BOFIT Policy Brief
2014 No. 10

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Ukrainian banking sector in turmoil

SUOMEN PANKKI · FINLANDS BANK ·
EUROJÄRJESTELMÄ
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Institute for Economies in Transition

BOFIT Policy Brief
Editor-in-Chief Iikka Korhonen

BOFIT Policy Brief 10/2014

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14.8.2014
ISSN 2342-205X (online)

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Contents

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Abstract

This paper describes the main characteristics of Ukraine's banking sector in the current difficult political and economic situation. We include shifts in the banking sector's size and structure since the 2008 global financial crisis, a brief assessment of Ukraine's fragile macroeconomic situation, and commentary on recent developments in the banking sector.

Current macroeconomic situation at glance

Ukraine's GDP grew rapidly during the boom years of 2000–2007. As can be seen from Figure 1, Ukraine's GDP in 2013 was still about 7 % below its 2008 peak when the current economic and political turmoil arrived. Sluggish or non-existent growth in 2012 and 2013 was accompanied by large and widening imbalances in the current account and public finances (Table 1).

In late April 2014, Ukraine and the International Monetary Fund reached agreement on a 24-month Stand-By Arrangement (SBA). The $17.1 billion loan package allowed Ukraine to immediately borrow $3.2 billion. The deal also paved the way for additional lending by others, including the World Bank. At the time of the SBA agreement, the IMF expected Ukraine's GDP to shrink by 5 % in 2014 and then grow by 2 % in 2015.

As Ukraine's previous IMF programs have tended to derail at the outset, the SBA contained several policy measures that Ukraine was required to implement before acceptance of the arrangement and disbursal of the first loan tranche. These measures included a 50 % hike in household gas rates in May 2014 – an important first step in bringing Ukraine's heavily subsidized energy prices closer to market levels. Asset quality of Ukrainian banks also received heightened scrutiny. The IMF program was initially seen as providing Ukraine with a realistic chance of moving ahead with large-scale structural reforms in areas where Ukraine has lagged behind its neighbors.

The recent hostilities in southeastern Ukraine have clouded the prospects of a near-term recovery of the Ukrainian economy and the efficacy of the SBA. The longer the fighting continues, the greater the strain on Ukraine's public finances. Ukraine must currently spend additional resources on the military, even as tax collection in the southeastern part of the country has become challenging.

On July 18, the IMF staff concluded its first review of Ukraine's program. Although all structural benchmarks of the first review were met, the Fund now expects Ukrainian GDP to contract by 6.5 % this year. Ukraine was praised for partially containing its public deficit within the SBA limits in the face of higher military spending by making cuts in other areas. Nevertheless, the combined fiscal and quasi-fiscal deficit (including Naftogaz losses) is expected to reach 10.1 % of GDP this year and 5.8 % in 2015.

The IMF Executive Board must decide on the release of the next loan tranche late this month. While Ukraine's balance-of-payments situation appears to be somewhat better than earlier feared (currency reserves declined by $800 million to $18.1 billion in June), it is clear Ukraine needs additional financing. Preliminary figures suggest Ukrainian GDP declined 4.7 % year-on-year in the second quarter, bringing the overall first-half GDP decrease to 3 %.

Boom and bust

Ukraine's boom-and-bust cycle of the past 15 years is clearly reflected in its banking sector performance. The banking sector enjoyed extremely high growth in the mid-2000s, thanks to improved economic prospects and a very favorable external environment. Part of the strong growth reflected the combination of banking sector's very low starting base at a time when demand for banking services soared (average annual growth of the loan portfolio exceeded 70 % during 2005–2008). The pre-recession period saw an eight-fold increase in the volume of household loans and loans to non-financial firms more than quintupled (Table 2). The ratio of domestic private sector borrowing to GDP, which stood around 33 % in 2005, climbed to around 80 % by 2008.

Notably, foreign lenders financed most of this credit boom. The loan-to-deposit ratio increased from just over 100 % in 2005 to nearly 220 % in 2008. At the end of 2008, foreign currency loans constituted about half of lending to non-financial firms and almost 65 % of lending to households. Thus, when external conditions (financial and economic) deteriorated in late 2008, this speedy credit expansion with large share of lending in foreign currencies and high debt-to-income ratios in an environment with poorly developed institutions led to gigantic bust.

The banking business withered amidst the global financial crisis. Banks felt the immediate effects of the drying up of foreign financing in 2009 as GDP contracted by 15 %. Devaluation of the hryvnia and problems at the country's sixth-largest bank provoked a massive run on deposits. Loan defaults increased sharply with share of non-performing loans rising from 17 % in 2008 to over 40 % in 2009 (IMF). The central bank joined other authorities in efforts to stave off contagion effects by implementing a number of emergency measures such as large-scale liquidity support, controls on early withdrawals of time deposits, restrictions to foreign currency lending, and an increase in deposit insurance coverage.[1] Under the guidance of the IMF and World Bank, the state recapitalized five banks.[2] Although the authorities managed to restore the depositor confidence, they failed to tackle persistent banking sector issues such as weak corporate governance, high levels of non-performing loans, and weak supervision.

The sharp deleveraging reflected not just reduced access to external borrowing due to high country risk, but also the reversal in funding flows of parent banks. Ukraine's current credit-to-GDP ratio stands at around 60 %, which is well in line with Ukraine's per capita income level. While lending to households only started to recover in 2013, growth in corporate lending averaged 9 % a year from 2009 to 2013. The share of foreign currency loans in the total loan stock decreased from nearly 60 % in 2008 to 35 % in 2012.

On the funding side, the loan-to-deposit ratio has only declined gradually. It stood at nearly 140 % at the end of 2013, which is still high compared to other emerging markets in Central and Eastern Europe. Moreover, while the official share of non-performing loans decreased slightly to below 8 % at the end of 2013, unofficial estimates put the figure much higher.[3] The asset quality problem thus remains one of the major risks facing Ukraine's banking system.

Since the start of this year, the situation in the banking sector worsened due to the ongoing political and economic crisis. This is reflected in all main banking sector indicators: negative real loan growth; lower credit quality; increased hryvnia costs of servicing foreign currency loans due to the weakened currency; and, based on official National Bank of Ukraine figures, a first-half increase from 7.7 % to 9.9 % in past due loans. This situation, in turn, has caused a decrease in the average capital adequacy ratio of nearly 2.5 percentage points to 15.9 % at present.

Trust in banks also eroded in the first half of the year. After nearly five years of steady growth, retail deposits in local currency decreased by 12 % between January and June 2014. Moreover, the ratio of foreign currency deposits to total deposits increased by over 5 percentage points, reaching 44 % at the end of June. The NBU has so far managed to support the banks by providing liquidity as needed. Given the current political and security situation, however, uncertainty about the future remains very high.

[1] Ukraine established an explicit deposit insurance scheme in 1998.
[2] Total recapitalization costs in 2009–2011 amounted to 4 % of GDP.
[3] Fitch Ratings estimated the NPL ratio of Fitch-rated banks at 19 % in 2012. That estimate more than doubled, however, if restructured loans were included.

Banking sector structure and ownership

At the end of June 2014 there were 174 licensed banks operating in Ukraine. Of that, 51 banks had foreign capital and 19 were fully foreign-owned. Most foreign banks entered the Ukrainian market during the mid-2000 boom period. Foreign investors, believing in the Ukrainian market's huge potential and bright long-term prospects, boosted the asset share of foreign-owned banks from 13 % in 2004 to around 50 % in 2008. The trend reversed with the financial crisis, bringing an exodus of foreign (non-Russian) banks (Table 3) and a major shake-up in the banking sector's ownership structure (Figure 2).

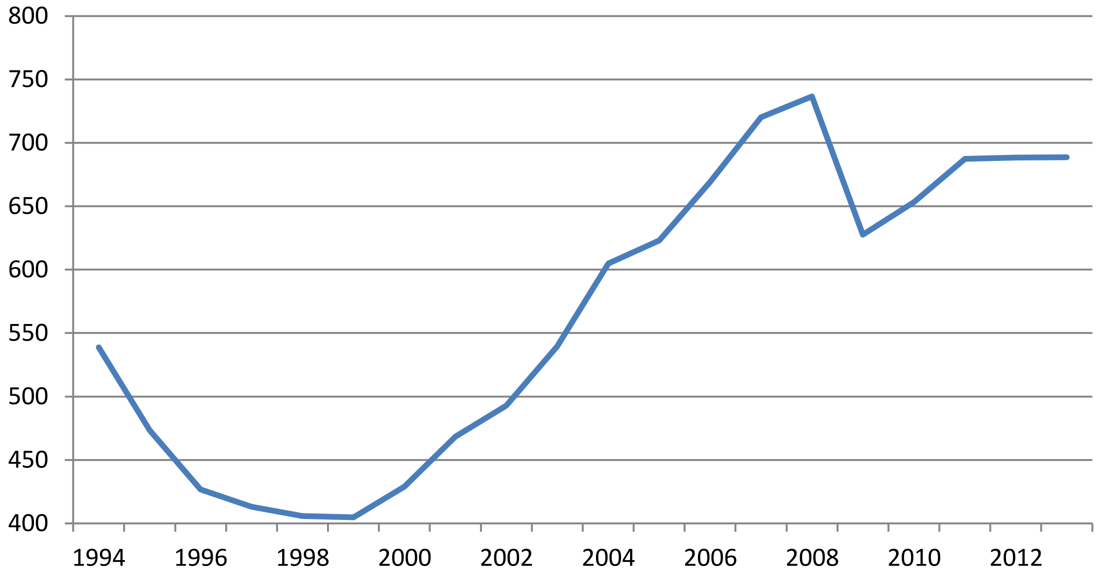
The ratio of foreign (non-Russian) bank assets to total banking sector assets decreased from 40 % in 2008 to 16 % at the end of 2013, while the participation of Russian banks increased slightly to 11 %. Several of the remaining foreign banks operating in the Ukrainian market have been unsuccessful so far in their efforts to sell their operations. On the other hand, the share of domestic private banks has increased. They now account for over half of banking sector assets. Many of these banks are directly connected to the major business groups. State-owned banks increased their share in the post-2008 crisis period, partly the result of nationalization of troubled banks.

While banks dominate Ukraine's financial sector, the banking sector is small relative to the size of the economy. Its total assets corresponded to just 88 % of GDP at the end of 2013 (Table 3). This is lower than in emerging economies of Central and Eastern Europe, and roughly the same proportion as in Russia (86 %). Unlike these other economies, Ukraine's banking sector has a very low degree of concentration. The five largest banks only account for about 40% of total banking sector assets (Table 4). Moreover, the financial crisis has not led to consolidation of Ukraine's banking system, which remains rather fragmented. Many small banks serve as "pocket banks," providing their services exclusively to related companies.

The way forward

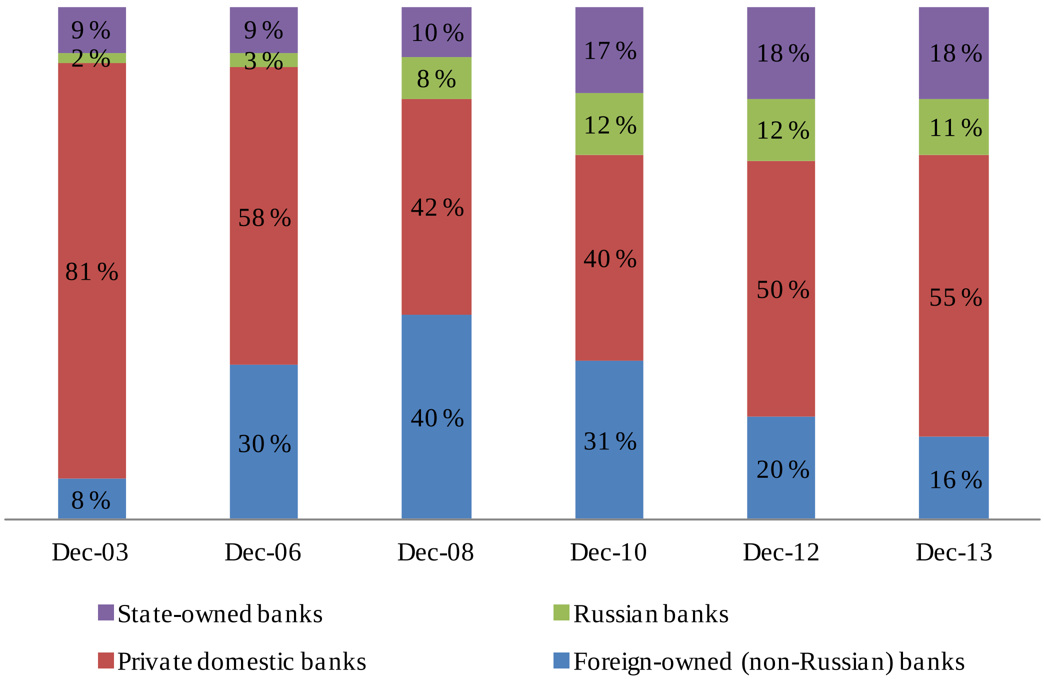
Ukrainian banking and the Ukrainian economy overall will not start to recover until the current political situation improves. Significant reduction in hostilities in the eastern Ukraine will be needed to restore investor confidence and improve public finances. And even under such a benign scenario, Ukraine faces a long, hard road of structural reforms in many areas, including banking.

Figure 1. Ukrainian GDP in constant prices (UAH billion)



Source: International Monetary Fund

Figure 2. Ukrainian banking market structure by ownership (total assets)



Source: Raiffeisen

Table 1. Selected macroeconomic indicators

	2010	2011	2012	2013	1H2014
GDP growth, %	4.1	5.2	0.2	-0.3	-3.0
Inflation (end-period), %	9.1	4.6	-0.2	0.2	12.0
Overall balance of public sector, including Naftogaz, % of GDP	-7.4	-4.3	-5.5	-7.7	n/a
Current account balance, % of GDP	-2.2	-6.3	-8.1	-8.3	n/a

Sources: IMF, National Bank of Ukraine

Table 2. Main indicators for the Ukrainian banking sector; end-year data, 2014 first half (UAH million, unless noted)

	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**1H2014**
Licensed banks (of which with foreign capital)	158(19)	160(19)	165(23)	170(35)	175 (47)	184(53)	182(51)	176(55)	176(53)	176(53)	180(49)	174(51)
Total banking sector assets	100 000	134 348	225 141	345 537	599 396	926 086	880 302	942 088	1 054 280	1 127 192	1 278 095	1 306 962
Total banking sector assets/GDP (%)	37	39	51	64	83	98	96	87	81	80	88	
Loans to nonfinancial corporations	57 403	71 589	106 078	160 503	260 476	443 665	462 215	500 961	575 545	605 425	691 903	747 575
Share of foreign currency loans to corporations	40.03 %	40.06 %	38.96 %	43.11 %	41.98 %	51.59 %	41.17 %	37.93 %	35.75 %	35.06 %	34.35 %	44.37 %
Loans to households	9 887	16 130	35 659	82 010	160 386	280 490	241 249	209 538	201 224	187 629	193 529	205 154
Loans to households; consumer credit				58 453	115 032	186 088	137 113	122 942	126 192	125 011	137 346	137 843
Share of foreign currency household loans				59.6 %	55.0 %	64.3 %	63.9 %	60.5 %	46.0 %	34.3 %	25.4 %	34.3 %
Loans to nonfinancial corporations and households/GDP	25.2 %	25.4 %	32.1 %	44.6 %	58.4 %	76.4 %	77.0 %	65.6 %	59.7 %	56.3 %	60.9 %	
Household deposits	33 115	42 502	74 778	108 860	167 239	217 860	214 098	275 093	310 390	369 264	441 951	427 802
Corporate deposits	23 901	34 365	50 976	65 614	95 583	118 188	94 796	116 105	153 120	173 319	195 160	192 982
Share of foreign currency deposits	33.7 %	38.7 %	35.7 %	39.5 %	33.6 %	44.9 %	48.2 %	42.8 %	43.5 %	44.8 %	37.8 %	43.5 %
Loans-to-deposit ratio	1.18	1.14	1.13	1.39	1.60	2.15	2.28	1.82	1.68	1.46	1.39	1.53
Asset concentration (five largest banks)	0.38	0.37	0.34	0.35	0.33	0.31	0.34	0.37	0.37	0.36	0.4	
Regulatory capital adequacy ratio* (%)	15.76	14.83	14.95	14.19	13.9	14	18.1	20.8	18.9	18.1	18.3	15.9
Return on assets (%)	0.827	1.07	1.31	1.34	1.5	1	-4.4	-1.5	-0.8	0.5	0.1	0.2

Sources: National Bank of Ukraine, own calculations

Table 3. Foreign banks leaving the Ukrainian market (2009–2013)

Year	Name of bank	Nationality	Action	Buyer information
2009	Home Credit Bank	Czech Republic	100% exit sale to Platinum Bank	Horizon Capital (45%), East Capital (25%), International Financial Corporation, IFC (5%), FPP Asset Management (4%), bank management (17%)
2009	Dresdner Bank	Germany	Liquidation of representative office	
2010	Renaissance Credit	Russia	SCM (Ukraine)	Rinat Akhmetov (100%)
2010	HSBC	UK	Closure of representative office	
2011	Bayerishe Landesbank	Germany	Closure of representative office	
2011	Kookmin Bank	South Korea	Closure of representative office	
2011	Conversbank	Russia	Global financial management group (Ukraine)	Ukrainian private investors (100%)
2011	Bank of Georgia	Georgia	80% exit sale to private investors	Ukrainian private investors
2011	Vostok Bank	International (Platinum Bank)	100% exit sale to private investors	Ukrainian private investors
2012	Volksbank	Austria	100% exit sale to Sberbank of Russia	Central Bank of Russia (52.32%), free circulation (47.68%)
2012	SEB Bank	Sweden	100% exit sale to Fidobank	Consulting firm “Finans Analit Servis,” Ukraine (79.9%); Ignace Marketing Limited, Cyprus (20%)
2012	Commerzbank	Germany	100% exit sale to “Smart Holding,” Ukraine	Cyprus-based Yernamio Consultings Ltd, controlled by Vadim Novitsky (98.68%)
2012	Societe Generale (Profin Bank)	France	100% exit sale to Alfa-Bank, Ukraine	ABH Ukraine Limited, Cyprus (part of Alfa Group, Russia) (80.1%); Alfa-Bank, Russia (19.9%).
2012	Erste Bank	Austria	100% exit sale to Fidobank	Consulting firm “Finans Analit Servis,” Ukraine (79.9%); Ignace Marketing Limited, Cyprus (20%)
2013	Swedbank	Sweden	100% exit sale to Delta Bank, Ukraine	Nikolai Lagun, Ukraine (70%); Cargill Financial Services, US (30%)
2013	Astra-Bank	Greece	100% exit sale to Delta Bank, Ukraine	Nikolai Lagun, Ukraine (70%), Cargill Financial Services, US (30%)

Sources: Raiffeisen, various bank websites
http://finance.bigmir.net/kredit_depozit/22728-Begut-s-korablja--kakie-inostrannye-banki-ushli-iz-Ukrainy

Table 4. Top 10 Ukrainian banks, ownership type, and shares of total banking sector assets (end- 2013)

	Majority owner	Share of total banking sector assets
Privatbank	domestic private	16.8 %
Oschadbank	state	8.1 %
Ukreximbank	state	7.4 %
Delta Bank	domestic private	4.3 %
Raiffeisen Bank Aval	foreign	3.4 %
Ukrsotsbank (UniCredit Bank)	foreign	3.4 %
Prominvestbank	foreign (Russia)	3.1 %
Sberbank of Russia	foreign (Russia)	2.7 %
First Ukrainian International Bank	domestic private	2.6 %
Nadra Bank	foreign (Cyprus)	2.4 %

Source: National Bank of Ukraine, various bank websites

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ISSN 2342-205X