

Ukraine's banking sector: still very weak, but some signs of improvement

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Ukraine has been undergoing a reform process, and the banking sector is certainly among the areas that have seen remarkable progress. The authorities started to tackle related-party lending (a long-standing structural impediment), resolved many undercapitalized banks and managed to restore a degree of confidence in the sector, as witnessed by the stabilization of deposits. As part of the banking sector clean-up, the country's largest credit institution was nationalized. This step contributed to considerable changes in the ownership structure, with the share of the state in total assets rising to about 50%. After the severe recession of 2014–2015, macroeconomic stabilization achieved with international support in 2016, if sustained, could pave the way for a resumption of lending. Yet, nonperforming loans (NPLs) have skyrocketed, credit risk is still very high, related-party lending is still a problem, resistance to reform remains stubborn, and economic recovery fragile, subject to political uncertainty. Further sound economic policies, progress with structural reforms (in particular with regard to the rule of law and corruption) and efforts to reduce NPLs appear essential to make a sustained banking recovery possible.

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In this article, we provide an analysis of the current situation in the Ukrainian banking sector against the backdrop of macroeconomic developments. We discuss the main features of the banking sector, major risks facing the sector and its future prospects. The paper is structured as follows: Section 1 gives a brief overview of the political, geopolitical and macroeconomic environment, followed by a detailed account of banking sector developments in section 2. Section 3 assesses current banking sector risks and shock-absorbing factors, and gives an outlook.

1 Political, geopolitical and macroeconomic environment

The military conflict in parts of eastern Ukraine (notably in the oblasts of Donetsk and Lugansk) that started in 2014 hit the economy through direct and indirect channels, such as a loss of industrial export capacity and confi-

dence effects, respectively, but economic activity began to recover in 2016. The political and geopolitical environment has remained shaky, however.

1.1 Political and geopolitical environment

The intensity of the military conflict has declined since a conflict settlement package was agreed in Minsk in February 2015. However, the OSCE special monitoring mission has frequently reported ceasefire violations along the contact line. In fact, hardly any progress has been made in implementing the Minsk agreement, which envisaged a complete ceasefire, the withdrawal of heavy weapons and further steps to settle the conflict. Political and other preconditions that would provide for a reintegration of the nongovernment-controlled areas into Ukrainian state structures have not been met. The

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trade embargo imposed by the Ukrainian government vis-à-vis the nongovernment-controlled areas and other largely interrelated events (blockage of rail lines by nationalists, seizure of Ukrainian assets by separatists, Russia's decision to recognize identity cards issued in separatist areas, physical attacks on Russian state-owned banks in Ukraine) rather pointed to lingering high tensions in 2017.

1.2 Macroeconomic background

A severe recession started in 2014 (GDP contraction of 6.6%) and deepened in 2015 (GDP contraction of 9.8%). The Ukrainian hryvnia depreciated sharply until the first quarter of 2015, but depreciation pressures lessened afterwards. The weakening of the hryvnia and administered price hikes drove inflation up to 61% in April 2015. Ukraine, moreover, had to correct large fiscal and quasi-fiscal imbalances under these very difficult circumstances.

Nevertheless, the Ukrainian authorities managed to stabilize the economy in tandem with international support efforts. The economy modestly recovered in 2016, when GDP rose by 2.3% supported by a bumper harvest.

The budget deficit amounted to only 2.3% of GDP in 2016 and thus was below the target of 3.7% agreed with the IMF under the Extended Fund Facility (EFF) arrangement. Disinflationary trends allowed the National Bank of Ukraine (NBU) to lower its key policy rate gradually from 30% in March 2015 to 13% in April 2017. However, inflation remains in double digits (end-April 2017: 12.2% year on year). The current account was almost in balance in 2015, but showed a deficit of 4.1% of GDP in 2016.

Notwithstanding delays in finishing the reviews, the EFF has remained on track, providing an important policy anchor. In April 2017, the IMF Executive Board completed the third review, enabling the disbursement of about USD 1 billion. Rebuilding foreign currency reserves (USD 17.2 billion at end-April) remains critical in light of the still high gross external debt stock (USD 113 billion at end-2016). Under the EFF, Ukraine achieved reform progress in various areas (notably in the banking and energy sectors and with regard to fighting corruption), but the momentum slowed down over time, leaving some reforms incomplete and

Table 1

Ukraine: main macroeconomic indicators

	2014	2015	2016
GDP growth (in real terms, %)	-6.6	-9.8	2.3
CPI inflation (end of period, %)	12.1	48.5	14.9
General government budget balance (% of GDP)	-4.5	-2.2	-2.3
Overall balance of public sector ¹ (% of GDP)	-10.0	-2.2	-2.3
General government debt (% of GDP)	69.4	79.1	81.0
Current account balance (% of GDP)	-3.5	-0.2	-4.1
Foreign direct investment (net, % of GDP)	-0.3	-3.3	-3.5
Official reserve assets (USD billion)	6.2	12.2	14.7
Gross external debt (% of GDP)	103.6	134	127.6
UAH/USD exchange rate (annual average)	12.0	22.0	25.5
UAH/EUR exchange rate (annual average)	15.9	24.4	28.3

Source: National Bank of Ukraine, State Statistics Service of Ukraine, IMF, wiw.

¹ Including the operational deficit of Naftogaz Ukraine.

others still largely untouched (pension, land, state-owned enterprises, privatizations). In the current program review, the IMF focuses on these areas and calls for further steps and concrete anticorruption results.

2 Banking sector development (2015–2017): deep contraction and incisive reforms

The Ukrainian banking sector has experienced a deep crisis (shrinking lending and deposit-taking, sharply rising proportion of bad loans and recapitalization needs), which triggered some important reform efforts (see below). The Ukrainian banking sector has traditionally been characterized by a big number of “pocket banks” or “agent banks,” i.e. banking outfits that actually function as extended financial departments for oligarchic owners or their firms. Accordingly, pocket banks frequently engage in connected or related-party lending and in some cases even in pyramid schemes (Buckley and Olearchyk, 2017).

In recent years, the NBU has been resolutely addressing this deep-seated structural flaw by cleaning the sector of many, typically smaller or medium-sized, problem banks unable or unwilling to recapitalize themselves. Most recently, this issue came to a head with respect to the country's largest commercial bank (see box 1). Overall, one may subdivide the partly dramatic shrinking and reform process that Ukraine's banks have been experiencing since 2014 into a period of severe crisis (essentially 2015), followed by a slowdown of deterioration tendencies, coupled with some elements of improvement.

2.1 Severe crisis (2015)

The severe and deepening recession as well as the additional sharp depreciation of the hryvnia and the resulting acceleration of inflation contributed to a continuing outflow of deposits, which contracted by 39% (in real terms and exchange rate-adjusted) in 2015. This happened despite exchange controls and administrative restrictions on deposit withdrawals introduced the previous year. Lending to the private sector shrank by 46% in 2015 (in real terms and exchange rate-adjusted), and lending to households even by 54%. The credit crunch primarily reflects the deterioration of credit quality rather than reduced liquidity: NPL ratios virtually doubled in the course of 2015, soaring to 28% in a narrow definition and to 46% in a broad definition.² Loan-loss provisions expanded too, but remained in a range of about half to two-thirds of the rising NPL levels. With the credit crunch outstripping the deposit crunch, the loan-to-deposit ratio declined from 151% at end-2014 to 138% a year later. Profitability was deeply negative in 2015 (ROE: –71%).

Given banks' extremely difficult situation, regulatory forbearance was introduced and banks were given until the end of 2018 to complete recapitalization, step by step. At the same time, the NBU, under the EFF, committed to a substantial restructuring of the sector, informed by diagnostic studies carried out in two waves (until mid-2015) on the 20 largest credit institutions (accounting for four-fifths of total sector assets). In this context, the NBU agreed recapitalization needs and measures to unwind related-party exposure as well as deadlines with individual

² Nonperforming loans narrowly defined correspond to the NBU's definition of NPLs as loans in the doubtful and loss categories. NPLs broadly defined and calculated by the IMF also include substandard loans (for more information see table 1).

banks. Where agreements could not be reached or were later breached, or where other important regulations (e.g. money laundering) were violated, the respective banks saw their licenses repealed.

This courageous, if risky, intervention contributed to cutting the number of banks active in Ukraine in 2015 by about one-fifth, to 117. Banking assets fell from 84% of GDP at end-2014 to 75% a year later. The intervention of course also had a negative statistical impact on banking activity (deposit-taking and lending). Domestic privately owned banks were particularly strongly squeezed; their share in total sector assets shrank by 10 percentage points, to 37%. While the majority of deposi-

tors in failed banks were reimbursed out of the restructured and recapitalized deposit insurance fund, no prosecutions were brought against bank owners and very little of the UAH 335 billion (USD 14.0 billion) of defaulted assets (as of end-2015) was recovered (Fitzgeorge-Parker, 2016, p. 38). Credit exposure to related parties was first officially measured by the NBU in mid-2015 and came to 31% at the end of the year, clearly exceeding the regulatory maximum of 25%.

Recapitalization of credit institutions has often been carried out through debt-equity swaps, particularly in the case of foreign-owned banks, whose share in the sector's total assets rose by 5 percentage points to 35% in 2015.

Table 2

Ukraine: main banking sector stability indicators (2014–2017)

	End-2014	End-2015	End-2016	End-March 2017
Commercial banks (number of active credit institutions)	145	117	96	92
Foreign-owned banks' share in statutory capital (%)	32.5	42.5	51.0	..
Number of banks not complying with selected banking regulations ¹	79	54	56	..
Total banking sector assets (liabilities) (excluding NBU, % of GDP)	87.4	74.4	68.9	..
Annual growth of total assets (in real terms, %)	-10.3	-25.9	-0.9	-7.4
Claims on general government and on NBU (share in total assets, %)	11.7	14.2	21.9	23.6
Private sector deposits (as ratio to GDP, %)	42.3	35.9	34.5	..
Private sector deposits (annual growth, real terms, exchange rate-adjusted, %)	-38.4	-38.9	-6.3	-8.3
Share of foreign currency deposits in private sector deposits (%)	45.5	44.7	45.7	44.9
Lending to the private sector (as ratio to GDP, %)	64.0	49.4	43.7	..
Lending to the private sector (annual growth, real terms, exchange rate-adjusted, %)	-31.2	-45.5	-14.9	-18.3
Share of foreign currency loans in lending to the private sector (%)	46.5	56.0	49.5	47.6
Nonperforming loans (% of total loans, NBU definition) ²	19.0	28.0	30.5	..
Nonperforming loans (% of total loans, broader definition, IMF calculation) ³	32.0	46.4	49.4	55.1 ⁴
Specific narrow provisions (% of NPLs, NBU definition) ²	63.7	63.8	65.1	..
Specific broad provisions (% of NPLs, broader definition) ³	42.6	44.8	45.6	..
Ratio of large credit risk exposure to regulatory capital (%) ⁵	250.0	364.1	308.3	284.1
Credit exposure to related parties (%) ⁶	..	31.2	36.7	28.7
Current liquidity ratio (%) ⁷	79.9	80.0	102.1	115.5
Capital adequacy ratio (overall, %) ⁸	15.6	12.3	12.7	13.7
Capital adequacy ratio (tier 1, %)	11.2	8.3	9.0	9.8
Return on assets (ROA, %)	-4.0	-5.9	-12.5	0.8
Return on equity (ROE, %)	-30.2	-70.7	-122.7	7.8

Source: NBU, IMF, and authors' calculations.

¹ Refers to all banks not meeting the capital adequacy requirements for tier 1 capital, prudential regulations and/or reserve regulations.

² Until May 2017, the NBU defined NPLs as loans in the doubtful and loss categories.

³ The broader definition (used by the IMF) also includes substandard loans.

⁴ Reflecting the NBU's new NPL definition (applicable from May 2017, more in line with internationally accepted standards): loans that are more than 90 days past due as well as loans with a low probability of repayment.

⁵ Regulatory maximum: 800%.

⁶ Regulatory maximum: 25%.

⁷ Regulatory minimum: 40%.

⁸ Regulatory minimum: 10%.

This development followed the withdrawal of numerous foreign-owned banks (including all but one majority-owned Austrian bank) from 2009 to 2014 (see Barisitz and Fungačova, 2015). The decline of BIS reporting banks' exposure vis-à-vis Ukraine started to decelerate somewhat from 2015. The asset share of state-owned banks rose from 22% to 28%. Other recapitalization efforts pertained to substantially enhancing loan collateral, and transferring assets to banks' balance sheets to settle loans (IMF, 2016, p. 17). Thus, while capital adequacy fell from 15.6% at end-2014 to 7.1% at end-September 2015, it recovered partly to 12.3% at end-2015.

2.2 IMF-supported fragile stabilization (from 2016)

Successful if fragile macrostabilization helped banks counter contractionary pressures and partly stabilize their financial situation, even if negative profitability has persisted until most recently. The erosion of private sector deposits appears to have come to a standstill in the second half of 2016 and their GDP ratio appears to have stabilized at about 35%, even if private sector deposits still contracted by 8% (in real terms and exchange rate-adjusted) in the year to end-March 2017. The foreign currency share of household deposits remains very high (51%) at end-March 2017. Lending to the private sector continued to shrink (with lending to households still shrinking more than lending to enterprises), but the

contraction rate slowed to 18% (end-March 2017).³

Whereas liquidity indicators have recovered, the further slight deterioration of already dismal credit quality (with the narrow NPL ratio increasing to 31% and the broader ratio swelling to 49% at end-2016) may lie at the roots of the persisting weakness of lending.⁴ Yet, notwithstanding the diagnostic exercises, not all problematic debt may have been fully recognized (NBU, 2016, p. 19; S&P Ratings-Direct, 2017, p. 9). In any case, Ukraine's new law on financial restructuring, drafted with the help of both the EBRD and the World Bank, and effective from October 2016, aims at facilitating voluntary out-of-court debt restructuring in order to help reduce NPLs and support the financial sector (Usov, 2017).

Although economic activity gained momentum in the final quarter of 2016 and continued to expand in the first months of 2017, banks did not appreciably step up lending in late 2016 and early 2017, but instead invested more heavily in government and central bank instruments (mostly by purchasing state bonds and NBU certificates of deposit), benefiting from attractive interest rates.⁵ As a result, the share of such instruments in banks' total assets almost doubled from late 2015 to end-March 2017 to around one-quarter – which corresponds to about 40% of total lending.⁶ Weak rule of law and creditor rights contributed to holding back lending. The share of foreign cur-

³ The category of loans from state-owned banks (SOBs) to state-owned enterprises (SOEs) reportedly revived in the second half of 2016.

⁴ Apart from the challenging economic situation, the high level of NPLs also reflects banks' inability to foreclose on assets and lack of incentives to restructure bad loans (IMF, 2017, p. 19).

⁵ The increase of banks' government bond purchases was partly related to Privatbank's nationalization in December 2016 (see also box 1).

⁶ This rise also reflected the placement of government bonds into Privatbank's portfolio (NBU, 2017a, p. 1, see also below).

rency loans declined somewhat in recent months, but remained at almost half of total lending. Despite a long-standing ban on such lending to households, the share of foreign currency-denominated retail loans only declined very slowly and was still 50% at end-March 2017.⁷ The above-mentioned tentative recovery of depositor confidence, coupled with not yet surmounted obstacles for lending, contributed to the further decline of the loan-to-deposit ratio to 123% at end-March 2017.

The NBU's activities to clean up the banking sector led to the closure of another 25 banks in 2016 and further

cuts, to 92 banks, in the first quarter of 2017, and most notably, to the nationalization of Privatbank, the country's ailing largest commercial bank (see box 1). Other banks from the group of the 20 largest banks had reportedly brought their capital adequacy ratios to at least 5% of risk-weighted assets, while Privatbank had failed to do so. The diagnostic studies first carried out on the top 20 banks were repeated at the next 20 credit institutions (ranked by assets). These banks have since had to reach a 5% capital adequacy ratio by end-May 2017. Banks' overall credit exposure to related parties stood at 29% at end-April 2017.

Box 1

Banking sector clean-up culminates in nationalization of Privatbank

In December 2016, the Ukrainian authorities decided to nationalize and recapitalize (by issuing sovereign bonds) the country's biggest bank (Privatbank) in light of its systemic role in Ukraine's financial system after it had repeatedly failed to meet capital requirements. The authorities acted in accordance with the national household deposit insurance legislation,¹ which serves as the legal basis for Ukraine's bank resolution framework. The nationalization of the bank, that was majority-privately owned by oligarchs and accounted for more than a fifth of total banking assets, was a required prior action under the EFF. The capital shortfall was estimated at EUR 5.4 billion (6.5% of GDP) at the time of nationalization and mainly stemmed from provisioning needs for related-party loans. According to the NBU, the corporate loan book almost entirely consisted of loans to related parties. This means that Privatbank simply constituted a huge "pocket bank" that accumulated deposits from Ukrainian households and passed most of the money on to companies related to the owners of the institution.

Yet, the liabilities of the bank also included international bonds and debt to related parties, corresponding to about EUR 1 billion (1.2% of GDP). When the bank was nationalized, these funds were bailed in, thus lowering the recapitalization costs for the state. Preliminary results from the post-nationalization audit have since revealed additional recapitalization costs of an amount similar to the bailed-in liabilities. Moreover, the NBU governor accused the former management of having committed fraudulent transactions exceeding EUR 0.5 billion shortly before the nationalization.

To minimize the costs for taxpayers, efforts to collect on related-party loans need to follow. In this regard, IMF conditionality envisages the involvement of an international asset management firm and another reputable audit firm in the process.

¹ http://www.fg.gov.ua/images/docs/law/new/_DGF_Law_Eng_Updated_2015.pdf

⁷ *Although one could argue that in this way there is no meaningful currency mismatch between deposits and loans, households' high exposure to foreign currency-denominated loans may give rise to particular concern, since many private individuals do not have foreign exchange earnings and thus are unhedged borrowers.*

The takeover of Privatbank pushed the state's share up to about half of total sector assets. The asset share of foreign-owned banks stayed at about 35%, while the share of remaining domestic privately owned banks dwindled to 15%.⁸ Meanwhile, the withdrawal of state-owned Russian banks (including Sberbank and VTB, accounting for about 9% of the Ukrainian market) appears likely to accelerate, following physical attacks on branches and restrictions imposed by the authorities prohibiting financial transactions between subsidiaries and their parent banks.⁹ All five Russian banks have put up their Ukrainian subsidiaries for sale or are in the process of divesting them (S&P RatingsDirect, 2017, p. 12; Die Presse, 2017).

After two years of hefty losses, negative ROE declined in the course of 2016, before swelling again in the final quarter, due to spiking provisions at Privatbank. Yet the first quarter of 2017 finally witnessed some (modest) profitability (ROE: 8%), reflecting improved results from trade operations and reduced provisioning costs. Meanwhile, sector capital adequacy stabilized at around 13% to 14%.

3 Risk assessment and outlook

3.1 Assessment of current banking sector risks and shock-absorbing factors

Credit risk

Credit risk remains the worst problem for the sector, with the NPL ratio (still) at record levels of 31% (narrow definition) and 49% (broad definition) at end-2016. Following a change in methodology – with the new framework capturing loans that are more than 90

days past due as well as loans with a low probability of repayment (NBU, 2017b) – the NPL ratio stood at 55% at the end of March 2017 (57% at the end of April). The NBU considers these figures to reflect the actual quality of banks' assets. Given lackluster recovery prospects (at least in the short term), credit risk is likely to remain high, and may recede only slowly.

– Connected lending risk

Despite efforts made in recent years to diminish the influence of oligarchs, there is a risk that the further unwinding of related-party loans does not proceed quickly enough, given some lingering transparency and corruption problems. Court rulings, as described in a recent NBU press release (NBU, 2017c), allowing i.a. banks to resume operations (thereby overturning NBU decisions to resolve failed banks) may contribute to this risk. However, this kind of risk is somewhat mitigated by the fact that current legislation does not provide for a mechanism for restoring bank's activity, including through court decisions. At the same time, there may be an increasing risk of directed lending within the expanded sector of state-owned banks.

– Exchange rate risk and other challenges

While exchange rate risk does not appear to be imminent, a further deterioration of Ukraine's twin deficits (current account and budget), possible heightened uncertainties connected to IMF support, populist policies, and a flare-up of tensions in the east could all contribute to weakening the hryvnia, stoke inflation, put renewed pressure

⁸ A sizeable part of FDI inflows to Ukraine continues to constitute bank recapitalization flows.

⁹ In 2015–2016, Ukrainian subsidiaries of Russian banks had received partly substantial recapitalization means from their parent institutions (Deuber and Schwabe, 2016, p. 6).

on unhedged borrowers, and delay the recovery of the sector. Other challenges include continued weak rule of law, feeble corporate governance (linked to the lack of successful flagship privatizations), and (as mentioned above) ingrained corruption.

– Shock-absorbing factors

While capital adequacy has improved from crisis levels, banking sector liquidity is satisfactory and monetary reserve assets have recovered from very modest previous levels, the fragile situation of the banking sector (with respect to credit quality and profitability), Ukraine's weak external position (with respect to the current account and foreign debt) and the legacy of Privatbank's sizeable related-party loan portfolio all imply that continued IMF support and international financial commitment ultimately remain the most important shock-absorbing factors for the country's financial sector.

3.2 Outlook

At least in the short term, sluggish banking recovery tendencies, mixed with considerable uncertainty, are likely to persist. The authorities' most recent decision to block trade with rebel areas (from March 2017) is likely to dampen the country's fledgling economic recovery by over 1 percentage point of GDP in 2017 (according to NBU assessments) and may act as a further drag thereafter.

How fast and how successfully the privatization of the recently nationalized Privatbank and the three other large state-owned Ukrainian banks (Oschadbank, Ukeximbank and Ukrgazbank) can proceed in the medium term, will depend on the overall eco-

nomic and political development of Ukraine. The smoother the transition toward a transparent and modern economy is, and the more geopolitical tensions recede, the higher the interest of investors will be. Yet, reforms and reformers have also met stubborn resistance from the oligarchic system and intransparent structures. A recent sign of strong pressures against reformers was the resignation of the NBU governor in April 2017, whom the IMF praised for progress made in cleaning up the banking system, but who apparently did not enjoy sufficient political support to carry on.

If the build-up of foreign currency reserves does not proceed well due to further delays in the IMF program, financial risks will increase as the election year 2019 approaches. With presidential and parliamentary elections coming up in 2019, getting reforms through parliament will get increasingly difficult. On top of this, sovereign external debt repayments will spike in 2019, which together with an overall fragile environment could precipitate pressures on the balance of payments.

Overall, the current outlook for the Ukrainian banking sector is for a slow and hesitant recovery, not excluding temporary setbacks – given past reforms and the great further potential for catching up, helped by probably continuing (if not necessarily uninterrupted) IMF assistance; yet tempered by a daunting level of NPLs waiting to be treated, lingering (risks from) related-party lending, the sustained fragility of the macroeconomic environment, persisting structural bottlenecks to reforms, and unresolved security issues in the east affecting the investment climate.

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