Mopping up Ukraine’s Banking Sector: Short-term Pain, Long-term Gain
- Summary of results -

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German Advisory Group in cooperation with the IER Kyiv

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1. Introduction
2. The economic environment and bank lending: Stylized Facts
3. Possible reasons for the contraction in lending
4. The restructuring of the banking system
5. How to restart lending? Policy recommendations

Contacts
Annex
1. Introduction

- During the current economic and financial crisis particularly in focus: Supply of credit provided by the banking system

- Why?
  - A credit crunch limits economic growth
  - A functioning banking sector is crucial for a sustained economic recovery

- This presentation summarizes our recent policy paper:
  - Analysis of recent developments in the banking sector,
  - Policy recommendations on how to improve the situation going forward,
  - A special focus on far-reaching reforms in the sector by the NBU
2. The economic environment and bank lending: Stylized Facts

- **Background:** Severe macroeconomic and financial crisis:
  - Cumulative double-digit real GDP decline over 2014/15
  - FX depreciation of about 70%
  - Inflation peaked at 60% yoy

- **Banking sector:**
  - Drastic decline in both nominal (-20% yoy at peak) and real (-40%) loan growth
  - But: Stabilisation during Q2/Q3 2015, speed of reduction has decreased

**Question:** Reduction in bank lending due to supply or demand factors?

![Graph showing real and nominal loan growth from Jan-12 to Sep-15](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.)
3. Possible reasons for the contraction in lending

- The significant contraction in output has clearly reduced the demand for loans by clients
  - Reduction in real lending rates
- This demand-side effect was exacerbated by tightened lending standards by banks, which caused a reduction in the supply of loans
  - NBU lending survey (see Annex) points to tightening, only recently some signs of easing

**Development of ex-ante real lending rates**

- Loans to households
- Loans to nonfinancial corps

**Conclusion 1:** The reduction in bank lending reflects both demand and supply side factors

**Source:** Own calculations based on NBU data

**Note:** Expected inflation is taken from NBU Enterprise Survey
What factors might be behind the reduction in the supply of credit?

- NBU tightened monetary policy to counter massive depreciation (in addition to severe administrative FX restrictions)
  - Rates on CD’s were increased up to 27% p.a. in Q1 2015 and slightly decreased afterwards
  - Banking liquidity above UAH 100 bn

Conclusion 2: The tight monetary policy stance, although contractionary, may have supported banks due to the resulting FX stabilisation and the positive impact on bank capital rebuilding
Households reduced their deposit holdings significantly during the crisis

- More a sign of reduced demand for banking services due to the crisis (similar to loan demand reduction)

- But also here: Tentative signs of stabilisation of the rate of decline of outflows

Conclusion 3: In light of the massive amount of liquidity held with the NBU, deposits outflows are not a significant cause for the decline in lending
Capital adequacy

- Significant reduction in capital adequacy ratio (CAR) below regulatory norms
  - Massive depreciation put pressure on the ratio
  - Surge in NPLs (also related in part to depreciation) and related provisioning
- Active banks raised almost UAH 130 bn during 2014/15, but more funds are needed

Conclusion 4: The low capitalization of the banking sector is a major factor for the reduced supply of loans

Source: NBU
Legal environment

- Even for well-capitalized banks, there is an additional obstacle that prevents them from re-starting lending: The lack of an adequate legal environment that ensures a reasonable expected return on investment.

- World Bank’s Doing Business: 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, 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 comes as no surprise that relationship lending was so attractive for banks.

Conclusion 5: The lack of creditor rights is a major obstacle to restart bank lending in the current environment.
4. The restructuring of the banking system

Dimensions: Starting in spring 2014, massive overhaul of banking system started by NBU

- As of 1/2016, only 117 active banks out of 182 registered
- 63 banks resolved over 2014/15 (=28% of bank loans in early 2014)
- Process still underway

Rationale: Increase transparency with respect to ownership structure

- Until recently, often undisclosed; related-party lending hidden from supervisor

Negative impact:

- Difficult to assess risks for depositors, ultimately for taxpayers (via DGF)
- Impedes proper portfolio diversification in banks and a competitive landscape in the real sector
The restructuring of the banking system (cont’d)

Impact:

- The closure of banks affects bank lending to some extent, as (proper) clients will find it difficult to establish new lending relationships under current conditions.

- But such short-term costs are outweighed by medium-term benefits. 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.

- 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

Policy recommendations in four different areas:

a) Bank recapitalization and restructuring

b) Resolution of NPLs and corporate insolvencies

c) Unwinding of related party loans

d) Improving bank supervision and regulation

In addition: Continue macroeconomic stabilisation and confidence-building efforts
a. Bank recapitalization and restructuring

- The recapitalisation efforts already mentioned are important, but not sufficient to return the banking system towards an reasonable capital adequacy ratio in the medium term.

- The Top-20 banks in the country have recently finalized a new wave of stress tests (results not publicly available), which require further substantial capital injections in the majority of institutions. Smaller groups of banks will follow with similar exercises at a later stage.

- Important to drive this process forward and specify detailed and credible recapitalization plans until 2018 (all banks are required to meet the standard CAR) for the different groups of banks.
  - Depending on the size of the bank, this ratio will be achieved by gradually injecting / converting / building capital over time.
b. Resolution of NPLs and corporate insolvencies

- Resolving non-performing loans (NPLs) that block new lending is a key priority. Different dimensions need to be addressed:
  - (a) the removal of impediments in the tax system that block debt restructuring and 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, and other legal acts are necessary and need to be worked out among the different stakeholders and approved by Parliament

- Important to avoid measures that inhibit banks’ return to healthy balance sheets. The positive effects of loan write-offs for economic growth need to be balanced against their detrimental effect on banks’ balance sheets
  - The problem of FX retail loans, especially in the mortgage segment, must be approached in a voluntary and targeted restructuring manner. We support draft legislation that has been worked out between the most affected banks under the supervision of the NBU
  - Corporate debt restructuring can 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.
c. Unwinding of related party loans

- Regulatory policies that force banks to **unwind related-party lending** need to be completed
  - After a thorough review by the NBU, banks need to present 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 Q1/2016

- The independent **Related Parties Monitoring Office (RPMO)** that started in the summer of 2015 is an important institution in this regard
  - 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 urgent and needs to be completed quickly.
  - At the same time, 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.**
d. Improving bank supervision and regulation

- Banks’ ownership structures must be made transparent as soon as possible, preferably in early 2016
  - Necessary condition for supervisors to be able to easily identify potential related-party issues and to prosecute illegal activities by banks
- But not sufficient, because transparency with respect to borrowers’ ownership structures is 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 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**
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Annex

Lending standards for household loans

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<tbody>
<tr>
<td></td>
<td>Q4</td>
<td>Q1</td>
<td>Q2</td>
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<tr>
<td>Mortgage loans</td>
<td>-0.8</td>
<td>39.2</td>
<td>22.4</td>
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<tr>
<td>Consumer loans</td>
<td>-4.9</td>
<td>53.3</td>
<td>30.3</td>
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</tbody>
</table>

Source: NBU lending survey

Note: In the table, 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. Latest 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.
# Lending standards for corporate loans

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<tr>
<td></td>
<td>Q4</td>
<td>Q1</td>
<td>Q2</td>
</tr>
<tr>
<td>Total</td>
<td>11.3</td>
<td>50.0</td>
<td>56.0</td>
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<tr>
<td>Loans to small and medium-sized</td>
<td>0.8</td>
<td>48.2</td>
<td>55.5</td>
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<td>enterprises</td>
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<tr>
<td>Loans to large enterprises</td>
<td>13.2</td>
<td>39.2</td>
<td>30.2</td>
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<tr>
<td>Short-term loans</td>
<td>4.6</td>
<td>45.3</td>
<td>33.5</td>
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<tr>
<td>Long-term loans</td>
<td>18.1</td>
<td>51.8</td>
<td>41.2</td>
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<tr>
<td>Loans in domestic currency</td>
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<td>43.7</td>
<td>37.9</td>
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<tr>
<td>Loans in foreign currency</td>
<td>17.0</td>
<td>52.8</td>
<td>47.0</td>
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</table>

*Source: NBU lending survey*