German Advisory Group Ukraine

NEWSLETTER

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Reforming the banking sector: Short-term pain, long-term gain

Ukraine's economic crisis that started in 2014 had a drastic impact on the banking system. As a result, bank lending declined heavily. According to our research, both demand and supply factors contributed to this decline.

At the same time, the National Bank of Ukraine decided to conduct far-reaching structural reforms to transform the sector. The number of active banks went down by more than 60 over the last two years; most of those banks removed are now under liquidation.

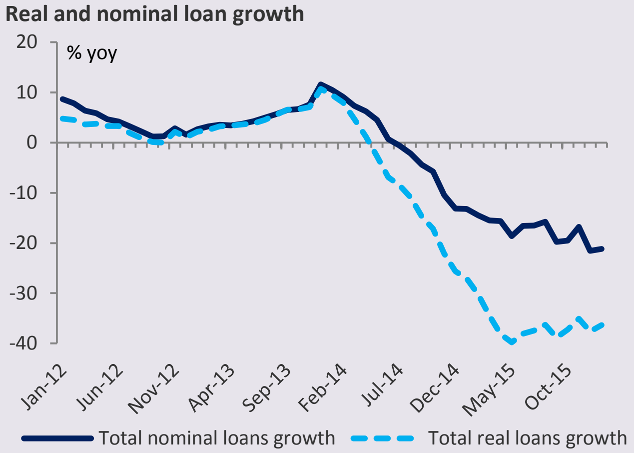
In our view this policy is without alternative but it is important to accomplish this consolidation process rather quickly, so that confidence in the banks returns and lending re-starts. A sector comprised of transparent banks that issue loans according to sound banking principles will help the economy to recover, but also lay the foundations for sustainable growth in the long-run.

The economic environment and bank lending

Starting in 2014, Ukraine suffered a severe economic crisis. Real GDP declined by 6.6% in 2014 and by 9.9% in 2015. Inflation peaked above 60% yoy in April 2015 and the Hryvnia has depreciated by 70% versus the US dollar since early 2014.

Against this background, the observable decline in bank lending does not come as a surprise. Loans declined by more than 20% yoy in nominal terms in 2015; the decline in real lending (i.e. adjusted by inflation) was even higher at about 40%.

Real and nominal loan growth



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

A positive development to note is that the steep fall in the growth rates seems to have bottomed out during the second half of 2015.

Possible reasons for the decline in lending

How can the observable reduction in bank lending be explained – is this due to a lack of demand, a lack of supply, or both? Demand-side factors definitely contributed to this development as the severe recession reduced credit demand. This is further supported by a reduction in lending rates in real terms during the crisis.

However, also supply-side factors seem to have played a role. This view is supported by lending surveys regularly conducted by the National Bank of Ukraine (NBU), which suggest a general tightening of loan standards by banks.

Another factor that might explain the reduction in the supply of loans is the monetary policy stance. The NBU was forced to tighten its stance, i.e. raise policy rates during the crisis. However, this policy, together with administrative measures, eventually helped to stabilise the fragile situation on the foreign exchange market and thus contributed to a stabilisation in the banking sector. Since banks hold high amounts of liquidity with the NBU (about UAH 100 bn), they also achieve significant interest income on their holdings of certificates of deposits. Given the ample liquidity available to banks, the observed fall in household deposits during the last years does not seem to be the main culprit in the reduction in lending; it is rather an indicator for a reduction in demand for banking services by the public during the crisis.

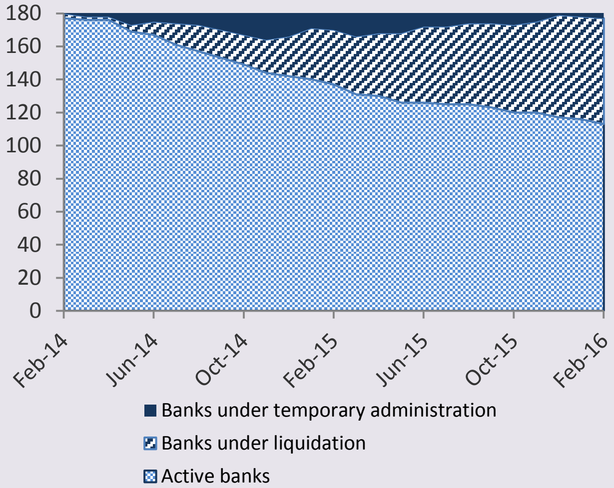
In our view, a very important reason for the reduction in the supply of loans is the banks' lack of capital. Indeed, the capital adequacy of the whole banking system has deteriorated below regulatory norms (capital is below 10% of risk-weighted assets), while some banks show even negative numbers. This is an issue that has already been addressed (about UAH 130 bn of capital have been raised during 2014/2015), but more progress on this front is clearly needed.

But even well-capitalized banks would probably not lend huge amounts of money in the current legal environment since it does not ensure an adequate return on investment. According to World Bank data, even secured creditors (i.e. banks that have collateral equal to the amount of the underlying loan) can recover only 8.3 cents per dollar lent at the end of insolvency proceedings. Thus, in many cases collateral does not protect banks from a de-facto total loss, which shows the lack of creditor rights.

Structural reforms in the banking sector

There are massive shifts going on in Ukraine's banking sector – the number of active banks in the country was reduced from 177 to 113 over the last two years; 64 banks are currently under liquidation for breaching regulatory norms.

Number of banks



Source: National Bank of Ukraine

A key rationale for this radial clean-up of the sector by its regulator, the NBU, is the insight that many of those banks that were removed from the system did not function as proper banks, but they engaged in non-transparent, opaque activities like lending to related parties. This creates risks to depositors and ultimately also to tax-payers, who need to foot the bill if the (often unknown) owner walks away from the bank during a crisis. At the same time, such lending does not allow for a proper risk diversification of banks' loan portfolios, and it also prevents a level playing field in the real sector as small and medium-sized companies must compete with larger, financially better connected groups. Taken together, such a dysfunctional banking system thus prevents a sustainable economic development. The NBU is thus right to reform the sector.

Policy recommendations

The economic crisis that started in 2014 negatively impacted the banking sector, whose main performance metrics deteriorated. However, behind these numbers a huge structural transformation of the whole sector is taking place. This reform – which is one of the major success stories of structural reforms in Ukraine so far – is driven by the regulator, the NBU.

It is important to accomplish this job rather sooner than later, so that confidence in the remaining banks is restored and the system can restart lending activity. For this, we think that further progress is needed in a number of areas. First, the bank recapitalisation efforts need to continue, such that all remaining banks fulfil the regulatory norm by 2018. Second, the resolution of non-performing loans (NPLs), which increased a lot during the crisis and is currently blocking new lending as well, must be accelerated. This calls for changes in a number of legal acts and shows also that other stakeholders like the Parliament play a crucial role in the sector. At the same time, we think that a possible loan restructuring (e.g. mortgages in foreign exchange) must be done in a voluntary and targeted manner; it would be counterproductive to shift the entire burden on banks' balance sheets as this would only aggravate the crisis. Third, the unwinding of related party loans in some banks needs to be completed. Fourth, banking supervision and regulation must be further improved, e.g. in terms of making bank ownership fully transparent. A continuous and joint challenge to all policymakers, not just the NBU, is to preserve hard-won macroeconomic stability since mid-2015 as there cannot be a recovery in the sector without a stable macroeconomic background.

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Note: For a detailed analysis of the subject, please refer to Policy Paper PP/01/2016 "Mopping up Ukraine's Banking Sector: Short-term Pain, Long-term Gain".
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German Advisory Group
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