

Ukrainian banking and finance: major changes and challenges



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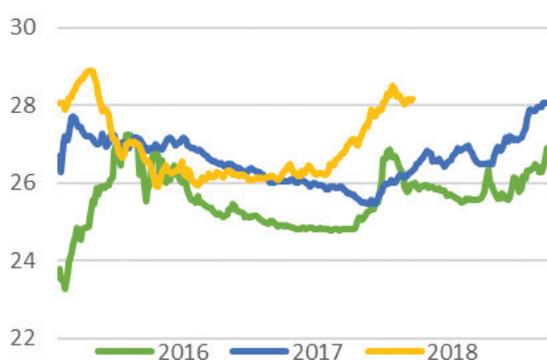
Inflation targeting instead of defending the currency peg

Many years of fixed exchange rate together with expansionary fiscal policy created huge external imbalances. Consequently, during 2014-2015 crisis the national currency lost almost 70% of its US dollar value. The National Bank lost US\$12 billion of its reserves defending the peg until the residual was insufficient to cover 3 months of imports.¹

The policy switch became inevitable, even with the IMF step-in, and the inflation targeting regime was introduced in 2016. Regulator proclaimed establishing price stability a key priority and set a CPI target of 5+1%², which they plan to reach by 2020. The fixed exchange rate was changed to floating, and monetary policy concentrated on bringing down price growth.

Currently, the policy rate stands at 17.5%, inflation dropped from 43%³ in 2015 to 9% as of August 2018. Reaching the annual 5% CPI target for 2019 poses a challenging task, however. This is because EM markets are typically turbulent, gas prices are increasing and local elections tempt politicians toward populist spending.

Chart 1. Hryvnia/US Dollar exchange rate



Source: <https://www.bloomberg.com/>

Chart 2. Policy rate and CPI during 2015-2018



Source: <http://www.ukrstat.gov.ua/>, <https://bank.gov.ua/>

¹ <https://index.minfin.com.ua/ua/finance/assets/>

² https://bank.gov.ua/control/uk/publish/article?art_id=42515307

³ <https://index.minfin.com.ua/economy/index/inflation/>

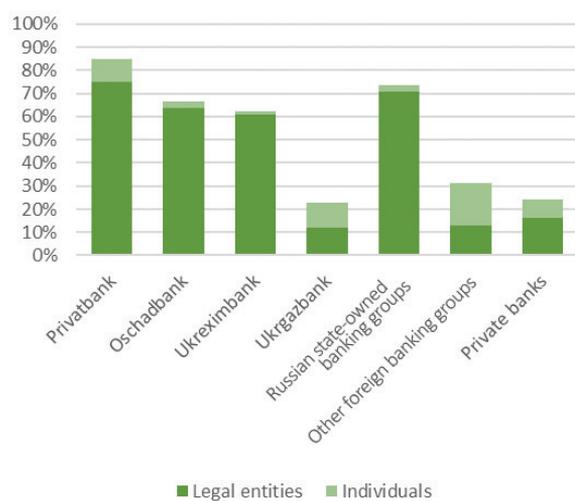
'Moral hazard' aftermath – fewer banks of better quality

Before 2014 the banking system was highly fragmented: there were 180 banks with assets above US\$160 billion. As usual for banking sectors in transition economies⁴ a high level of moral hazard in the system worked against the weak institutions. Combined with a lack of regulatory enforcement, this led to widespread related-party lending, bank looting, money laundering and fraud.

After the escalation of military conflict in Eastern Ukraine and the subsequent sharp economic decline, the vulnerability of the Ukrainian banking system became apparent. Many Ukrainian private banks which lacked backing from either strong foreign banking groups or the government became insolvent. Additionally, fraudulent entities were forced to shut down on a massive scale.

In the aftermath of the crisis and the banking system clean-up, there currently remain 81 operating banks⁵ with total assets of US\$50 billion⁶ (\$27 bn of the assets belong to the four state-owned banks) and on the balance sheet of the public Deposit Guarantee Fund there are \$15 bn of legacy toxic loans issued previously by liquidated banks.

Chart 3. Impaired loans in different categories of banks, % of gross loan portfolio



Source: National Bank of Ukraine

The system's overall health now looks better. Hidden non-performing loans were gradually reported and provisioned. Losses were mostly covered with fresh equity injections. Nevertheless, toxic debt in the sector still looms large and unresolved and the growth of lending is yet to recover.

⁴ <http://www1.worldbank.org/prem/lessons1990s/Chap%207%20financial%20092104%20rw.pdf>

⁵ <https://index.minfin.com.ua/ua/banks/stat/count/2018>

⁶ 1 half 2018

Strengthening of the supervision

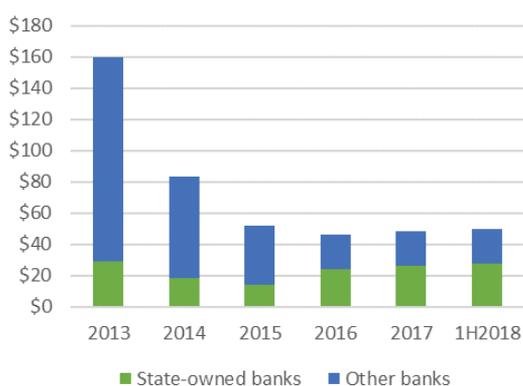
In response to the crisis and reacting to advice from the IMF and other external sources, the NBU introduced a number of important changes to banking sector regulations aimed at preventing the recurrence of the banking crisis. One of the key elements of new guidelines was the introduction of new macroprudential regulations aimed at limiting credit to related-parties and guaranteeing that banks have a certain level of capital. This reform package, in a nutshell, required banks to restructure their credit portfolios and attract more capital. This would have been difficult even in a more favorable environment, but difficult macroeconomic conditions and bad management made it practically impossible for many financial institutions. Thus, some lenders bankrupted and left the market. The state had to nationalize the biggest private bank, while NBU played a key role ensuring that the change of ownership proceeded smoothly. Today NBU is working to introduce Basel III standards of bank supervision.⁷

State-owned banks now rule the market

In December 2016 the largest nationalization in Ukrainian history happened. Privatbank, Ukraine's largest bank, which previously belonged to Ukrainian oligarch Ihor Kolomoysky, was bailed-out by the government. Investigations showed that 97% of loans given by the bank were issued to former shareholders and to related-parties. An unprecedented US\$5.9 billion of fresh equity was injected by the government.

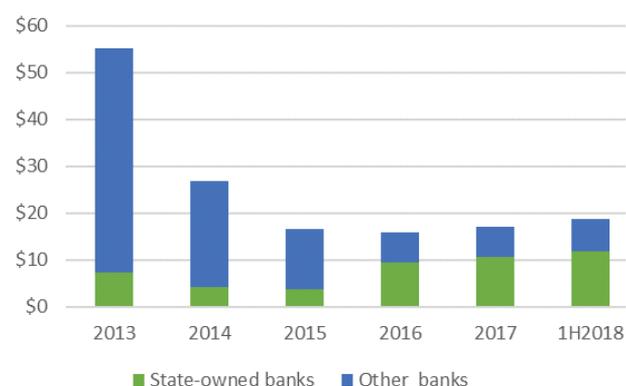
So, there are currently 4 state banks in Ukraine: Privatbank, Oschadbank, Ukrgazbank and Ukreximbank. The 2014-2015 crisis aftermath included not only Privatbank nationalization, but also liquidation of many private banks and thus the rapid climb of state-owned banks (SOBs) on market positions. Share of the SOBs in total loans to customers doubled from 19% to 38% and the amount of SOB retail deposits reached a 62% share as of 01.01.2018. Massive recapitalization, provided by the Ministry of Finance also fueled this growth.

Chart 4. Banking system assets ownership structure (\$ bn)



Source: <https://bank.gov.ua/>

Chart 5. Retail deposits amounts (\$bn)



Source: <https://bank.gov.ua/>

⁷ White Book on Reforms 2018, available at <http://www.kse.org.ua/en/about/support/buy-white-book-on-reforms/>

In total Oschadbank, Ukreximbank, Ukrgazbank and Privatbank received over US\$8,4 billion in capital injections and were able to create sizeable provisions for impairment as their portfolio quality was reportedly much worse than in foreign banks or in local private banks. However, the worst times for them in terms of heavy credit losses are behind, but the bad debt resolution path would be rocky.

Currently, the government's strategy is to sell all banks to strategic investors in the long-run. Privatbank and Oschadbank are both well-positioned in the payments market with significant market shares in payment cards, servicing together 126 thousand clients from retail trade and services. Contrary to them, Ukreximbank has almost no retail business (less than 1% of gross loans) and focuses on corporate lending. Ukrgazbank occupies 1-4% in each large market, being a universal mid-sized bank. It positively stands out due to its new strategic focus on SME and green energy and its comparatively lower share of non-performing loans in portfolio.

New currency law paves the way to FX liberalization in future

In 2014, to maintain stability of the national financial system and to prevent further devaluation of hryvnia, NBU enacted heavy capital and current account operations controls, in addition to the previously cumbersome and very restrictive regulation.

To enable the freedom of capital and currency movement, new legislation was developed. In June 2018 President P. Poroshenko signed a new law "On currency and foreign exchange operations" to enact greatly more liberalized rules within the foreign exchange market. The goal is to set up the rules to where no restrictions are placed on the transaction at all. Only notification requirements for statistical purposes and best-practice documentation requirements are necessary to legitimize the transaction. In the meantime, the regulation remains heavily restrictive, and the horizon for the actual liberalization seems distant with only some selected rules to be eased.

In 2019 Ukraine has to undergo a valuation procedure under the Association Agreement with the EU: the national treatment regime in financial services could be launched after 2019 if this valuation proves Ukraine and EU are ready to open the borders. For European banks, pension funds and mutual fund managers this regime could open Ukraine as a brand new market of 40 million people. Currently foreign banks and financial companies cannot sell their products to Ukrainians unless they have a Ukrainian subsidiary. But the devil will be in details, and we recommend following the issue closely.

