Foreign currency expenditures must be approved by governmental authorities.⁴

In western economies, the Central Bank serves as an interbank clearinghouse for debits and credits to member accounts. This is accomplished through processing of

³The ability of the central bank to successfully introduce the *grivna* is uncertain. Presently, there are no plans to link the currency to any commodity such as gold or to another standard such as the dollar or the European Currency Unit.

⁴Black market currency transactions are common throughout Ukraine, especially in Kiev.

checks and electronic transfers of funds. In modern financial systems, clearance procedures are highly automated with state-of-the-art computer hardware and software. These systems can process billions of transactions per day. They are necessary to maintain functioning free markets and are highly advantageous for the free flow of commerce for domestic and international transactions.

The bank clearinghouse functions for Ukraine have not been developed to the standard of western clearance procedures, and therefore much account clearing must be completed through manual cash transactions.⁵ This system is a serious impediment to free market commerce since the collection of debts can take extended periods of time and may not be compatible with the liquidity requirements of various enterprises. In periods of high inflation and high interest rates, this can cause business activity to decrease since profits can be reduced or eliminated by the cost imposed by declining currency values (inflation) and by high interest costs.⁶

The antiquated nature of clearance procedures in Ukraine and the economic instability prevalent throughout the economy prohibit the introduction of modern financial and secondary market financial instruments that facilitate capital formation for development activity and encourage economic growth.

Ukrpromstroibank. The Ukrpromstroibank (hereinafter called the Industrial Projects Bank of Ukraine or IPB) is chartered to provide loans or direct credits to industrial enterprises for investment projects approved by the state.

Direct credits and loans are provided to industrial enterprises for investment projects such as the construction of plants or the purchase of equipment for manufacturing. Funding is also provided for working capital, also by loans and direct credits. Industrial enterprises (which are primarily huge manufacturing conglomerates) have also constructed housing, schools and other socially beneficially projects for the benefit of their respective employees. These enterprises received bank loans for many of these projects.⁷ All loans to industrial enterprises were repaid to the IPB which theoretically transferred funds back to the Central Bank.

Ukrsocialbank. The primary function of the Ukrsocialbank of Ukraine (hereinafter called the Ukrainian Social Bank or USB) is to provide loans or direct credits to social

⁵One process for account clearing resulted in semiannual gatherings of all industrial enterprises where huge amounts of cash would be shoved across tables in order to clear account imbalances.

⁶When the economic environment is intrinsically unstable, one would expect that businesses would have a incentive and a greater need to engage in barter transactions since commodities with more stable free market prices are more highly valued and inflation resistant than unstable currencies. Barter transactions are inherently inefficient and act as an impediment to the growth of business activity.

⁷Many projects were funded in whole or in part with retained earnings.

enterprises for social development projects approved by the state. Social development projects are defined as those that serve a social or public purpose such as housing, hospitals and medical facilities, schools, transportation facilities and commercial shops.

Direct credits and loans have been provided from the state (oblasts) for social investment projects. The USB was also responsible for providing loans to housing cooperatives for new construction of approved multi-family private housing. Cooperative housing loans will be discussed in a later section of this report entitled Housing Finance Sector Analysis.

Ukragroprombank. The Ukragroprombank of Ukraine (hereinafter called the Ukrainian Agricultural Industrial Bank or AIB) provides loans or direct credits and loans to agricultural industrial enterprises that are primarily located in the rural areas of Ukraine.

Sberegatelny Bank. The Sberegatelny Bank of Ukraine (hereinafter called the Depository Bank or DB) is the major bank where Ukrainians deposit personal savings. The Depository Bank paid interest on savings in accordance with the time frame selected by the depositor. Depositors who invested funds for longer periods of time received higher interest.

Commercial Joint Stock Banks. Recently, commercial banks have begun operations. Commercial banks are free market banking institutions that have been capitalized with private funding and are privately owned.⁸ Commercial banks are similar to western banking institutions in that funding sources are obtained from either investors or depositors and are the sole source of lending activity.

As of September of 1992, there were approximately 120 commercial banks, 30 of which were located in Kiev. The banks have very little regulation and operate outside of a centralized bank regulatory environment. There is no deposit insurance or other guarantees provided to banks by the Government of Ukraine, and the security of customer deposits is entirely dependent upon sound banking operations of the respective institutions. Because commercial banks are thought to be risky, they have not been able to attract a large amount of funds from depositors.⁹ Funds for lending and investing activity have come from invested capital and/or retained earnings.

Most commercial banks have become involved in investing in projects through loans or equity infusions and are owners of and investors in many of the businesses for which they have provided funds. Therefore, banks have taken upon the role of merchant banks

⁸Bank ownership to foreigners is restricted and must be approved by the Ministry of Finance.

⁹In fact, many banks have not been able to attract any deposits from the general public.

or investment banks in addition to the role of commercial banks as defined by the banking system in use in the United States today.¹⁰

4.2 Current Status of Banking System

The banking system in Ukraine is currently experiencing a major crisis. Many state enterprises are unable to repay large loans and need additional credits in order to meet operating expense requirements. The state banking system is insolvent and depends upon the Central Bank for credits in order to meet financing demands and maintain liquidity. In other words, the entire state banking sector is wholly dependent upon a continuing series of government-approved bailouts. The alternative to a bailout would be to eliminate or reduce subsidies, which would collapse many state-owned enterprises and rapidly increase unemployment.¹¹ A continuation of credits to unprofitable enterprises is highly inflationary and will lead to greater economic instability and a slowing of the reform process.

The interest rate and inflationary environment have subjected the state and the fledgling private banking industry to huge risks for which they are inadequately prepared. State banks, in addition to owning a large number of nonperforming loans to state-owned enterprises, have experienced numerous problems with loans to housing cooperatives. Banks made loans to housing cooperatives for the construction of private multifamily housing. The loan amount was equal to 70 percent of the estimated cost of the housing and was made during a period of rapidly increasing construction prices. Price increases resulted in loan funds being exhausted prior to the completion of construction, leaving projects unfinished and cooperative loans in a default status.¹²

The instability of the state banking sector has resulted in many problems for the emerging private commercial banking sector. Since funds deposited in state banks are guaranteed, depositors feel more comfortable investing savings in the state banks. Private banks have been unable to attract a significant volume of deposits from citizens, and are forced to rely on capital and retained earnings for lending activity.¹³ Lending activity is

¹⁰Many banks have invested in and are owners of insurance companies and have incurred substantial additional liabilities and risks.

¹¹This event could also be politically destabilizing. It is likely that the IMF will require reduced subsidies in return for hard currency credits which Ukraine will need in order to purchase needed foreign sourced commodities (especially oil and gas).

¹²There is no provision in Soviet or Ukrainian law to deal with bank foreclosures of properties. In the words of one vice-president of the USB, "These things never happen, and there was no need for any laws to deal with them. Now that we have this problem, we don't know what to do. We have taken control of the unfinished properties, but we are not sure that we have a legal right to do so. We are sitting here and we don't know what to do."

¹³There is no state or privately supported deposit insurance program for commercial banks.

also constrained by the lack of collateral that can be used to securitize loans.¹⁴ As long as consumer confidence in the commercial banking industry is lacking, this sector will be unable to provide a viable alternative to the state banking sector. Although commercial banking has tremendous potential, it is still a minor factor in the banking sector.

Many of the present problems can be traced back to the structure of the old Soviet financial system. The central bank, through the budgetary process, provided credits to thousands of enterprises that lost money¹⁵ and were inefficient providers of goods and services. The oversupply of financial credits to the economy was inherently inflationary. However, with wages and prices rigidly controlled and with goods and services in short supply, citizens were forced to save excess currency. In the event that citizens were lucky enough to purchase a commodity such as a color television or an automobile, they could immediately sell that commodity for a value far in excess of its cost.¹⁶

It should be no surprise that prices have increased dramatically with the freeing of price controls on many commodities and the advent of limited free markets. It is interesting to note that the excess saving of rubles (also known as the *ruble overhang*), present when the Soviet Union began economic reform, was seen as a major threat to economic stability.¹⁷ The massive subsidization of inefficient industries by the central banks of Russia and Ukraine and the freeing of prices on privately produced goods has ignited hyper-inflation, which has severely devalued family savings accumulated during the long tenure of the Soviet system.

The volatile nature of the money markets and the uncertain future direction of the economy do not provide a good climate for capital markets or for capital formation, which is needed for long-term asset based lending.¹⁸ Commercial bankers are reluctant to lend long-term money since they are unable to match loan funds with long-term deposit terms and do not have any financial institutions where they can market long-term securities. Certificates of deposit in the current economic climate seldom have terms of more than three months. In addition, the lack of private ownership of fixed assets removes the major source of bank collateral needed for loan securitization.

¹⁴Most fixed assets are property of the state and cannot be used to securitize loans.

¹⁵Many of the government owned enterprises showed large profits, but this was due to price fixing and/or budgetary allocations of credits.

¹⁶In the case of color televisions, they could be purchased when found for about two months wages, and could be immediately sold for wages that would equal three years wages. These price distortions provide evidence of the severe inflation which was being depressed by government controls.

¹⁷It was thought that citizens with excess ruble savings would all begin to spend their currency immediately for foreign goods and ignite hyper-inflation and a foreign currency crisis. Many economists were suggesting at that time that excess rubles be traded for housing in order to gain control over money supply and inflation.

¹⁸This is especially true for undeveloped capital markets similar to those which exist in Ukraine.

5 HOUSING FINANCE SECTOR ANALYSIS

Under the Soviet system, multi-family housing finance was derived from three major sources:¹⁹

1. State banks provided credits for local units of government to construct new housing.
2. Large industrial enterprises provided funds for housing construction from retained earnings and/or from loans from state banks. Enterprise-owned housing was provided primarily to employees.
3. Citizen groups were permitted to form private housing cooperatives, which were financed with household savings and bank loans. Each owner of a cooperative unit provided an up-front equity payment of 30 percent of the development cost. The remaining funds equal to 70 percent of the development cost were provided in the form of a long-term loan by the Ukrainian Social Bank.

5.1 Previous System of Housing Sector Finance

The state planning apparatus developed five-year plans and budgets that allocated funding for new housing construction and for rehabilitation of existing housing on an annual basis. Since the cost of labor and materials was fixed, construction prices were set with a high degree of certainty. Project construction was completed using a combination of loan and grant funds.²⁰ Most housing was built under the auspices of the state, and tenants were selected from a waiting list. Tenants paid a nominal monthly fee for maintenance and utility services.²¹

The primary lending program for housing was the 70/30 loan program established for cooperative housing. This financing vehicle was very popular with users but only financed about 5-7 percent of new multi-family housing. All owners of co-op units were required to provide an equity contribution of 30 percent of the project cost prior to the commencement of construction. When equity financing was in place, the bank (primarily the Ukrainian Social Bank) made 70 percent loans available to the project. Loans were made for a term of 25 years with an interest rate of 0.5 percent. Loan payments were

¹⁹Single-family housing was primarily financed with savings, but made up only a small percentage of housing construction.

²⁰Funds were obtained from taxes on state enterprises and other government revenues in addition to direct credits.

²¹The payment of this fee only covered a very small portion of the cost of services. For all practical purposes, an extensive array of costly services was provided free to the tenants.

reasonable for the average wage earner, and the program was very popular with participants. The quality of construction was better than most state-owned housing, since many of the co-op members were also employed by construction enterprises. *The major obstacle to individual groups who wanted to form co-ops was obtaining land for construction. Once land was obtained, the process moved forward quickly.*

Some families were fortunate enough to be provided with a parcel of land in or near their communities, where it was feasible to construct a single-family home. Most of these homes were constructed by private contractors and paid for in cash by tenant-owners. Often homes were constructed over a long period of time (several years) because of a shortage of building materials and the limited financial resources of the new owners.²² It was possible to obtain a loan from a bank for construction of single-family homes, but bank financing for single-family homes was not a major line of business for state banks.

5.2 Existing Conditions in the Housing Finance Sector

State banks are now in great financial difficulty. With housing construction costs increasing at a pace much greater than wage inflation, the private cooperative housing program is no longer viable. Although the housing finance program technically remains an ongoing residential lending program, it is not being used.

In the past few years, the cost of a house has increased from 100,000 rubles to over 1,000,000 rubles.²³ However, the maximum home loan from a state bank for private housing cooperatives is 80,000 rubles,²⁴ less than 8 percent of the cost of an average new home. This financing mechanism is not viable.²⁵ State banks formerly loaned funds at an interest rate of 0.5 percent per annum. The interest rate has been increased recently, but is not in line with inflation. Since the state banking system is not based upon free market principles, it is not a practicable mechanism for a housing finance system. Were state banks to be privatized, their usefulness in the housing finance sector could be made workable in a more stable economic environment.

²²Most single-family homes are constructed in areas with limited access to water, sewerage or paved roads.

²³These costs are estimates. Rapid inflation is causing home prices and worker wages to change dramatically and quickly. This estimate is considered to be a snapshot of average wages (70,000-90,000 rubles per year and average costs of new housing (600,000-1,350,000 per year) in September of 1992. These averages will be used in this report to describe problems with housing finance issues.

²⁴This may soon be increased to 500,000 rubles with a 25% interest rate.

²⁵With the high inflation rate, recent buyers of co-op housing units using loan funds are observing a dramatic decrease in the fixed rate loan payment on an inflation adjusted basis. If inflation continues unabated for another year in the 400% to 1000% range the loan payments will be negligible as a percentage of income. However, the value of the home will increase on par with inflation, again proving that real estate (especially leveraged real estate) in a high demand market with high inflation is one of the best investments that a consumer can make.

The development of the commercial/merchant banking sector offers a real long-range opportunity for the development of a market-driven housing finance system. Banks and bank branches are being established throughout the country, and their growth and expansion should provide the basis for the development of a network of investors and borrowers. Although the commercial banking sector is small and rudimentary in its banking practices, the growth and development of a market-driven economy will push banks to expand and to develop more sophisticated practices rapidly. The high education level of the citizens of Ukraine and their ability to develop international networks should help to facilitate this process.

All of the commercial bankers who were interviewed for this report expressed a strong desire to participate in the financing of new housing and in the financing of housing rehabilitation. Although banks are not presently involved in lending activity for home construction, the bankers feel that the expansion and modernization of the housing stock are areas with significant economic growth and profit potential.

Commercial banks are not now engaged in systematic lending for the housing sector. With 50 percent interest rates and construction costs of new housing six to twelve times the average salary, the economics of lending are not prudent. For example, if a homeowner earning 90,000 rubles per year was to construct a new home at a cost of 750,000 rubles (a very inexpensive home) with a 80 percent mortgage, he or she would have to borrow 600,000 rubles. The annual interest cost of this loan would be 300,000 rubles per year, which is *3.3 times the owners annual salary*. The repayment of this loan would pose an onerous burden on the borrower, with loan default as the likely outcome.²⁶

Without exception, all of the commercial bankers interviewed for this report expressed an unequivocal interest in developing a mortgage lending program. However, they repeated that mortgage lending is not viable in the high interest rate climate. The bankers are maintaining a policy where most loans are made for a maximum duration of three months at an interest rate of approximately 50 percent. Most depositors, who received about 30 percent for their short-term deposits, refuse to deposit funds for more than three months.

Commercial banks do not have the underwriting capacity to evaluate a large scale housing finance program. Presently, loans must be collateralized using gold, foreign currency, or items with proven tangible worth. Most lenders will not accept job history,

²⁶It should be noted that commodity price inflation appears to be well in excess of wage inflation. This is due in part to the cost of foreign inputs being raised to world market levels and the increase in food and other commodities being sold at much higher prices by private vendors who offer better service and better products.

credit history or verification of previous income and present financial condition as acceptable means upon which to evaluate the creditworthiness of borrowers.²⁷

Collateral is an essential component of loans, and any deficiency in the availability of collateral for loan securitization will inhibit the expansion of lending activity for development. It is very important to note that property is the major source of traditional loan collateral. Since most property in Ukraine is owned by the state, the availability of property for collateral is severely restricted. Unless the privatization of land and housing proceeds rapidly, the lack of property for collateral will present a major restraining factor to the growth of lending in the housing sector.

Commercial banks will have to develop credit systems and a capacity to underwrite loans prior to engaging in a large scale lending program for housing or other commercial business activity. Banks will also have to develop in-house lending policies and requirements relative to loan portfolio diversification, risk reduction, underwriting standards, nonperforming credits and house rules that limit excessive credit and capital exposure.

The rapidly changing economic environment has created a great deal of uncertainty, as borrowers and commercial lenders have no basis upon which to judge future economic conditions. Commercial bankers and borrowers alike recognize that medium-and long-term lending and borrowing is not practicable in this environment.²⁸

5.3 Household Savings as a Financing Vehicle for Housing

Financing a new home with household savings is usually the most costly method of financing. Under many free market scenarios, household savings would not be the preferred method of financing. The reasons are clear. Most families do not have the funds on hand that would be necessary to purchase or construct a home outright. Second, it is more feasible to borrow on a long-term basis to purchase a home, since the yearly occupancy costs are lower and the home will be used and will maintain its value over a long period of time.

In many developing countries, the cost of building a new home is expensive to residents in proportion to local incomes, but relatively inexpensive when compared with prices for new homes built in more developed western countries. In fact, the cost of a new home in Ukraine would be in the neighborhood of \$5,000 to \$12,000, not a

²⁷For all practical purposes, there is no credit history.

²⁸With inflation now accelerating past 400% and expected to increase beyond 1000% next year, one would expect a deterioration in the banking environment whereby deposits beyond a few days are not feasible. In Kiev, there were many transactions where local individuals refused to accept Ukrainian currency and would only accept foreign currency.

particularly large sum by western standards. It would not be unreasonable to assume that many residents of Ukraine (or many other developing countries) could obtain savings in the amount of \$5,000 to \$12,000. Foreign currency may have been obtained from friends or relatives in the west or may have been earned from business activities or the ownership of jewelry. The currency or savings could be used to buy some building materials from the west or could be converted to local currency to purchase a new home.²⁹

There is evidence that household savings are being used to finance significant new home construction in Ukraine. This is especially true in the western Ukraine where many new high quality homes have been constructed.³⁰ Interviews with private contractors have verified the demand for new single family housing construction using household savings, much of it with foreign currency.

Clearly, the long range prospects of the housing sector would be weakened if household savings were the *sole* source of capital for the housing industry. However, with the economy highly unstable and the private construction industry small and of limited capacity, equity finance (household savings) offers a major opportunity to stimulate the growth of the private housing construction industry. Equity financing will provide a market for housing construction and enable small construction firms to begin to build capacity for expanded sector development in the coming years.

5.4 Government Loan Guarantees and Housing Finance

This section of the report investigates the feasibility of providing government loan guarantees to the banking and finance sectors as a means of mobilizing long-term market rate financing for the housing sector. Loan guarantees could provide a mechanism where market risk was assumed by the central government, providing a climate for capital formation. *Before proceeding, it must be noted that loan guarantees represent a huge liability of the government and could be a source of financial instability during times of great economic difficulty. It would also be feasible to investigate the substitutability of land and/or housing collateral as a replacement for loan guarantees.*

In the United States, loan guarantees exist as a government-approved financing mechanism and long-term home mortgages have implicit *government (and some private) guarantees of principal repayment* equal to 80-100 percent of the principal amount of the mortgage. Loan guarantees have been and continue to be a valuable tool in the mobilization of capital for housing sector development. Indeed, loan guarantees have, over a period of decades, helped to facilitate the allocation of considerable resources to

²⁹As a point of fact, many new homes in Ukraine are financed in this manner. Private contractors have indicated that many families have saved hard currency received from friends and relatives or from various jobs.

³⁰Source: Mr. Don Bohdan Wynnyczok, International Executive Service Corps, Country Director, Ukraine.

the housing sector and have resulted in an unprecedented high percentage of home ownership. The large amount of capital invested in the housing sector has generated economic activity that accounts for a large percentage of the US Gross Domestic Product (GDP).

Since 1939, the US financial system has been relatively stable, except for the period during and after the Second World War (from 1941-1948) when new housing activity was at a standstill as a result of the war effort. The stability of the financial system and the relatively low inflation provided a climate where mortgage loan guarantees and a system of federally sponsored savings and loan associations were effectively used to mobilize capital for the housing sector. Until the 1970's, these financing mechanisms functioned well. Economic growth allowed the government to maintain the liability for the loan guarantees without placing a significant burden on government financial resources.

Loan guarantees have worked in the U.S. because private holders of capital were willing to assume interest rate risk and invest private funds in medium- and long-term securities. These investors have provided significant amounts of the capital that were necessary for the growth of the housing sector. *Without the confidence of private investors and their willingness to invest in mortgage securities, loan guarantees would have been a worthless tool for capital formation in the housing sector.*³¹

Financing mechanisms such as a housing loan guarantee program should be considered. A program designed to provide guarantees of partial principal repayment (70-80 percent) of housing mortgages should be considered as part of a long-range program to allocate funds to the housing sector, once economic stabilization is achieved. Guarantees represent enormous potential liabilities and should only be employed if substantial risk reduction measures are employed. These measures include fair market property valuations, substantial homeowner equity requirements and loss prevention programs with substantial reserves.

5.5 Mortgage, Foreclosure and Property Laws

Ukraine does not now have a law that permits housing mortgages. In order to develop a fully functioning housing industry, it is very important to begin a process whereby a housing loan program could be supported within a legal framework. The first priority should be the development of a law that permits mortgages on property and sets forth the conditions of each mortgage. *A mortgage law should be developed. The mortgage holder should be permitted to originate a foreclosure process in the event that the borrower defaults on the mortgage and makes no reasonable attempt to bring the mortgage current.*

³¹Mortgage backed securities with loan guarantees may have not been as popular if property were not collateralized to mortgage loans.

The second priority will be the development of regulations that govern the adjudication proceedings regarding disputes relative to mortgage defaults. Included in the process will be the authorization to create new legal institutions (or modify existing ones) that will be sanctioned by law to resolve disputes and facilitate foreclosures.

The government of Ukraine also needs to develop property laws. Property laws will define ownership of real and intellectual property, and will permit property to be encumbered as collateral for mortgages and other financial instruments. *Property laws will facilitate the transfer of property from sellers to buyers.*

5.6 Housing Finance Bank

In Ukraine, the feasibility of a Housing Finance Bank (HFB) should be evaluated. The HFB would be composed of one or more institutions whose purpose would be to mobilize funds for long-term investments in the housing sector, once economic stabilization is achieved. The Housing Finance Bank could serve as a depository for funds for the housing sector and could be an intermediary between the banking sector, which would originate mortgage loans and the investment sector, which would provide capital through the purchase of *collateralized mortgaged-backed securities*.

The bank could be developed with modern technology to allow the design and implementation of sophisticated financial instruments for both investors and borrowers. This institution could operate with many of the government and market support mechanisms³² that have been provided to savings banks in the United States and the European Community and to the Federal National Mortgage Association in the United States. In addition, the institution could, in conjunction with commercial and investment/merchant banks, develop programs and financial instruments that would be attractive to providers of low risk capital.

The bank could be provided with the authority to collateralize mortgages with property and to issue 80 percent government loan guarantees on each mortgage so that providers of funds could be induced to loan, knowing that a substantial amount of the principal value of their funds would be protected by government guarantees³³. Since each investor would be buying a collateralized mortgaged backed security that would be comprised of thousands of mortgages from throughout the country, added comfort would come from the fact that no single default would have a measurable impact on that security. The individual risk would be factored out of the system leaving systematic risk as the principal form of uncertainty.

³²Such as government backed loan guarantees, lower reserve requirements or specialized tax benefits.

³³Loan guarantees should not exceed 80% of the loan value and should decline in proportion with principal amortization.

Investors would also take some comfort in knowing that the mortgages were secured by housing that met strict underwriting tests. Underwriting, if performed according to standards in effect in the European Community or in the United States, would insure that homes were constructed according to well-designed building codes. Home buyers who defaulted on their mortgages would lose invested equity (savings) in the amount of 10-40 percent, depending upon the requirements for down payments. Down payments offer financial protection to both the government guarantors and the holders of collateralized mortgage-backed securities by decreasing lender risk. Down payments are a form of primary mortgage insurance and permit government guarantees to assume the position of secondary mortgage insurance. *Loan guarantees should not exceed 70 percent of the value of the home. Value should be defined as fair market value or actual cost, whichever is lower.*

In addition to guarantees, a proposal often made for housing finance institutions operating in unstable, high-inflation economies is that they introduce Alternative Mortgage Instruments (AMIs) such as Dual Index Mortgages (DIMs). Such instruments allow lenders to limit their risk by setting mortgage payment ceilings at some percentage of price level, or, in the case of DIMs, income level. Nominally, such instruments would allow the asset value of the mortgages to keep pace with inflation. But AMIs would not be a viable option at this time for the HFB or other banks in Ukraine for three reasons. First, AMIs can only work even in theory in a fairly stable economy with predictable inflation rates. Ukraine's economy is rapidly accelerating toward hyper-inflation, and such unpredictability would make AMIs very difficult to set up. Second, AMIs, if employed widely, can be inflationary; risk is effectively transferred from banks to the government, ultimately responsible for the unpaid mortgage balance; the only solution, in the end, is to print money. Most important, the banking system in Ukraine is currently able to process only very simple transactions; there is no institutional capacity to manage complex instruments such as AMIs. *DIMs and other AMIs are therefore not feasible at this time in Ukraine.*

Although current economic conditions in Ukraine are not conducive to a successful operating environment for a Housing Finance Bank, it is appropriate to begin to assess the feasibility of developing this institution with appropriate Ukrainian governmental officials. *Developing a Housing Finance Bank in Ukraine will require considerable time and effort, and the bank could be instrumental to the growth of the housing sector.*

5.7 Foreign Loan Guarantees for Housing

Foreign loan guarantee programs provide hard currency loans to country borrowers, and must be repaid in hard currency. If loan funds are provided to home buyers as a result of loan guarantees, and if funds for repayment are to be obtained from home buyers, then home buyers must assume exchange rate risk in addition to all of the standard risks inherent with a home mortgage loan. *It is not appropriate to require home buyers to assume foreign exchange risk.*

If exchange rates fluctuate (for example through devaluation of the host country currency), then the homeowner mortgage repayments will increase. Unless there is a corresponding increase in worker income (usually there is not), *the mortgage payment will increase without a proportional increase in wage income*. This increases the risks of loan default. If most homeowners could not afford or refused to pay the increased mortgage payment, the government would be forced either to pay the loan from hard currency reserves or to default and re-negotiate the loan if excess foreign currencies were not available. In essence, this would be a massive government subsidization of the housing industry and would allocate scarce financial resources from other important sectors of the economy.

Foreign loan guarantees can be considered during an adjustment program or when economic stability is attained. Foreign donor governments should extract agreements from borrower governments that the funds being provided through foreign credits will be allocated to productive investments. If foreign credits are allocated to consumption, the loans may serve to destabilize the economy by imposing added foreign debt burdens without contributing to the productive sector of the economy.

5.8 Housing Finance Summary

The Ukrainian housing sector presents an unprecedented challenge to the development community. Ukraine, with its population of over 50 million, desperately needs a productive housing industry that can serve as an engine of growth for a declining economy. The country also needs to develop a system for housing finance in order to foster the mobilization of substantial financial resources to support growth and development of a private housing sector. Housing finance must be coordinated with other reforms such as land privatization and banking and economic reforms in order to foster sustained economic improvement.

It is important to build the housing finance industry on fundamentally sound banking and financial principles so as not to risk future economic crises brought about by unsound and unwise financial practices. Ukraine should not rush to embrace complicated multi-indexed financial instruments that attempt to leapfrog the conditions of economic instability that presently permeate the economy. The market-oriented Ukrainian banking and housing sectors are in their infant stages of development, and they should not be burdened with financial instrumentation that they do not fully understand and for which they are not capable of integrating into their non-sophisticated bank operating environment.

In the near term, household savings represent a unique source of funds for the private housing sector and can provide a strong and important boost to this infant sector. It is also practical to put in place the infrastructure that would allow housing finance and development to grow. This includes mortgage and foreclosure laws, condominium laws and, most importantly, private ownership of land and housing. Housing finance cannot

grow without extensive collateral, and private land and housing represent an instant source of funds that can serve as the needed collateral for a rapidly expanded lending base for housing.

The introduction of a housing finance system will be a difficult and time-consuming process. Although it is impossible to predict when economic conditions will permit a fully functioning housing system to grow and develop, it would be appropriate to begin to access what financial and institutional vehicles will be needed in order to facilitate this process. In conjunction with this assessment, a study should be made to determine the viability of a Housing Finance Bank, which could serve as a mechanism to collect and deposit funds, as well as a vehicle for lending to the housing sector. The initial feasibility assessment of a Housing Finance Bank should also include an assessment of the impact of a government sponsored housing loan guarantee program on the housing finance sector.

5.9 Other Financial Sources: An Emerging Insurance Sector

The newly emerging insurance industry represents a future source of capital for the housing sector. However, funding from insurance companies can only be provided to the housing sector when industry assets substantially increase and when insurance portfolio managers are able to earn real rates of return on their portfolio.

In a market economy, the insurance sector is traditionally a source of long-term capital for the housing sector and would be instrumental to capital formation in Ukraine. Insurance portfolios could be an important equity financing source for manufacturing companies providing goods and services to the housing sector. Purchases of long-term mortgage-backed securities with insurance assets could be an important source of funding for residential construction.

The insurance sector is in its infancy and has relatively little experience in operating in Ukraine. Insurance companies are completely *unregulated* and are very risky for both owner/investors and policyholders. There are no capital requirements for this industry and no guidelines or regulations regarding the writing of policies or the processing of claims. Insurance coverage can be obtained by presenting a specific request for coverage to insurance company representatives.

Insurance companies process requests for coverage through an underwriting process that attempts to evaluate and quantify risk using limited data and inexperienced personnel. The underwriting process begins by providing specific information about the risk to the company, which assigns the assessment of the risk to a four-person evaluation team. The team generally consists of a lawyer, an economist, a finance expert, and an industry expert. There is little if any information available through statistical tables, so the risk analysis is very subjective. The risk team evaluates the risk independently, and

then presents its findings to management, who makes the final decision on whether or not to issue a policy.

Policy claims are presented to company management for payment. There is no legal process to adjudicate disputes, nor is there any industry group to provide guidance or oversight on disputes. The claims procedure is entirely subjective and is left to the sole discretion of the company.

Insurance companies have begun to diversify risk by allocating a portion of each policy to other branches of the same company. Since insurance branches are diversified throughout the country, this spreads geographical risk, but retains specific corporate risk. Company representatives informed me that many insurers have begun to diversify risk by reinsuring policies with other companies. This is an important development since many policies are taken out to insure losses in corporations that are partially or wholly owned subsidiaries such as banks.³⁴

There is no industry sponsored group that provides oversight to the insurance industry. Should there be a liquidity crisis caused by the failure of a company or by a large disaster, there is no central fund that could provide liquidity to the industry. The insurance industry has a definitive 'wild west' flavor, although the potential of this sector as a financing source for housing is enormous.

6 OTHER ISSUES RELATED TO HOUSING FINANCE

6.1 Land: Availability and Ownership

The government of Ukraine exerts enormous control over land and property. Land is owned by the government, and it is very difficult for private residents or business owners to obtain land for new housing or for business development. *Without land, builders cannot build.* Since most housing is owned by the government, private markets for housing do not function well. The limiting constraints imposed by government ownership and control dominate the housing market and have severely retarded the growth of a private housing sector.

³⁴In other words, the invested capital of an insurance company is used to capitalize a bank which provides a loan to a customer. The customer loan is insured by the insurance company owning the bank. This means that the bank's own capital is used to insure the loan repayment. This is a form of self-insurance, which clearly defeats the purpose of obtaining insurance coverage to reduce risk.

The capital and other financial assets of the industry are being invested in start-up businesses such as banks and import-export trade organizations. There are no regulations relative to the investment of insurance company assets.

The government allocates only a small amount of property to individuals for the construction of homes. This is done on an ad hoc basis and must be approved by the local governments. The process of obtaining land is long and arduous, and is often frustrated by government red tape and inaction. For all practical purposes, the private market for land is non-existent.

In the United States, we view single-family housing within the context of financing. When we begin the process of buying or building a home, our major concern is our ability to qualify for financing and meet financial obligations. The availability of land, building materials or contractors is not a constraining factor, except for price. However, *in Ukraine, the major constraint on the construction of new housing by the private sector is the availability of land.*

Many business and government officials in Ukraine concede that the limited availability of land is the major (but by no means the only) stumbling block to growth of the housing sector. *For the free market housing sector to grow and prosper, the privatization of land must proceed rapidly.³⁵ Without a free market in land, the housing construction industry will be gridlocked, and the growth and development of that sector will be severely limited. For the housing sector to serve as an engine for growth in the economy, land must be privatized and made available to the public without unreasonable restrictions.*

6.2 Housing Construction Industry

The housing construction industry is dominated by large state-owned construction conglomerates. Although these corporations are separate legal entities, it is difficult to distinguish a company from a ministry since their managerial and financial affairs are inter-linked and operating and budget authority is devolved from the central ministries responsible for construction. *Unless the construction industry is privatized, the free market housing sector will be constrained by bureaucratic inefficiency and low productivity.*

The government construction industry is mismanaged, overstaffed, inefficient, and unproductive. The quality of construction is extremely poor, and many residents who are allocated government-owned housing must spend up to a year completely renovating their new units before they can be made livable. According to sources at the city level, most of the talented and trained young workers have quit the large construction concerns to work for the newly emerging private construction sector. Government officials and management employees of construction companies complain of worker absenteeism and of the high degree of alcoholism among employees. The construction sector must be broken apart and privatized in order to restore some level of efficiency and productivity to construction output.

³⁵The privatization of land must be institutionalized. It is very important to develop a legal and administrative process for the disposition of land. Land sales can also serve as a revenue source to local governments, thereby alleviating the economic costs of their political transformation.

There has been a large increase in the private construction industry. Private contractors are small but growing quickly. Private contractors are primarily engaged in building, expanding and renovating single-family units. Some large construction firms have hired small construction companies to finish large projects which they have been unable to complete for various reasons.

The major constraint to the growth and development of the private construction industry is the inability of builders or citizens to obtain land for construction. Builders claim that there are sufficient household savings available from residents to fund a high level of single-family construction activity. The low level of construction has reduced the rate of growth of the private construction sector. Although equity financing (household savings) has limitations, there is an abundance of demand for new housing from citizens who could provide large amounts of funding for new single-family construction.³⁶

6.3 Construction Building Materials Industry

In Ukraine, a large number of extensive residential projects have been initiated, but cannot be completed because there is a shortage of some building materials. The lack of building materials is a result of a deficiency in some raw materials, poor supplier performance and the inability to procure building materials that were produced in other republics of the former Soviet Union and now must be bought with scarce foreign currency. Foreign produced materials have increased in price by a factor of 10-200 times the ruble prices that existed in the former Soviet Union.

During periods of peak housing construction activity in the 1980's, there was a severe shortage of building materials. Since the collapse of the Soviet Union, construction has decreased and many building materials³⁷ are now available in adequate quantities. However, the quality of building materials is very poor. Material and manufacturing deficiencies have given newly finished housing the appearance of being dilapidated. Virtually all building materials are manufactured in government-owned factories, which are notoriously inefficient providers of poor quality products.

There is an enormous need for improvements in both the quality and quantity of building materials. The future of this industry lies with the privatization of material and component manufacturers and suppliers of raw materials. There is an opportunity to promote growth in this industry by supporting privatization and investment in new enterprises. *The US government should consider a program whereby privatized and newly formed Ukrainian building materials companies could associate with US companies through intermediaries such as the National Association of Homebuilders in order to form numerous*

³⁶The private builders explained that there is a large supply of funds (including hard currency funds) available for new single family construction, and that the demand for new housing is overwhelming.

³⁷These include building materials manufactured in Ukraine.

low cost joint ventures of capital and technology. A program of this type could help to increase the manufacturing capacity of the building materials industry in Ukraine and provide US businesses with opportunities to invest and sell in Ukraine and elsewhere in the former Soviet Union.

6.4 Housing Markets: Privatization and Housing Demand

Most housing in Ukraine is owned by the state and provided to residents according to a formula basis. There is a serious shortage of housing, and the demand for new housing is extremely high. Because housing is owned by the state, housing mobility is severely constricted. The state is responsible for the upkeep and maintenance of housing, and their efforts to achieve adequate maintenance has fallen far short of expectations. Existing housing is in a state of disrepair and needs extensive renovation and modernization.

The transformation of the housing sector from state domination to a system based upon free market principles will be extraordinarily complex. However, a housing sector based on free market principles cannot exist without a private housing market. Ukraine recently adopted legislation that permits the privatization of housing. The implementation of this bill is now underway. Its successful implementation is of paramount importance and should proceed as quickly as possible. *Without a functioning private market for existing housing, it will be difficult to install a housing system founded on market principles.*

6.5 Municipal Government: Housing Services and Utilities

Local governments, including municipal governments such as Kiev and Kharkov, provide a wide spectrum of public services to residents of public, cooperative and private housing. Government is responsible for maintenance and repair of public housing and for supplying water and sanitation service. The government is also responsible for providing utility service, including electricity and heat. *The occupants of public housing units have little authority over the buildings where they live, and contribute only a very small portion of the cost of providing maintenance and utility services.*

The present system will need to be substantially overhauled with the introduction of a free market system. The government will need to reduce and in many cases eliminate the subsidies to service and utility providers. Government will have to raise incomes commensurate with the level of subsidy reductions to service providers. Users of services will make direct payments to utility companies and to municipal service providers for the

actual cost of services.³⁸ *The implementation of this new system will be enormously complicated.*

Many officials of the municipalities are unhappy with the present system and have expressed a desire to begin the process for a planned transformation to a system based on user fees and property taxes. The municipal and state (oblast) governments will need a great deal of technical assistance for this transformation.

The usage of energy in homes and factories has been reported to be approximately three times higher in Ukrainian homes and factories than in more modern western countries. Once homeowners are required to pay for energy and other utility services based on usage, there will be a huge incentive to reduce the usage of energy. This will provide economic opportunities for development of products and services for energy conservation that would have a major benefit to Ukraine, which must purchase a great deal of its oil and gas from other countries.

7 CONCLUSIONS & RECOMMENDATIONS

7.1 Conclusions

7.1.1 Housing Finance

The housing finance sector is undeveloped. The primitive nature of the banking system and the present economic instability have not created a climate where a sophisticated housing finance industry could be mobilized to provide funds for the rapid growth and expansion of the housing sector.

Ukraine needs a mortgage and property law that clearly defines ownership of real property and the rights of mortgage holders. The law must permit property to be used as collateral for loans. The law should also allow the mortgage holder to originate a foreclosure process in the event that the borrower defaults on the mortgage.

Collateral is an essential component of loans, and any deficiency in the availability of collateral for loan securitization will retard the expansion of lending activity for residential development. A land and housing privatization program will help to resolve the deficiency in collateral.

It is *extremely important* to recognize the risks that can result from the implementation of various financing mechanisms. *The cardinal formula for economic growth is a stable*

³⁸The present system of municipal services is a classic case of indirect taxation. Although residents may feel that they are being provided services at very little cost, the low levels of their income are in large part due to an allocation of scarce financial resources to service providers instead of workers.

financial system built on free market fundamentals and constructed with prudent financial instrumentation. Financing mechanisms that have worked the best over long periods of time are those devices that have been designed to reduce or eliminate risk and embrace sound economic and banking principles.

7.1.2 Housing Financial Instruments

- a. **The feasibility of a Housing Finance Bank (HFB) should be evaluated. Private markets require that funds for housing be obtained and loaned from private sources. The Housing Finance Bank would offer a reliable mechanism for mobilizing funds for the housing sector. A Housing Finance Bank can be provided with financial tools that will facilitate the acquisition of funds for housing development activities.**
- b. ***A housing loan guaranty program* and other financing mechanisms should be considered together with a Housing Bank.**
- c. ***Household savings (equity financing)* can be a significant source of funds for housing development during a period of transition to a market economy.**
- d. ***Foreign loan guarantees* should only be provided if they promote investment or are made in conjunction with substantive economic reform.**
- e. **The privatization of land and housing is necessary to create private markets and foster the development of the housing finance sector.**
- f. **Government should not put onerous restrictions on financing or home ownership.**

7.1.3 Banking

The state banking system is insolvent and depends upon the central bank for credits in order to meet financing demands and maintain liquidity. In other words, the entire state banking sector is wholly dependent upon a continuing series of government approved bailouts.

The development of the commercial banking sector offers a real long-range opportunity for the development of a market-driven housing finance system. Banks and bank branches are being established throughout the country, and their growth and expansion should provide the basis for the development of a network of investors and borrowers for housing.

The limited technological capability of the commercial banking sector, the ancient nature of funds clearance procedures in Ukraine and the economic instability prevalent

throughout the economy prohibit the introduction of modern financial and secondary market financial instruments that facilitate capital formation for development activity.

- a. Commercial bank lending for housing construction and renovation is not viable in the present economic environment of hyper-inflation and high interest rates.
- b. Bank lending for the housing sector can only be made on a short-term basis until economic stabilization and comprehensive reforms are achieved.

7.1.4 Other Important Issues Related to Housing Finance

All of the major facets of the housing sector in Ukraine are constructed around socialist concepts developed in the Soviet period. The transition to a market economy requires that the privatization of land and property and the dismantling of barriers to free enterprise proceed rapidly.

- a. Structural economic reforms that can serve as a foundation to build a self-sustaining economy must be implemented promptly.
- b. Land must be privatized and made available to the public without unreasonable restrictions.
- c. Unless the privatization of land and housing proceeds rapidly, the lack of property for loan securitization and collateralization will present a major restraining factor to the growth of lending in the housing sector.
- d. Without a functioning private market for land and existing housing, it will be difficult to install a housing system founded on market principles.
- e. The centralized construction sector must be broken apart and privatized in order to restore some level of efficiency and productivity to construction output. Without privatization, the construction sector will be constrained by bureaucratic inefficiency and low productivity.
- f. The existing municipal finance system will need to be substantially overhauled with the introduction of a free market system. The government will need to reduce and in many cases eliminate the subsidies to service and utility providers. A system of user fees and property taxes will need to be installed. The implementation of the new system will be enormously complicated.

7.2 Recommendations

7.2.1 Housing Finance

Develop a mortgage law. The law should define the rights of mortgage holders and property owners. The law will permit foreclosure on defaulted mortgages and must make provisions for the development of legal systems and processes (including courts) for adjudication of claims and disputes.

Conduct a study to determine the feasibility of a Housing Finance Bank. There is a need for the development of an institutional mechanism for the housing finance sector that could serve as an instrument for mobilizing capital to promote new housing construction and rehabilitation.

7.2.2 Housing Financial Instruments

Consider financing mechanisms such as a housing loan guarantee program. A program designed to provide guarantees of partial principal repayment (70-80 percent) of housing mortgages should be considered as part of a long-range program to allocate funds to the housing sector, once economic stabilization is achieved. Guarantees represent enormous potential liabilities and should only be employed if substantial risk reduction measures are employed. These measures include factors such as fair market property valuations, substantial homeowner equity requirements and loss prevention programs with substantial reserves.

7.2.3 Banking

Implement financial reforms on a rapid and systematic basis. These reforms include an overhaul of the central bank, the reform and privatization of the state-owned banks, and the development of a regulatory program consistent with banking and insurance practices (including reserve requirements set by the Bank for International Settlements) for the commercial banking and insurance sectors. A regulatory framework for the monitoring and supervision of banks should also be developed.

7.2.4 Other Important Issues Related to Housing Finance

Privatize land as rapidly as possible. Land must be made readily available for private construction. Land is also needed to serve as collateralization for housing loans. A land privatization program should be incorporated into the economic restructuring agreement being negotiated between the IMF and the government of Ukraine and should be a major priority of A.I.D. housing and urban development policy toward Ukraine.

Privatize existing housing as rapidly and as completely as possible. Housing privatization should be included as part of an economic reform package for Ukraine and

should be a major priority of A.I.D. housing and urban development policy toward Ukraine. Private housing is necessary to foster a free market in housing.

Privatize the construction industry. Existing state-owned construction conglomerates should be broken into smaller and more manageable enterprises. Small private construction concerns should be encouraged and given equal opportunity to compete on all construction projects with state-owned enterprises.

Restructure local governments so that housing services are privatized and fund municipal services and utility providers from local taxes and user fees. A new system for municipal finance and local taxing should be developed and implemented. Central government subsidies to service and utility providers should be reduced or eliminated and salaries of employees should be increased by an amount commensurate with the level of subsidy reduction.

Consideration should be given to a program whereby privatized and newly formed Ukrainian building materials companies could associate with US companies through intermediaries such as the National Association of Homebuilders in order to form numerous low-cost joint ventures of capital and technology. This type of program could help to increase the manufacturing capacity of the building materials industry in Ukraine and provide US businesses with opportunities to invest and sell in Ukraine and elsewhere in the former Soviet Union.

Develop new laws, regulations and legal institutions in order to set in place a legal foundation and a legal process for the governmental and economic reforms that are being implemented. A law governing *condominiums* and *private ownership of property* should be developed and implemented rapidly.

7.3 Recommendations for Technical Assistance to Ukraine

7.3.1 Short-Term Technical Assistance

- a. USAID should consider the drafting of a *mortgage law* that could be introduced in the Supreme Rata.
- b. A technical consultant should conduct a preliminary study to assess the feasibility of a *Housing Finance Bank*. This assessment should also include an analysis of a government loan guarantee program. A Housing Finance Bank should be coordinated with the policies of the Central Bank.
- c. Assist several Ukrainian cities in the development of a municipal finance system of *user fees and property taxes* to replace communal housing fees. The initial assistance should include an assessment of the priority areas of change.

- d. **Technical assistance should be provided to the central government and to city governments in the *privatization of housing*. The government is going to need assistance in developing a system for the privatization process.**
- e. **Ukraine should be provided with assistance in the development and implementation of a *privatization program for land*. Ukraine's urban centers have expressed an interest in working with technical assistance contractors to develop this program for commercial land and for land allocated to foreign development. Assistance should focus on the development of a privatization process that could allow land disposition to occur rapidly. These cities also need some assistance in valuing parcels and defining land use criteria.**
- f. **Consideration should be given to a program whereby privatized and newly formed Ukrainian building materials companies could associate with US companies through intermediaries such as the National Association of Homebuilders in order to form numerous low cost joint ventures of capital and technology. This type of program could help to increase the manufacturing capacity of the building materials industry in Ukraine and provide US businesses with opportunities to invest and sell in Ukraine and elsewhere in the former Soviet Union.**

7.3.2 Medium- to Long-Term Technical Assistance

- a. **USAID should consider a program to design and develop a Housing Finance Bank. The program would entail the preparation of laws, the design of a banking structure, the design of financial instruments, the design of a loan guarantee program, the design of an operating plan, and extensive training and manual preparation.**
- b. **The entire Ukrainian Municipal Finance System will require a major overhaul. The government will need to reduce or eliminate the subsidies to service and utility providers. Government will have to raise incomes commensurate with the level of subsidy reductions to service providers. Costs of services will be paid by users in the form of direct payment to utility providers and in the form of property and other taxes to municipal service providers. The implementation of this system will be enormously complicated, and will require a major technical assistance effort.**

APPENDIX A

KHARKOV MUNICIPAL FINANCE ASSESSMENT

Statement of Problem

The City of Kharkov is experiencing a budgetary crisis as a direct result of the political changes incurred through the Ukrainian declaration of independence from the Soviet Union. The Ukrainian Central Bank is experiencing an economic crisis and has been forced to provide massive subsidization to loss-plagued state enterprises by printing money. The large increase in money supply has caused price inflation to increase by over 400 percent.

As a result of the economic problems, the City of Kharkov has been placed into a financial bind. The cost of providing services is going up, but traditional revenue sources have not kept pace with increased costs. In order to continue to provide services, Kharkov needs to develop alternative means of increasing revenue.

Revenue Enhancement Considerations

There are three major policy initiatives that the City of Kharkov can use to lead to revenue enhancement:

1. Raise money through land and asset sales.
2. Increase revenue by imposing additional fees for municipal services.
3. Reduce the cost of providing services.

Asset sales

The City of Kharkov has valuable resources that could be sold or leased on a long-term basis to the private sector. Since the demand for housing is great, the City should consider selling sites for single-family home construction to homebuilders. In addition, the City could offer to sell approved development sites to private contractors who could build new housing and commercial establishments in accordance with the General Plan of Kharkov. Providing land for housing would also facilitate the construction of new housing, which would help to resolve the housing shortage. The City could also consider selling rolling stock or other equipment to private sector firms.

Kharkov should consider privatizing some City services that are now being performed by the municipality. Privatization could be achieved through a bidding process whereby contracts would be awarded to the lowest bidder. City agencies could be allowed to bid on service projects, but would be given no preference in the award of contracts. If savings could be achieved, it would help to resolve the budget problems.

The City should consider selling some uncompleted housing projects so they could be finished and sold to the general public. This program would provide some competition to state-owned contractors, and might propel them to improve the quality and the productivity of state construction projects.

Municipal Service Fees

Kharkov, like most cities of the former Soviet Union, depends on the state for budget authority and for funds to provide municipal services. Economic restructuring will result in the development of programs that raise funds locally. The City should consider any means whereby it can obtain revenues through the provision of municipal services. These fees include taxes on tourism, gasoline, automobile license fees, and specific fees for individual services.

The communal services fee charged to homeowners does not provide sufficient revenue to cover the cost of services provided. The City should increase this fee. The fee increase could be structured so as not to impact on poor and elderly retired persons.

Cost Reduction

Revenue enhancement can be achieved by reducing the cost of services. This can be achieved through efficiency programs whereby service activity is modified to be more cost conscious. In addition, some services could be eliminated, thereby effecting additional cost savings.

There is overstaffing prevalent throughout the service industry. The City should consider policies to reduce the level of employment. It is irresponsible to have excess employment when revenues do not support the costs needed to sustain high employment and high cost services lower priority services.

Conclusion

The City of Kharkov should consider a wide range of options to resolve its budget problems. It is time for City officials to accept that a paradigm shift has occurred and that solutions to problems are going to require alternative means and new methods of municipal management. This is the opportune moment for the City to experiment with privatization of land and services, and with a fundamental restructuring of the municipal financing system. The old system has failed, and a new system must be developed as quickly as possible.

**APPENDIX B
LIST OF PERSONS CONTACTED**

Ministry of Investment and Construction

Vladimir Gusakov Deputy Minister

State Committee on Housing

Anatoly Okhrimchuk Chairman of Housing Department

International Academy of Architecture

Badajants Timofij General Director 293.81.00

Ukrainian Social Bank

Tatyana Alifanova Deputy Director, Kiev Branch 227.70.21
227.98.78 Fax

Ukrainian Central Bank

George Yurchyshyn Acting Deputy Director 293.6110

Ukrainian State Project-Production Association

Vladimir I. Nudelman Chief Science Division 295.07.94

State Administration of Kiev

Production, Housing and Repair Association

Yuri S. Korniytchenko Director
Nina Ponomarenko Director
Eugen M. Opimakh Chief Engineer 224.22.94

Fund of Municipal Property

Alexander N. Bondar Vice Chairman of the Fund 221.24.48
Chief of Department of Privatization 229.60.84 Fax

Construction Department

Victor A. Velichko Director & Deputy Presidents Representative
Georgi Stotski Deputy Director

Kharkov

Foreign Insurance Company

Gennady N. Missevra 300.252 321.001 Fax

State Industrial Projects Bank

Vladimir S. Serba Chief of Department (0572) 27.67.74

B-2

NLK Bank (0572) 33.27.14
Ludmilia N. Litkevich Head of the Board (0572) 33.72.65 (F)

Dobrodiy
Stepan S. Erdik President (0572) 47.55.15
Ivan Dmitryk Vice-President (0572) 47.55.17(F)

Dobepue
Vladimir V. Bogdan General Director (0572) 475.043
Bogdan B. Basilevich General Director (0572) 474.169(F)
Pavel A. Iechnko Deputy Director

Department of Budget and Finance
Yatsenko Ludmila Vasilyevna Chief of Department

Kharkov Executive Committee (0572) 22.83.90
Ljubov N. Pogyljaeva Vice Chairman (0572) 20.92.79(F)
Chairman of the Planning Commission

Department of International Relations
Dr. Michael G. Stanchev Chief of Department (0572) 43.14.29
Natalya V. Lezhneva (0572) 43.27.27(F)

International Executive Service Corps 228.3419
Donald Bohdan Wynnyczok Country Director
Victor H. Shmatalo Deputy Director
Gordon Murphy Volunteer Executive (Kharkov)
Thomas Reed Volunteer Executive (Kharkov)

USAID Tel: 70 44 221-7646
Amy Osborn Fax 001-873-151-3424
A. T. Bilecky

Aggio Bank
Stanislav M. Arzhevitin Chairman 295.31.61
Sergey Vl. Shcerbakov Deputy Chairman 295.31.64 Fax
Sergei I. Hohlov Deputy Chairman
Vladimer A. Smolenko Chief Credit Officer
Nick Marvchak Chief of Financial Dept.
(Former Head-Ukrainian State Construction Company)

City of Philadelphia
City Planning Commission (215) 686-4631
Ernest Leonardo Chief, Comprehensive Planning

Translators: Kharkov-Natalya (Natasha) V. Lezhneva. Call her home: (8-0572) 276.090

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