Lending for the acquisition of unfinished housing units and linkage of sales and loan contracts

Options for better consumer protection for Ukraine based on international experiences

Hans-Joachim Dübel, Finpolconsult

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List of abbreviations

CCD	Consumer credit directive
EU	European Union
GMAC	General Motors Acceptance Corporation
MBS	Mortgage-backed security
REIT	Real estate investment trust
SHF	Sociedad Hipotecaria Federal (Mexico)
SOFOL	Sociedad Financiera de Objectivo Limitado (Mexico)
U.S.	United States

Note: This paper broadens the discussion of sections on construction finance and linked credits contained in the main report: Consumer Protection Issues in Mortgage Lending in Ukraine: Case, Scope and Implementation Strategy for Regulation, Policy Report #2 of the Technitas Consortium for the EU Project on the Establishment of Mortgage Rules and Legislation – Ukraine.

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1 Protecting consumers in the short-term

1.1 Current legal situation

Insufficient risk mitigation

Securing an investment in unfinished housing units is difficult in Ukraine, and the idea of creating a mortgage-style surety over the purchase contract is obsolete.

- First, **unfinished buildings are not subject to registration as a separate real estate object**;[1]
- Secondly, developers will also acquire the respective land plot only under **short term leases**, freehold transfers are rare exceptions;
- Thirdly, many buildings have **no formal building permits** or violate planning, zoning or other laws, which creates strong legal risk for investors.

Neither the land nor the building therefore does deliver acceptable sureties as risk mitigants of a financing until land is eventually transferred to freehold or long-term leases are closed, and buildings are technically and legally completed.

Contradicting laws concerning risk allocation

Due to strong lobby interest and a dearth of other forms of construction finance, an important body of Ukrainian law moreover enables, rather than discourages, construction finance through involvement of consumers as investors into unfinished housing units:

- According to the Civil Code, **investors of funds in trust management – including consumers - bear all the risks** associated with such management with the exception to circumstances when investor's losses were caused by deliberate trustee negligence, which is a subjective judgment;
- The Law of Ukraine on Financial and Credit Mechanisms and Property Management in the Course of Construction and Transactions with Real Estate (Financial Mechanisms Law) **enables** the financing of residential construction directly for the account of an investor (consumer) through **construction finance funds** held in trust by a financial intermediary;
- The law also allows investors to obtain a loan from a bank in order to finance the respective investment. It considers such **loans to be secured by pledge of the investor's rights under investment (purchase) contract;**

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[1] Civil Code of Ukraine (art. 331 par. 3) has been recently amended so that unfinished buildings can be now subject to registration. But failing the necessary executive regulations this mechanism is still not functioning in practice.

- According to Mortgage Crediting Law such loans are even **classified as mortgage loans**, with all related legal-regulatory favors**;**
- Finally, despite the obvious conflicts of interest, **failure of the purchase contract** to perform **does not entail non-performance of the loan contract under *any* circumstance**.[2]

Therefore, in practice all risks associated with construction of new residential property are shifted onto the consumer from lenders, of whom many act simultaenously as the trustees of the construction finance funds.

Yet, in a remarkable contrast to the above, consumer protection legislation passed in early 2006 takes the opposite extreme view.

- The fate of the consumer's loan contract with the lender is supposed to share the fate of the consumer's contract with the developer under the provisions of the **Law of Ukraine "On Consumer Rights Protection**". The law introduces in Article 11 the concept of "linked contracts", borrowed from EU legislation (see below), into Ukrainian legislation.[3]

We understand that the Financial Mechanisms Law formally prevails over the provisions of the Consumer Protection Law because it is a lex specialis. Whatever the legal hierarchy, **both laws** - Article 50 Part 7 of the Financial Mechanisms Law and Article 11 Consumer Protection Law – **take mutually incompatible and extreme positions** that call for a rethinking of the legal approach to the issue.

1.2 Main short-term protection approaches

It should be clearly understood that reducing consumer risk exposure in the current practices will mean assigning **higher costs** for this type of construction finance, since some other party – lender, developer, or insurer – will have to take that risk.[4] Yet, our assumption is that this cost increase is justified to the extent that **consumers** are **protected from taking the full downside risk of an unfinished property investment** and that the named parties are better suited to screen and monitor project and corporate finance risks.

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[2] The Financial Mechanisms Law explicitly states that "… delays in construction or poor performance of the developer will not affect legal relationship between the bank and the borrower under the mortgage loan contract and will not constitute any grounds for discontinuing performance of loan obligations by the borrower" (Article 50, Part 7 of the Law).

[3] The Law rules in Article 11 "the lender must refund to the consumer the amount of the payments made by the consumer on the rescission of the sale (work or service) contract or adjust the loan liabilities of the consumer appropriately." If the consumer excercises rights arising from Article 8 and 10 regarding non- or poor performance of a contract for carrying out works or providing services, Article 11 entitles him to lower his debt or make claims against the lender.

[4] Whether such interest cost increases lead directly to higher housing costs is not sure since house prices in Ukraine have partly been inflated through high demand supported by strong interest rate compression.

Formulations of lender liability

The main economic problem with the provisions such as those in Article 11 of the Law on Consumer Rights Protection is that they intend to create a **universal linkage between property sales and loan contract** that **leads to unacceptable risks** for lenders and is bound to eliminate the lending practice altogether. Consumers essentially receive a costfree put option on a purchased property to the lender, which many will likely exercise even in case of minor defects of the housing units.

Such an elimination strategy is undesirable since there will be always circumstances in which **financing of the construction phase by consumers can be an optimal financing form**: consider the progressive construction of a customized single-family home, where construction is actively monitored by the consumer. In this case, banks finance the installments paid by the consumer to the developer according to construction progress, with very limited risk for the consumer and little reason to assume collusion between bank and developer against the consumer.

The preferred strategy is therefore to search for **conditions** to be fulfilled that **justify the assumption of a linkage of both contracts**, and thus liability of the lender. The EU Consumer Credit Directive (CCD) discussion pursues precisely this route. It focuses on the concept of a **'commercial unit'** between both contracts; understandably, the precise definition of what establishes such a unit has been contested. The modified CCD proposal of 2005 uses the following wording in Part 2 of Article 14 on 'linked transactions', which limits the definition to clearly described circumstances, which must be simultaenously fulfilled:

> "2. Where:
>
> (a) in order to buy goods or obtain services the consumer enters into a credit agreement with a person other than the supplier of them;
>
> (b) the creditor and the supplier of the goods or services have a pre-existing agreement whereby credit is made available exclusively by that creditor to customers of that supplier for the acquisition of goods or services from that supplier;
>
> (c) the consumer referred to in point (a) obtains credit pursuant to that preexisting agreement;
>
> (d) the goods or services covered by the credit agreement are not supplied, or are supplied only in part, or are not in conformity with the contract to supply them;
>
> (e) the consumer has pursued his remedies against the supplier but has failed to obtain the satisfaction to which he is entitled, the consumer shall have the right to pursue remedies against the creditor.
>
> Member States shall determine to what extent and under what conditions these remedies shall be exercisable."

It would seem that putting the onus on consumer to prove the **pre-existence of an agreement between developer and lender** is quite **restrictive**. Under Ukrainian circumstances such an agreement could be assumed as existent if there is evidence of an **alignment of business interests** between developer and lender, such as derived from

direct ownership links, exclusivity of relationship, or common project development and marketing. This is the route taken by German law.[5]

As a general ethics rule designed to reveal potential conflicts of interest, lenders should be forced to actively and comprehensively **disclose the nature of their relationship to developers** whose construction projects are being financed, to the consumer. The details of such disclosure need to be determined, but should encompass at least a description of business relations and revelation of joint business and project interest, if existing.

However, in a corresponding negative definition it should be made clear that the mere **existence of a business relationship is not sufficient proof** for assuming a commercial unit. Our 2005 survey results in that regard yielded highly variable practices in Ukraine – in many cases it would seem that most lenders operate with a handful of developers that can be efficiently monitored by the corporate finance department, an at arms length relationship that which should be in the interest of consumers. Yet, on this count, law-makers, or bank regulators (see below), could ask for evidence of a minimum number of independent business relationships.

In particular a commercial unit should **not be assumed simply because a lender provides in parallel to the lending to consumers construction finance to the project**. This is in practice not just often unavoidable - an involvement of the lender also may help to improve the monitoring of the project on behalf of the involved consumers. Yet, in such a parallel lender-consumer investment situation one might consider additional legal constraints imposed on lenders:

- the lender should **not be more preferentially secured** by collateral and other means than the consumers he has financed; currently, in Ukraine lenders frequently enjoy project completion guarantees that consumers don't, on the same project;
- the lender should also have to ensure that her **own actions** against the developer in such cases **should not preempt the consumers to pursue adequate remedies** against the developer;
- the lender should have **a duty to share information with consumers** that would lead to the assumption that the developer may fail to deliver on the project or be threatened by bankruptcy; such rules can be softened in the presence of greater overall project transparency rules (see below).

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[5] The German Civil Code in Para 358 (3), makes the commercial unit assumption in situations where:

- The creditor himself has procured the real estate, or
- The creditor beyond the loan contract has promoted the acquisition of the real estate through cooperation with the seller, by
  - either aligning the seller's interests partially or fully with his own interest, or
  - assuming functions of the seller during planning, advertising or execution of the project, or
  - unilaterally favoring the seller.

(Translation by the authors)

Ideally, such constraints should also lead to an abolition of the practice of **formal separation of consumer trust funding from lender developer finance** in favor of integrated construction finance accounts, disbursed under the supervision of the lenders' corporate finance department without assigning full legal liability to the lender. We detail a number of additional possible bank regulatory constraints below.

Lender liability should also be **limited to a specific time period** after the termination of construction during which the consumer can make his claims, for example 3 months after the consumer has moved in. If liability is not limited in time, Ukrainian mortgage loans may never be efficiently securitized or placed into the cover of covered bonds.

Clearly, together with a modern legal formulation of the issue, the **inadequate formulations of the Financial Mechanisms Law and Mortgage Crediting Law should be repealed**, since both laws provide for high risk profile model for construction business financing of a pyramid-type, where all financial risks burden is shifted to consumers. A breakdown of these schemes risks to undermine the validity of mortgage finance in Ukraine in general.

Third-party guarantees

It is important to note that **assigning liability** to the lender means generating an **implicit guaranty commitment**, which is costly to the lender. Loans burdened with such a commitment are harder to refinance, indeed impossible in most publicly financed transactions (e.g. securitizations, covered bonds), which generates an additional cost increase over the level justified by a minimum risk protection of the consumer.

While the fact that a loan is disbursed protects the consumer to some degree financially, he may still be subjected to legal claims of the lender to continue with debt service until the case has been settled. Such requests may only be turned down after lengthy court procedures. More important even, the **investment goal** – a completed unit – will usually **not be reached through lender liability**; the consumer is thus exposed to residual project completion risk - to the extent of the difference between the final construction costs and the already financed amounts (considering also the costs of delays) and has to come up with additional capital for the completion.

An alternative mechanism is a **completion guaranty (builder's warranty)** provided by a third party, e.g. a specialized insurer. Such guarantees are a frequent practice in the United States and other anglo-saxon countries. They assign explicit costs to the coverage of this risk, which need to be borne by the beneficiary – either the consumer, or the lender, or ideally both.

Because, clearly, if a legal liability is present, both sides – consumers and lenders - have an incentive to take out insurance: the lender in order to avoid loosing the disbursed loan amount, and the consumer in order to avoid residual completion risk. **Lender protection** by completion guarantees is **already practiced** in some cases in Ukraine. Extending coverage to the consumer as beneficiary would be the logical extension.

Table 2 provides an overview over the advantages and disadvantages of both approaches.

Table 2: Assessment of benefits and risks/costs of two alternative protection mechanisms for consumers

	Liability de-jure (lender)	Completion guaranty (insurer)
Benefits	No cash premium costs, greater construction volumes.	Explicit, capitalized & regulated insurance scheme. Swift payout. Third party monitoring of construction. Assigns actuarial price to construction risk. Sorts out high-risk construction (uninsurable).
Risks/Costs	Project completion risk; Not eligible for securitization (e.g. exclusion of predatory loans in US from ratings), implies higher costs.	Public market may not exist or be illiquid. Market may be fake, i.e. third party guarantor be tied to developer. Cash premium to be paid may discourage some construction schemes.

The **supply of completion guaranty services** could be **encouraged** by two mechanisms: one option is to render completion guarantees mandatory, at least in certain cases (e.g. leaving out detached owner-occupied houses). Alternatively, and preferably, the presence of a completion guarantee could be acknowledged legally as evidence eliminating lender liability under the linked contract concept, provided that its coverage is sufficiently deep.

1.3 Short-term action plan

It would seem that due to numerous public scandals the **loss of trust** of the public in Ukraine in financing unfinished housing construction is deep. Nevertheless, in the short-term, the route of using consumers as financiers is economically unavoidable. We suggest therefore the following short-term action plan.

1. The fraud cases suggests not only more systematic and consequential public prosecution ex-post, but also **greater transparency requirements** being imposed **on the entire process of property development.**

- The introduction of **international accounting standards** in some segments of the Ukrainian economy in order to raise foreign capital is already an encouraging sign. More can be done to accelerate this process through upgrading national accounting standards and introducing **broader auditing requirements** – especially in a simplified form for unlisted developers.

  Ukraine could also consider to introduce **mandatory retail housing project disclosure** standards, including real-time construction progress and expenses reporting.

  In interviews held for the main study in 2005 several banks called for such enhanced transparency measures which thought were necessary to complement their own, often tedious developer and project monitoring efforts.

- The public sector itself can make an important short-term contributions to greater trust into the developer industry by **making public** land management (e.g., sales pipeline), public planning (e.g., land conversion, infrastructure

planning), building permission and land transfer **decisions more transparent** and **proactively notifying the public about the legality of a given project.**

In particular, new land management rules should expressly allow for transferring **freehold,** or at least a long-term leasehold, ownership to a land plot underneath a future building during the construction phase. Such a bold transfer step requires public transparent **public land auctions or tenders.**

These steps will help minimizing the currently numerous cases where conflicts over proper public building permits, unauthorized land transfers and other public decisions are at the heart of consumer losses.

Better corporate and public governance, transparency and property rights could also induce more competition, not just between national firms but also by international competitors that increase the potential for higher standards.

We understand that a Presidential decree has been passed during 2006 charging the Government of Ukraine to address some of the above issues.

2. **Bank lending to consumers** for unfinished construction in Ukraine should be forced to **legally assume its hidden costs** and be generally more tightly regulated, according to **modified legal liability** and **completion guaranty** mechanisms explored above.

   - Bank regulators should in addition enforce the application of **proper corporate and project finance techniques** to loan underwriting, rather than consumer lending techniques.
   - Loans backed by construction project rights can also clearly **not be classified (preferentially) as mortgage loans**, which is the status quo.

     Both steps have important implications inter alia for accounting, capital requirements and counterparty exposure limits within banks.
   - Similarly, at least the reporting on consumer-sponsored project trust funds need to be improved in line with better project reporting. Ideally, the practice of **formal separation of consumer funding through trusts from lender developer finance should be abolished** in favor of integrated development accounts, disbursed under the supervision and legal responsibility of the lenders' corporate finance department.

3. To remove the pressure from consumers to take project finance risks, banks should be **encouraged**, rather than discouraged **to provide direct developer finance** by **bank regulators**.

   - To enhance the availability of construction finance, **land underneath incomplete construction should be usable as collateral** against construction loans. This requires **registration of unfinished buildings**, respectively the land underneath. New rules of land distribution in urban areas must be approved to this end, and the new registration rules be implemented.

- Greater regulatory acceptance of direct developer finance also requires a systematic **monitoring of construction finance activities and risks**, as well as the adaptation of suitable intervention instruments by bank regulators.
- Clearly, the establishment of a competitive market is important to reduce risks – for this reason bank lending to tied developers should be pre-empted by the regulators and **conditions for tiedness** been established (e.g. number of developers a lender works with).
- We infer from a survey undertaken in 2005 within the study that most Ukrainian banks have established (partly widely varying) project and corporate finance standards, which bank regulators could **review and assist in order to raise minimum levels.**

2 Developing construction finance in the long-term

Incomplete or inexistent construction financing markets have a significant negative impact on the housing industry and on consumers. Developers that have to embark on the 'bycicle' system - raising cash from sales only that can be reinvested in buying land, building material and paying labor - cannot grow into larger scale.

Without scale, project scales remain small, construction processes cannot be rationalized. Moreover, a lack of diversification of project sales risks renders developers bottom lines vulnerable. The overall result are **high housing construction costs and a high share of 'crook' developers** that 'ride the cycle' and cut corners, or worse divert funds prepaid by clients.

Access to construction finance is thus central, and creating it should be a focus of any housing finance development strategy.

Private finance sources

Construction finance systems start generally with private[6] finance sources:

- The first step are project finance mechanisms. Most popular are **deferred sale models** whereby consumers buys an apartment in installments after having provided downpayments, often also in installments. Ownership is only transferred after the entire financing has been completed, which implies a leasing period of ca 5-10 years after completion of the unit – in total with the savings phase, the financing can reach typical mortgage terms of 15-20 years.

  Finance in this models is technically provided by developers, sometimes leasing companies, yet materially comes almost entirely from consumers in a kind of mutual savings & loan system. Consequently, the model raises severe consumer protection issues, which are often not sufficiently addressed. The model is mostly

[6] We differentiate between private finance stemming from banks, consumers and other private counterparties, and public finance raised through issuance of stocks, bonds and other publicly held instruments.

used in emerging markets with little availability of standing investment finance for consumers (e.g. Russia, Egypt, Brazil).

- Once banks start to provide lending to the sector, a second step are **bank loans to consumers,** which in turn are invested **into purchasing unfinished units**. As we have explored, this creates an amalgam of project finance (consumer implicitly provides credit to developer for future construction works) and consumer finance (bank loan to developer) with significant consumer risk exposure.

  Ukraine's developer finance system has currently reached this level, which is similar to economic and housing market comparator countries such as Turkey or Russia.

- Often in parallel with second step, banks are starting to provide direct **corporate (bridge) loans to developers**. The perceived risk of such loans leads often to very high interest rates, minimum capital and transparency requirements imposed on borrowing developers. Many bank regulators try to systematically discourage developer lending.

  Ideally, direct lending should substitute consumer loans for unfinished housing units and thus help the development of a clearly separated financial system – consumer loans for long-term investment in finished houses, bank loans for construction finance. Such a transition has occurred in neighbouring Romania, Hungary or Poland, where consumer funding of the construction phase has become unusual.

  Yet, the costs and regulatory factors frequently induce developers to keep focusing on 'cheaper' consumer funds. Still, some of the risk can be avoided and costs can be lowered for instance by syndicating loans among several lenders, or requiring completion guarantees. Also, in developed markets, there are often specialized lenders for construction finance, which combine sophisticated project and corporate finance techniques to minimize risk.

- A product providing construction finance in a somewhat middle way are **consumer loans disbursed in incremental installments with lender monitoring** of the construction progress.

  In this case, the consumer will pay the developer after predetermined construction phase, usually starting with his own equity in the financing for the land. This form of construction finance in stages has the advantage of lowering the financing costs – the consumer is still providing project finance – yet better protecting the consumer by involving the lender into monitoring of the project, and if necessary denying disbursement. Also, typically the consumer becomes already the owner of the land with his equity downpayment, and thus is secured or can use the security for attracting a bank loan.

  Incremental construction finance is widely practiced in Western Europe, while being fairly uncommon in the U.S. where mortgage loans usually require completion of the house.

- Finance provided by **private equity funds or other forms of participations** such as partnerships are an increasingly common source of funds for developers in EMs. These financing options are particularly attractive for highly profitable markets and developer businesses, which provide sufficient return on equity.

Table 1: Alternative routes for construction finance

Type of finance & investor	Private finance	Public finance
Equity		
Consumer	Consumer purchase of unfinished units; Installment sales to consumers.	
Corporate	Private equity; partnerships.	Stock listings; Real estate investment trusts, closed real estate investment funds.
Debt		
Consumer	Installment sales with prior savings period; Bank loans to consumers for unfinished units; Bank loans to consumers with incremental disbursements by construction progress.	
Corporate	Bank construction loans (single or syndication); Mezzanine finance.[7] .	Corporate bonds (secured/ covered & unsecured); MBS of construction loans only, or with construction loan share.

Public finance sources

As financial markets mature, public funding options for developers become available. Such funding options do not raise consumer protection issues, as in the case of many private finance mechanisms. Yet, transparency requirements for investors in such instruments are generally high, as are implicitly minimum scale requirements for developers and project sponsors.

- A first public step for larger developers is **to go public through listing on the stock market**. Many emerging markets have sizeable listed developer segments, often in situations where bank finance is scarce and expensive (e.g. Brazil, Turkey).
- Similarly, a number emerging markets have early started **listed real estate investment trusts (REIT)** to allow investors to directly hold properties in traded instruments (e.g. Turkey, Bulgaria). While such instruments due to their tax-deferred structure[8] are more attractive for the holding of income generating properties such as rental housing or commercial real estate than for construction finance, they generally attract capital into the construction sector and allow for

[7] This is debt whose creditors in the bankruptcy case of a developer are subordinated to other creditors, e.g. secured creditors such as mortgage lenders, but who are still prioritized over the developer's shareholders.

[8] Income taxation takes place at the investor, rather than the issuer, level. This requires the issuer – the REIT – to disburse a minimum proportion of its profits in cash (typical figures are ca 90%).

greater capacity use and higher capital turnover. Also, depending on the tax treatment, REITs can hold a limited ratio of properties under construction.

- In some emerging markets, stock-listed or larger developers have grown through issuance of **corporate bonds** (e.g. Brazil), often such bonds are collateralized by the sales revenues of project or cross-collateralized by other assets in the form of collateralized debt obligations. Corporate bonds reduce the dependence on banks, who often only provide only short-term lines that are in addition frequently callable.
- Most recently **specializing mortgage backed securities (MBS)** have emerged as a financing option in the most advanced emerging markets. Such MBS usually will focus on construction loans only - an example would be the 2006 GMAC Financiera deal in Mexico (see also text box overleaf). Western European securitizations have come to the market that pool construction loan loans (e.g. via construction deposits to be drawn down over time) with long-term mortgages on finished housing units.

Summary

A **long-term development strategy** for the construction sector in Ukraine should aim at fully developing access options to construction finance mechanisms.

- For private finance access options, legal and regulatory steps as outlined in the **short-term action plan** are needed, esp. with regard to facilitating direct developer lending.
- A **capital market development strategy** should focus on ensuring general investor protection standards – in particular transparency, developing publicly traded instruments, such as MBS, REITs and closed end real estate investment funds, and facilitating the initial public offerings of developers in the stock markets.
- As the build-up and improvement of governance of public development agencies proceeds in Ukraine, it could also be envisaged to **directly promote** the construction loan securitization market in low-income housing construction with some form of public sponsorship, e.g. along the lines of the Mexican SOFOL-SHF public-private partnership model described above.

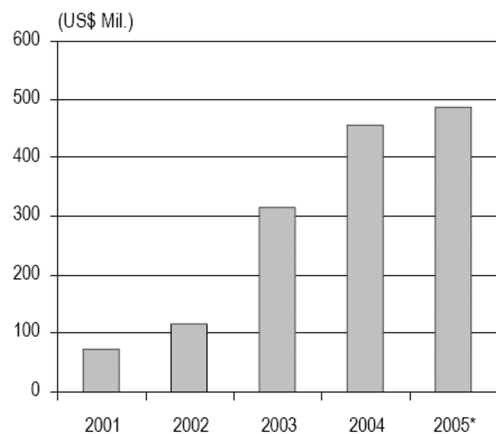
  The key for such public involvement would be the build-up of a proper underwriting and licensing system for developers, as well as a focus on socially desirable construction activities targeted to low-income households. A successful model could provide motivation to develop the construction loan securitization market as well as private sector guarantees to credit-enhance it.

Case: Public-private partnership in Mexican low-income housing construction bridge loan securitizations

The successful Mexican special purpose housing finance companies SOFOLs have started in 2006 to securitize a part of their portfolio construction bridge loans. Those loans cover land acquisition, land servicing and construction expenses of developers.

The earliest securitization of such loans in Mexico was already done in 2001, in early 2006, there were 22 deals with an accumulated volume of 1.4 billion USD. Figure 1 shows the per annum originations.

Figure 1: Construction bridge loans in Mexican low-income housing finance



Source: FitchRatings, Mexican low-income housing construction bridge loan methodology, 2006.

The initial SOFOL construction lending program was funded directly by the Mexican government, which at the end of 2003 however stopped the practice. Instead the new public agency SHF evolved into a partial guarantor of such loans as they became securitized, covering timely payment to investors. The lenders, SOFOL's, who underwrite the developers, provide the remaining credit support to investors. However, the SHF registers developers in order to render them eligible for its guarantees.

Annex - Risk analysis for consumers in unfinished housing construction[9]

Market practices

The multi-family construction sector traditionally is of high relevance for the Ukrainian housing market and continues to dominate new construction activity in the cities. Some form of construction finance is needed due to the large construction volumes to be financed, but either lenders do not provide such finance or only under conditions imposing high costs on developers. Developers thus tap consumers for financing the construction phase, which has lead to a widespread practice of consumers being invested into unfinished housing units.

Different motivations of consumers currently support this financing model. In the present dynamic house price environment, some consumers hope for maximizing their capital gains and sharing the significant developer margins when investing early in the construction process. Other consumers simply lack the affordability to buy newly constructed and finished units at high prices and trade a lower price against the additional risk due to financial necessity.

While a construction finance involvement of consumers with their own funds is already problematic due to numerous cases of fraud[10], it has become so more critically so in the past 2-3 years since the leveraging of such investment through bank credit has become available. Based on our interviews, we estimate that by mid-2005 in Kiev more than 50% of a typical new construction project was financed through retail lending, with virtually cost free land provided by municipalities, capital/retained earnings by developers and highly priced bank loans to developers funding the remainder.

Table 1: Lender's Involvement in Construction Finance, September 2005

Lender No	1	2	3	4	5	6
Share of unfinished housing loans in new originations	~5%	50%	>50%	60% Kiev, 40% rest of Ukraine	Mostly SFH lending (~10%), MFH ~60%*	Just started
Increase of share relative to 2004?	Decrease	Increase	Increase	Increase	Constant	Strong increase
Earliest disbursement data, % of construction progress	80%	30%	No policy	60-80%	No policy	No policy

[9] Taken from main report: Consumer Protection Issues in Mortgage Lending in Ukraine: Case, Scope and Implementation Strategy for Regulation, Policy Report #2 of the Technitas Consortium for the EU Project on the Establishment of Mortgage Rules and Legislation – Ukraine.

[10] A recent example is the "Elita-Center" fraud which became public in February, 2006. In this case, over 100 million dollars had been collected from over 1.500 consumers under the pretext of building housing in Kyiv, which was never started.

Approx. number of co-operating developers	Under 10	40	No policy	~20	~100	No policy
Risk policy focus	Portfolio limit, licensing system	Licensing system for developers	Focus on SFH*	Licensing system for developers, completion guarantees	Focus on SFH, licensing system for developers; mark-up for construct. loans	Corporate credit approach to developers

Source: authors' interviews during September 2005. *SFH – single-family houses, MFH – multi-family houses.

Conversely, rather than reducing the practice as could be expected from developments in comparator markets, Ukrainian lenders have shifted attention back to this 'primary' market. Four of the six interviewed lenders in late 2005 indicated shares in the home loan portfolio in the multifamily sector of around 50%, in Kiev above that ratio. This is up from around 20-30% indicated by the same banks in an interview series undertaken in January 2005 by the EU-Tecnitas project11 and consistent with the general notion of a pick-up of related construction activity – especially in Kiev. One retail lender who so far had only limited construction finance involvement entered the market anew as part of a strategy to gain market share and boost profitability.

Considering strategies to contain risks related to the practice, only one out six lenders indicated to pursue an explicit and low (5%) portfolio limit with regard to construction finance, two others try to diversify into the (severely supply-constrained) single-family housing sector (SFH). All interviewed lenders have a quasi-licensing system for developers in place, although the range of and standards for 'licenses' appears to be highly variable. Corporate credit underwriting techniques are hampered by the lack of reliable data and outright fraud, leading two out of six lenders to call for public regulation of the industry. In addition, all interviewed lenders appear to be well aware of the potential risks consumers face when leveraging up in the market.

Risk factors for consumers

- **Project risks.** Restrictively formulated property purchase contracts are typically used to shift design/quality risk and completion delay risk due to lack of financing sources, cost overrun or even the lack of valid building permits to consumers.
- **Unsound underwriting practices of lenders.** While some lenders indicate to lend at minimum construction progress only, the practice seems to be rather biased towards making financings available as early as the consumer or developer desire, including from the construction start. Only one lender differentiates his margins by construction stage, or by construction vs. finished and secondary housing market loans to steer consumers away from risky financings.

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11 Source: individual questionnaire returns made available to the authors by the Technitas Consortium. For the questionnaires see the Annex of Technitas Consortium (2005).

- **Lack of sureties**. In Ukraine, neither the developer nor the acquiring consumers usually become the owners of the land underneath the buildings. In few cases, completion guarantees are given by developers or their mother companies to lenders; these do not benefit directly consumers, however. This situation leaves the consumer with an unsecured claim the developer's assets.
- **Collusion risk between lender and developer:** close economic ties of lenders and developers – in a few cases exclusive business relationships or even direct ownership linkages – generate a common interest of lender and developer in maximizing prices and minimizing construction costs, often via reduced quality or saving administrative procedures (such as getting a proper building permit). Such situations have triggered bold responses by law-makers elsewhere: in many EU countries, but also in emerging markets such as Turkey, if a close economic tie is present between lender and developer the lender risks being held responsible for deficiencies in the property sales contract that he assisted in funding. This is currently not the case in Ukraine, where some elements of legislation even seem to protect such close economic ties.

In fairness, a risk-mitigating factor of a close relationship to developers is the fact that many lenders bring corporate credit underwriting and project management capacity to the investment process that consumers utterly lack. However such capacity differs between lenders and is applied under widely varying standards.