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Mopping up Ukraine's Banking Sector: Short-term Pain, Long-term Gain

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Mopping up Ukraine's Banking Sector: Short-term Pain, Long-term Gain

Executive Summary

Ukraine's economy has experienced significant headwinds during the recent economic and financial crisis, but a key point of concern among different stakeholders is the provision of credit by the banking sector, which stands for the majority of financial intermediation in Ukraine. These concerns are well founded, as the functioning of the banking sector is essential for any sustained economic recovery in Ukraine.

At first glance, the key performance metrics of the banking sector, e.g. loans issued and deposits taken, show disappointing results, with double-digit declines in nominal and real terms during 2015. However, the rate of decline seems to have bottomed out during midyear, and certain segments (e.g. retail deposits in local currency) are growing again. A more difficult question relates to the reasons behind the decline in lending. We argue that demand-side problems explain a significant part of this fall, but supply factors are also at play, in part explained by serious capital shortfalls in many institutions due to a surge in non-performing loans (NPLs). An additional factor that needs to be mentioned is the fundamental changes in the banking sector initiated by the National Bank of Ukraine (NBU), with the objective of creating a transparent and efficient financial sector. This mopping up of the sector has resulted in the closure of more than 60 (out of 180) banks over the last two years.

What can be done by the authorities to restart lending? A continuous challenge is to preserve and further entrench macroeconomic stability, which is still fragile. Other recommendations relate to financial sector policies that help to finalise the banking sector reforms as quickly as possible. Here, we would like to highlight four areas:

1. **Bank recapitalisation:** Banks' capital shortfalls are in the process of being identified. It is of utmost importance to arrange and execute credible plans to close these shortfalls until 2018, when the standard capital adequacy ratio shall apply.
2. **Quick resolution of NPLs:** Reforms in the tax system, the corporate insolvency and the credit enforcement framework are needed to facilitate a quick resolution of NPLs. An "out-of-court" corporate restructuring approach ("Kyiv approach") can support this process. In restructuring retail loans like e.g. FX mortgages, we favour a voluntary approach, as more radical solutions would threaten financial stability.
3. **Unwinding of related-party exposure:** The regulatory policies to unwind related-party lending need to be completed. The planned credit registry is a welcome step as long as it does not compete with private credit bureaus, but complements their work.
4. **Improved supervision and regulation:** Making bank ownership fully transparent is a key prerequisite for many other issues (e.g. related-party lending) and shall proceed as quickly as possible.

It is important to note that fostering a sound banking sector is a joint exercise for a number of institutions in Ukraine. The NBU as the supervisor plays the key role, but Parliament is also important for passing required changes in the regulatory and legal framework. A quick adoption of a number of key draft laws that are already submitted to Parliament would be an important step.

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1. Introduction

Ukraine's economy has experienced significant headwinds during the recent economic and financial crisis, but a key point of concern among different stakeholders is the provision of credit by the banking sector, which stands for the majority of financial intermediation in Ukraine. This relates to the question about the reasons for the observable contraction of credit (e.g. demand versus supply), as well as the correct policy response. It is a well-established fact that countries suffering from a "credit crunch" find it very hard to obtain the necessary sources for investment and experience as a result severe limits for economic growth. Thus, the functioning of the banking sector is essential for any sustained economic recovery in Ukraine.

In order to shed more light on these developments, this paper analyses recent developments in bank lending, and derives policy recommendations on how to improve the situation going forward.

The paper is structured as follows: In the next chapter, we will analyse recent bank lending developments in more detail. This cannot be done in isolation from wider economic trends, so we will briefly touch upon them as well in chapter 2. In chapter 3 we will discuss possible reason for a contraction in lending, namely the rapid fall in deposits, massive capital shortfalls at many institutions, as well as a contractionary monetary policy stance. However, we think that these "traditional" reasons for poor lending dynamics fall short of giving the full picture in Ukraine. An important additional factor is the fundamental change happening in the banking sector, which has been initiated by the National Bank of Ukraine (NBU) with the objective of creating a transparent and efficient financial sector. Over the past two years, the NBU has closed numerous banks and conducted policies to clean-up other banks' balance sheets, thereby fostering a sounder banking sector. This mopping up and its consequences need to be discussed as well. Chapter 4 deals with these reforms, their rationale, and their relationship to lending developments. In chapter 5, we conclude with some policy recommendations on how to restart lending.

2. The economic environment and bank lending: Stylized Facts

The economic environment: During the last two years, Ukraine faced a number of severe political and economic challenges, which led to a deep recession, a strong depreciation of the domestic currency and rampant inflation. On a positive note, there are gradually signs emerging that the situation has at least stabilised, as the exchange rate is more or less flat, inflation is gradually coming down, and the economy started to show signs of growth recently.

However, we should not limit ourselves to the last two years, as the economic performance of Ukraine at least since the great financial crisis of 2007/2008 was truly poor. The double-digit decline of real GDP during 2009 was in size roughly similar to the recent one, but also in the years between, growth was very meagre and real GDP basically stagnant during 2012-2013.

Figure 1

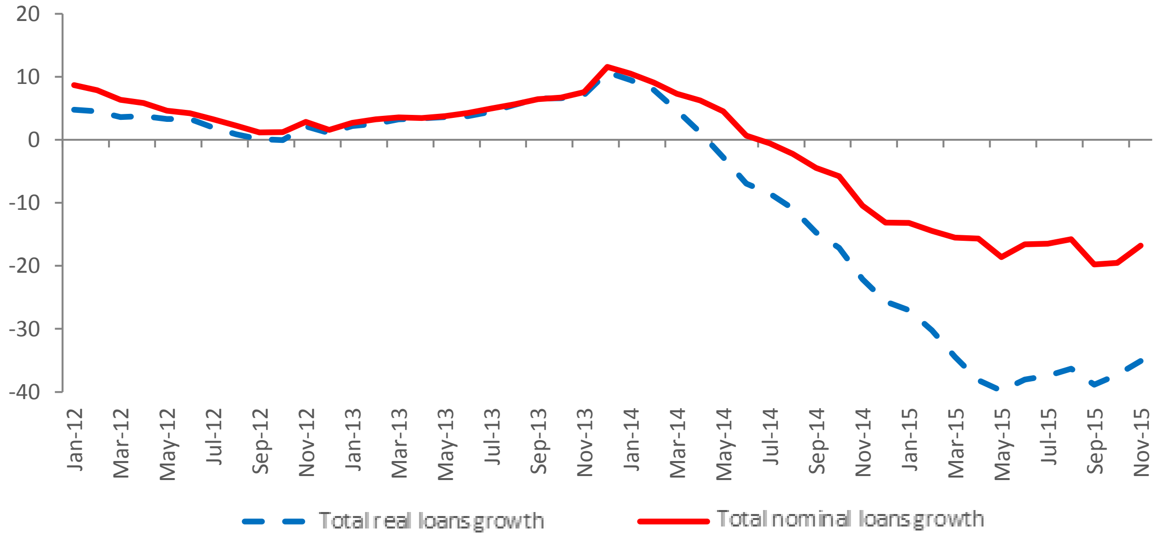
Real GDP Growth (%)

Source: Ukrstat

The contraction of bank lending: One aspect that stands out with regards to the economic performance of the last two years is the development of bank lending, which started to decline in January 2014 and reached a low of –20% yoy in September 2015 (Figure 2). In real terms, i.e. controlling for the burst of inflation, the stock of outstanding loans was up to 40% below the level the year before in September 2015. Both nominal and real loan growth have bottomed out and reduced their pace of decline since then.

Figure 2

Real and nominal loan growth (% yoy)



Source: Own calculations based on NBU data

Notes: Real change based on CPI, nominal change is adjusted for exchange rate effects, not adjusted for bank liquidations

Crucial to an assessment of this development is to whether this was caused by banks restricting their supply of loans to the real economy or, alternatively, whether this is related to a contraction of loan demand due to the recession and the uncertainty Ukraine currently faces. After all, firms and households may have simply put spending for investment and consumption on hold for the time being.

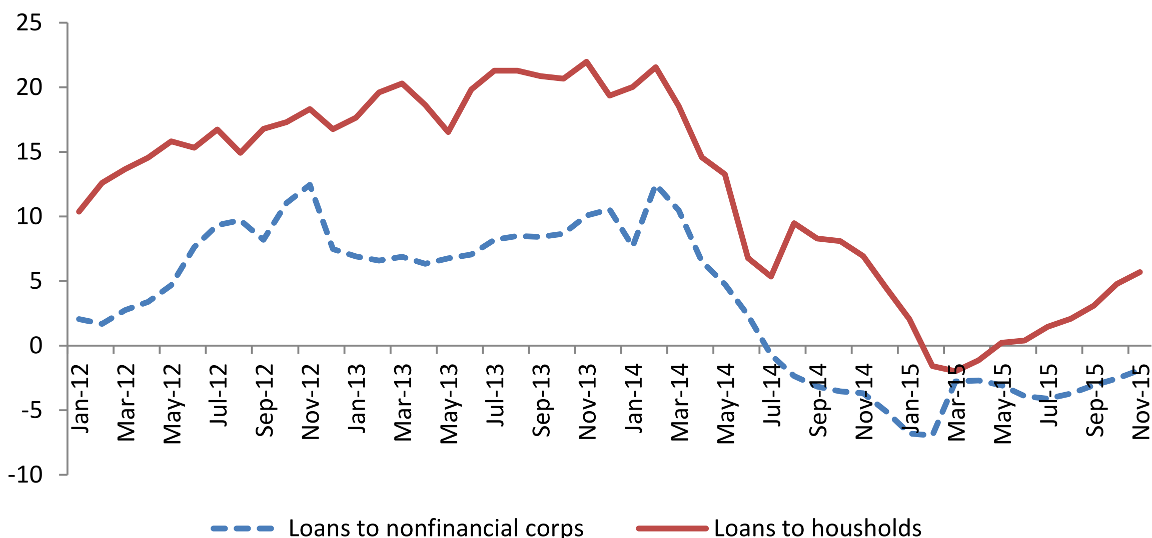
A second issue in this context relates to the current efforts by the National Bank of Ukraine to restructure the banking sector. 63 out of a total of 180 banks working at the beginning of 2014 have been removed from the system as of January 2016 (two more were resold in part), which raises the question of its implication for lending dynamics, both short- and long-term.

3. Possible reasons for the contraction in lending

What might have caused the observable contraction in lending? A notable development is the fall of ex-ante real rates of interest charged by banks to non-financial corporations and households since the beginning of 2014 (Figure 3).

Figure 3

Development of ex-ante real lending rates (% p.a.)



Source: Own calculations based on the NBU data

Note: Expected inflation is taken from NBU Enterprise Survey

A reduction of lending rates is generally an indication of a banks' reaction to a fall in the demand for loans. However, according to results from regular interviews by the National Bank of Ukraine (NBU) with bank managers [See Tables 1 and 2 in the Annex], banks' lending standards have increasingly tightened in the course of the last two years while demand for loans has –perhaps somewhat counterintuitively- increased. So, the evidence is not entirely clear to what extent demand factors are behind the contraction of outstanding loans, but supply effects certainly played a role.

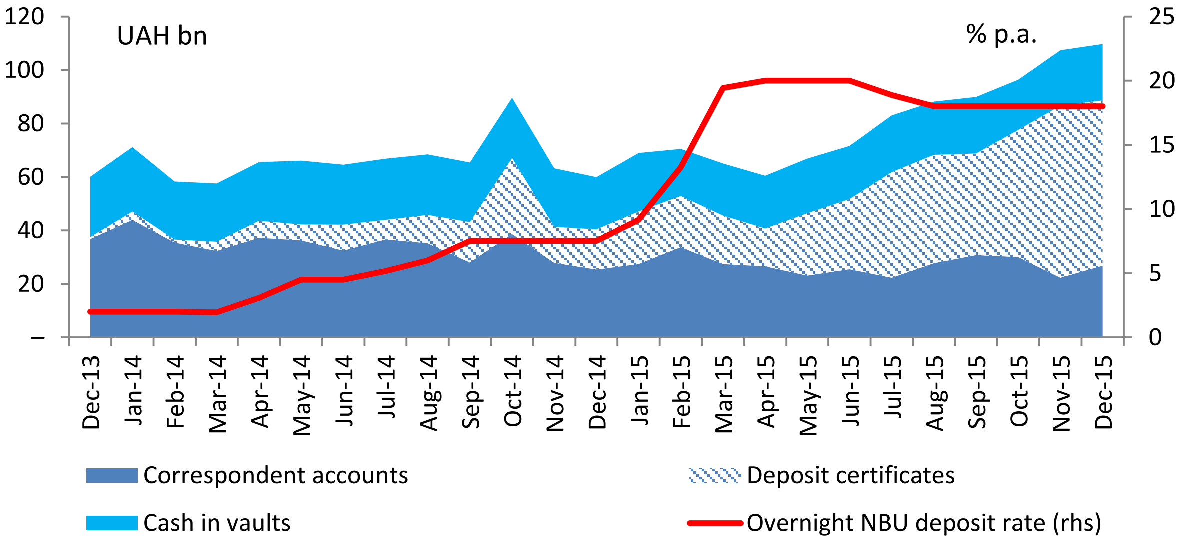
Conclusion 1: Bank lending has contracted strongly in the year to November 2015. This reflects the contraction in output which reduced the demand for loans, but was exacerbated by tightened lending standards by banks which caused a reduction in the supply of loans.

In the following we will discuss potential reasons for this reduction in the supply of loans by banks: The massive outflow of bank deposits during the crisis, the significant shortfalls in capital as well as the NBU's monetary policy stance. Another reason why banks are hesitant to issue new loans is the prevailing legal environment.

The monetary policy stance: The NBU has embarked on a contractionary monetary policy in order to counter the massive depreciation of the Hryvnia and resulting burst of inflation. One important instrument employed are the liquidity absorbing overnight deposits facilities and certificates of deposits (CDs) issued by the NBU (with maturities between 4 and 89 days this year, see Figure 4). The rates paid on these facilities were 7.5% for overnight deposits and between 11% and 13% for CDs at the beginning of 2015 but massively raised to 20% and up to 27% respectively until March 2015 and only slightly reduced to 18% and 19-22% respectively in July 2015. The effect was a large inflow of banks' assets into these facilities which otherwise may have been converted into foreign currency.

Figure 4

Banking system liquidity and CD rates



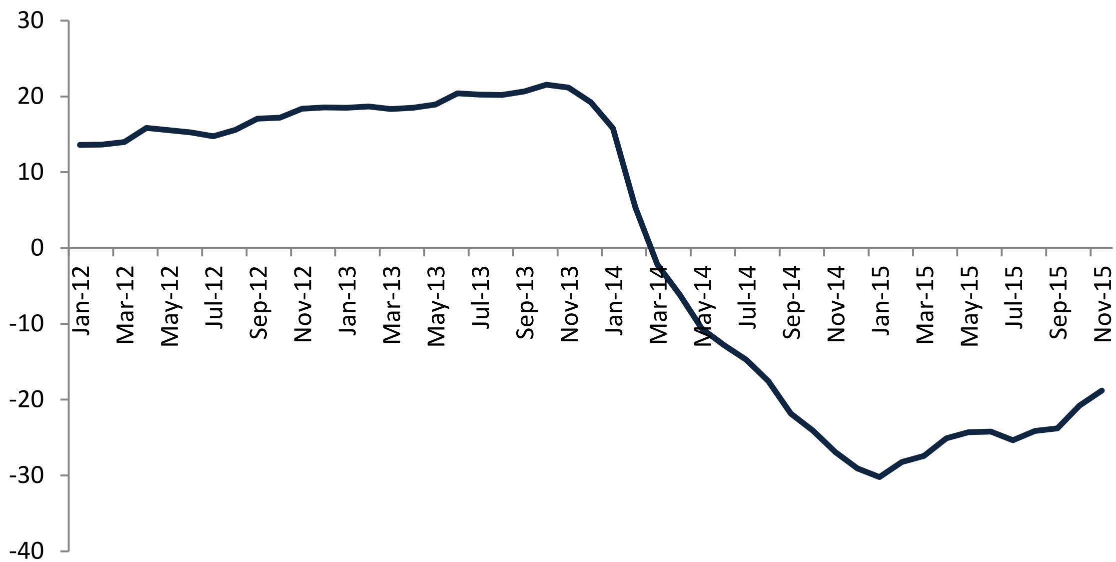
Source: NBU

It is unlikely that in the current environment banks would have invested this liquidity in the form of loans to firms and households and would thereby have boosted economic growth. Rather, this policy, together with the heavy use of administrative FX restrictions, clearly contributed to the stabilization of the Hryvnia, which formed in turn the basis for the observable macroeconomic stabilisation. Furthermore, it is rather an effect of than a cause of the economic environment which caused the reduction in lending.

Deposit outflows: Households reduced their holdings of bank deposits significantly during the crisis, as Figure 5 shows.

Figure 5

Household deposit growth in % (12-month change, adjusted for FX changes)



Source: Own calculations based on NBU data

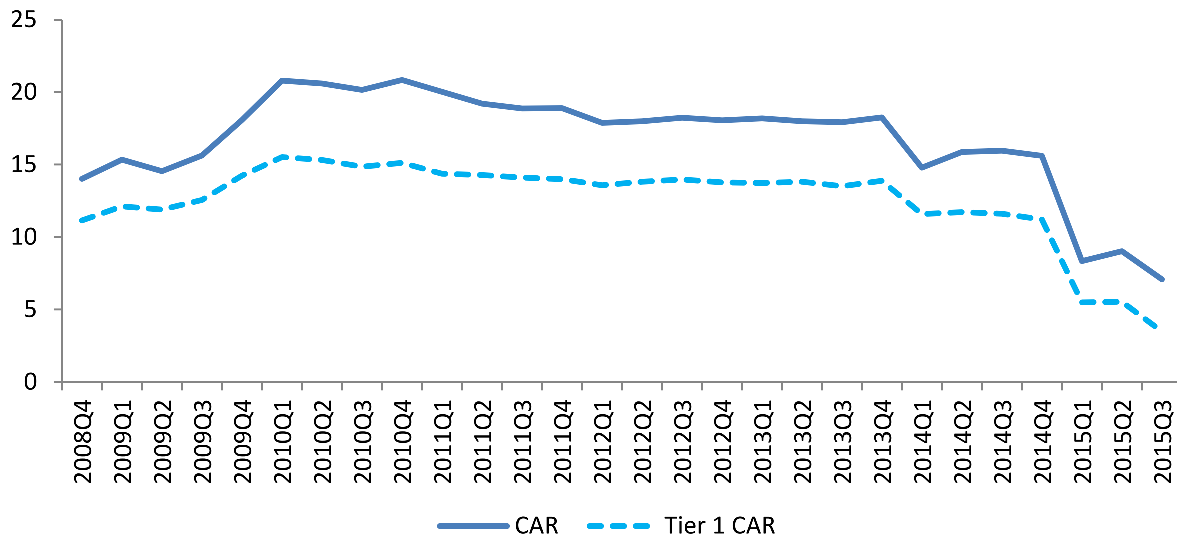
Note: Deposits not adjusted for bank liquidations

This contraction in deposits, whose pace bottomed out in early 2015, implied a severely reduced capacity to extend loans. However, given the fall in demand for such loans and the high amounts of liquidity parked with the NBU in the form of CDs and the overnight facility, deposit outflows clearly can't be the main reason for reduction in lending. Both the lack of demand for loans and the reduced supply of deposits from households were likely caused by the volatile political and economic situation, including the annexation of Crimea and the conflict in the East, and can be interpreted as a reduced demand for banking services. Banks did not suffer from too little liquidity to extend loans.

Capital shortfalls: Banks need to hold a certain amount of capital for regulatory purposes that is specified as a fraction of risk-weighted assets. The rapid depreciation of the Hryvnia put pressure on the capital-adequacy-ratio (CAR) as a jump in risk-weighted assets (since many assets are in foreign currency) met an unchanged capital base (which is in domestic currency). Following this, the stock of capital was depleted as a surge in non-performing loans caused massive losses. These losses were exacerbated by the strong depreciation of the Hryvnia, because the Ukrainian financial sector is highly dollarized with many loans denominated in foreign currencies. Borrowers with loans denominated in an appreciating (foreign) currency and revenues denominated in a depreciating currency (i.e. Hryvnia) are easily driven into insolvency and forced to default on bank loans.

Figure 6

Capital adequacy ratio of the banking sector (%)



Source: NBU

Such a massive shortfall of capital inhibits banks from lending which shows up in the increase in lending standards mentioned above. Since the crisis started, the NBU, in close cooperation with the IMF and other institutions, required banks to raise new capital and/or convert debt instruments into equity capital to address this shortfall. The Government injected UAH 18 bn in state-owned banks in 2014, and injected a further UAH 3.2 bn in state-owned Ukrgazbank in 2015. The Top-20 banks in the country raised, or initiated raising about UAH 91 bn of fresh equity in 2015, while the overall sum for all active banks was estimated at about UAH 95 bn in 2015. Overall, the total capital injections in 2014 and 2015 by active banks exceeded UAH 128 bn. Among private banks, the majority of the funds were provided by foreign owners, with local owners only providing a smaller part. Furthermore, the high central bank deposit rates mentioned above constitute subsidized income for banks that helps to stabilize their profits which can be retained to increase the capital base. Thereby the banking sector will find it easier to increase the supply of loans when demand for them ultimately picks up again.

Conclusion 2: The low capitalization of banks is an important cause of the reduced supply of loans while the deposit outflow is unlikely to have had a big effect. The tight monetary policy, although contractionary given the hikes in interest rates, may rather have helped banks because of the FX stabilization and its positive effect on bank capital.

The legal environment: However, even for well-capitalized banks there is an obstacle that prevents them from re-starting lending: The lack of an adequate legal environment that supports a reasonable expected return on investment. This shows up in the World Bank's Doing Business Report in the chapter on "Resolving Insolvencies": Secured creditors recover a meagre 8.3 cents on the dollar from an insolvent firm at the end of insolvency proceedings. This implies that even collateral does not protect a bank from a de facto total loss if a customer declares insolvency. Furthermore, the average cost of such insolvency proceedings are 42 percent of the collateral value. This may imply that more than the amount lent to the firm may be lost. With this in mind it is no surprise that relationship lending, which will be discussed in the next section, was so attractive for banks.

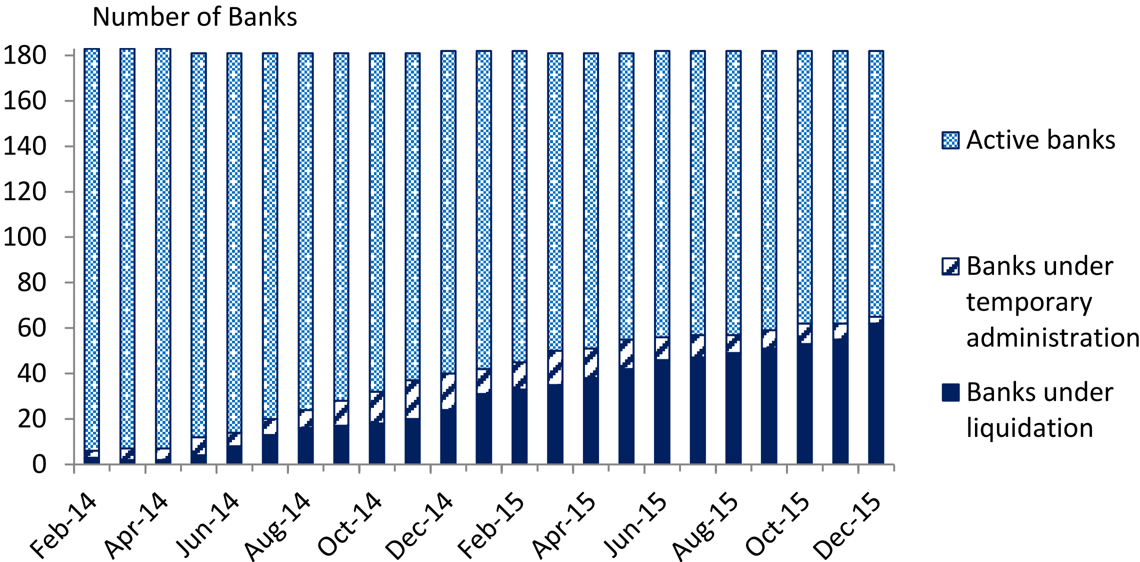
Conclusion 3: The lack of creditor rights is a major obstacle to restart bank lending in the current environment, but makes it even harder to overcome the old relationship lending model.

4. The restructuring of the banking system: Dimensions, rationale and impact

The NBU's restructuring of the banking sector: Starting in spring 2014, the NBU embarked upon a comprehensive overhaul of the banking sector. As of January 19 2016, among the 182 registered banks only 117 were active while 62 were in the process of liquidation and three under temporary administration. 63 banks that were resolved in 2014 and 2015 accounted for 28% of the total loans issued and 25% of bank assets in the beginning of 2014.

Figure 7

Number of Banks in Ukraine



Source: NBU, own calculations based on information provided by the Deposit Guarantee Funds (DGF)

This massive restructuring is expected to continue until next year and ultimately result in significantly less than 100 remaining banks. One immediate effect of closing down such a large number of banks is, of course, a reduction of those banks' lending to firms and households. In the presence of the currently tight lending standards, it may be difficult for those customers to find a new bank with which it has no established lending relationship.

Conclusion 4: The closure of banks has contributed to the reduced supply of loans as recorded in official statistics.

Rationale for bank restructuring: Understanding and accepting the logic behind these reforms is key in order to justify the short-run costs it may cause. The enormous re-structuring effort described and the implied short-term costs involved can only be justified if at least in the medium-run or long-run the banking sector can be expected to contribute to a stronger and fairer economy. To some extent the bank closures are easy to justify as many of those banks were simply conducting illegal activities. However, there is a broader motivation and in the following, we provide a rationale in support of this effort. We argue that both for political and economic reasons the reform needs to be continued and completed as quickly as possible.

An important goal of the current reform effort is to **increase the transparency with respect to ownership structures of banks and their customers.** Until recently, many Ukrainian banks were characterized by undisclosed ownership structures. This makes a bank's business model opaque from the perspective of regulators as it allows disguising related-party lending. Related-party lending is

here understood as a bank's lending to companies which are owned by the bank's owners themselves or to companies that are closely connected to the bank owners. In many cases, the severity of related-party lending is further hidden by complicated ownership structures on the side of firms borrowing from banks.

The lack of transparency and related-party lending is a serious concern for several reasons:

- First, it prevents bank supervisors from understanding the kind and size of risks a bank is taking and who is ultimately bearing responsibility for losses incurred by the bank. In case a bank fails and needs to be restructured or liquidated, lack of accountability will necessarily increase the burden for people not responsible for the failure, i.e. depositors and tax payers, given that deposits are protected by a deposit insurance scheme which is backed by the government. The Deposit Guarantee Funds (DGF) paid out over UAH 62 bn to depositors in failed banks in 2014 and 2015 (including two bridge banks and asset sale) and remaining claims on failed banks as of the end of 2015 may add up to another UAH 10 bn. This is both a serious economic and political concern because firms and banks will take on risks that they wouldn't if they worked prudently or their business could simply be to steal depositors' money. This imprudent, or in the extreme case criminal, banking practice is thus subsidized by the general public and sets incentives that severely harm economic development of the country and which, rightfully, can be regarded as politically scandalous.
- Second, banks benefit from the privilege of access to liquidity injections by the central bank while other, non-financial firms do not. Banks should lend this liquidity to *any* firm where the loan generates a positive expected pay off for both the bank and the firm as this is the best way to support the general economic development the benefits of which are broadly shared. And it supports a stable banking system. In contrast, banks should not lend this liquidity just to *specific* connected firms where the loans generate uncertain payoffs for the bank and certain positive payoffs to those firms. This will necessarily result in growth of firms with questionable business models that are unlikely to serve the economy's long-run economic development and will result in an unstable banking sector.
- Third, related-party lending inhibits sober portfolio diversification conducted by banks. The usual function of banks is to re-finance their business by collecting deposits of a large pool of households and firms and lend to a large pool of households and firms. Thereby they indirectly allow depositors to hold a well-diversified and thereby safe portfolio. At the same time depositors are able to access their deposits easily at least as long as not all do so at the same time. Deposits are thus both liquid and earn a (low) rate of interest. If, in contrast, the loan portfolio is little diversified as is likely the case with ample intransparent related-party lending, it may be extremely risky. Usually investors in risky assets are compensated for bearing such risk by a higher return or interest. If depositors are not aware of this trade-off, or if they simply lack alternative means to store their savings and cash, they are served badly. And, as in the prior section, the banking sector is almost certainly unstable and costly for the general public.
- Fourth, concentration of bank lending to related companies may inhibit sustainable growth of the overall economy, the benefits of which are consequently not widely shared. Small and medium-sized enterprises (SMEs) may not have access to bank lending and their growth is thereby inhibited[1]. Banks could do so deliberately in order to protect incumbent firms from competition. They then do not fulfil their function of directing an economy's savings to the

[1] See German Advisory Group Policy Paper PP/02/2016 for a detailed analysis.

most productive firms' investment. Inefficient firms survive and the aggregate productivity of firms and workers and ultimately average real incomes suffer.

Conclusion 5: The restructuring of the Ukrainian banking sector addresses structural weaknesses that prevent the Ukrainian economy to prosper and its citizens and taxpayers to be protected from unfair banking practices.

If overall bank loan supply to firms and households suffers because banks are closed in the restructuring process, this is necessarily unavoidable but is a price worth paying as ultimately the creation of a better banking system is feasible. However, a speedy completion of the restructuring process will reduce the burden of adjustment as it will allow deposits of liquidated banks to be quickly re-allocated to sound banks which will then be able to increase their supply of loans and support a recovery of the economy.

Conclusion 6: The mopping up of the Ukrainian banking sector should be completed as quickly as possible in order for aggregate loan supply to increase quickly and support the recovery of the economy.

5. How to restart lending? Policy recommendations

The major question going forward is what needs to be done so that bank lending can recover and support the growth of the Ukrainian economy. As we have argued above, the NBU has done a great job over the last two years in achieving macroeconomic stabilisation, restoring confidence and fostering a banking system that will be conducive to economic growth in the medium-run. The stabilization of the Hryvnia and the deposit inflows to the banking system are first indications that the NBU succeeded in its stabilization policies and it seems reasonable that it will at some point be able to reduce its policy rates. The necessary recapitalization of banks is on track and will increasingly reduce the regulatory restrictions on bank lending.

Hence, the focus for reform is now on financial sector policies that support banks to extend credit to the private sector without fear of having to write off loans outstanding because borrowers find it too easy to default on their obligations. This is also a task for the Parliament, which needs to adopt a corresponding legal and regulatory framework. In particular, a number of draft laws that were developed to address these shortcomings await currently adoption by the Parliament. We want to highlight four areas of reform that are ongoing and that need to be completed soon:

1. **Bank recapitalization and restructuring:** The recapitalisation efforts mentioned in chapter 3 are important, but not sufficient to return the banking system towards a reasonable capital adequacy ratio. The Top-20 banks in the country have only recently finalized a new wave of stress tests, whose results are not known to the public, but which require further substantial capital injections in the majority of institutions. The smaller groups of banks will follow with similar exercises at a later stage.

   It is important to **drive this process forward** and **specify detailed and credible recapitalization plans** for the different groups of banks. Overall, the recapitalisation process is planned to be finished by 2018, when all banks are required to meet the standard CAR. Depending on the size of the bank, this ratio will be achieved by gradually injecting and/or building capital over time.

2. **Resolution of NPLs and corporate insolvencies:** Resolving the significant amount of non-performing loans (NPLs) that sit on the balance sheets of banks, thereby blocking new lending is a key priority. This problem has different dimensions that need to be addressed in parallel: (a) the removal of **impediments in the tax system** that block debt restructuring as

well as the sale of such loans to other parties, (b) improving the **corporate insolvency** framework, and (c) strengthening the legal framework for **credit enforcement**. Respective changes in the tax code, the bankruptcy law, other legal acts and anti-corruption efforts are necessary and need to be worked out among the different stakeholders and approved by Parliament.

Furthermore, because banks, as of now, are not yet in a position to support economic growth, it will be important to avoid measures that inhibit banks' return to healthy balance sheets. The positive effects of write-offs of FX mortgage and corporate debt for economic growth need to be balanced against their detrimental effect on banks' balance sheets. Any debt restructuring of domestic borrowers vis-à-vis domestic creditors is a re-distribution of wealth within the economy that may or may not have positive net effects on growth. In this regard, we are concerned by attempts (e.g. draft law 1558-1 from 2015) to force the burden of FX retail loan restructuring almost entirely on banks. Putting the (still weak) capital position of banks under further pressure might also entail further negative consequences for fiscal and financial stability. The problem of FX retail loans, especially in the mortgage segment, can only be approached in a **voluntary and targeted restructuring approach**, which strikes the right balance between the different parties. We support draft legislation that has been worked out between the most affected banks under the supervision of the NBU, as well as the related lifting of the moratorium on foreclosures of FX mortgages.

Corporate debt restructuring can also benefit from the introduction of alternative **"out-of-court" restructuring**, which follows internal best practice (e.g. the "Istanbul approach"). The necessary legal framework should be adopted as quickly as possible.

3. **Unwinding of related party loans:** The regulatory policies that force banks to **unwind related-party lending need to be completed.** After a thorough review of the relevant exposures by the NBU, banks need to present to the authorities **concrete plans** about how they plan to reduce their related party exposure. We suggest that for the biggest banks, such plans are presented and approved rather quickly, i.e. in the first few months of 2016, while for smaller banks a somewhat longer time frame can be allowed. It is necessary that banks adhere to that time frame so that they can quickly restart lending to other customers.

   The Related Parties Monitoring Office (RPMO) that started operations in summer of 2015 is an important institution in this regard. It must be able to operate free from political or other influence in order to fulfill its mandate properly. Furthermore, for an effective operation, the planned credit-registry is, among other benefits, paramount for the RPMO's operation as it will provide it with the necessary information on credit relationships. Work on this registry is therefore urgent and needs to be completed quickly. However, it is important not to challenge the existence of private credit bureaus in the country, whose performance has improved over the last couple of years. **The credit registry shall complement the work and the products of private bureaus but not compete with them.**

4. **Improving bank supervision and regulation: Banks' ownership structures must be made transparent as soon as possible**, preferably in early 2016. This is a necessary condition for supervisors to be able to easily identify potential related-party issues and to prosecute illegal activities by banks. But it is not sufficient because transparency with respect to borrowers' ownership structures is obviously needed too, both for identification of related party lending and for prosecution of illegal activities by non-financial firms. Hence, setting up a universal, publicly accessible firm registry is an urgent task too and will help banks to be protected from customers being able to walk away from loan contracts too easily. The legal environment will thereby improve a lot for banks and allow them to re-start lending again.

6. Annex

In Table 1 and 2, we see the balance of "tighter" and "loose" answers to the question “Did lending standards became tighter or more relaxed”. A positive balance means tighter standards on average. During 2014-2015H1, the observed positive balance of 30-50% means that up to half of all banks tightened lending standards each quarter. More recent data show that in 2015Q3 some banks eased lending standards and much less banks tightened. This effect is most pronounced for consumer loans and short-term loans for businesses. In case of consumer loans, it seems that more banks relaxed their standards than tightened. For short term business loans, it was close to balance.

Table 1

Lending standards for household loans

Indicator	2013	2014				2015		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Mortgage loans	-0.8	39.2	22.4	12.6	32.3	25.6	19.0	0.9
Consumer loans	-4.9	53.3	30.3	34.4	39.6	39.7	19.0	-6.4

Source: NBU lending survey

Table 2

Lending standards for corporate loans

Indicator	2013	2014				2015		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Total	**11.3**	**50.0**	**56.0**	**47.1**	**47.3**	**42.7**	**30.2**	**3.1**
Loans to small and medium-sized enterprises	0.8	48.2	55.5	45.5	46.4	40.6	25.2	8.5
Loans to large enterprises	13.2	39.2	30.2	38.5	35.6	40.4	34.3	7.3
Short-term loans	4.6	45.3	33.5	41.6	43.3	37.4	26.4	1.3
Long-term loans	18.1	51.8	41.2	42.7	38.9	50.8	37.2	19.7
Loans in domestic currency	5.4	43.7	37.9	41.7	44.0	38.4	27.2	2.2
Loans in foreign currency	17.0	52.8	47.0	51.7	52.0	56.8	44.3	21.9

Source: NBU lending survey

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