

Ukraine: struggling banking sector amid substantial uncertainty¹

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The situation of banks in Ukraine is exceptionally challenging for a number of reasons. First of all, banks had not managed to recover from the 2008–09 crisis before being hit again in 2014. Hence, the deep Ukrainian recession and the hryvnia's plunge – together with strong exposure to geopolitical tensions – tipped the banking sector again deeply into the red. Amid an environment of persistent uncertainty, many foreign-owned banks have left the country. In addition to chronic structural shortcomings, such as weak rule of law, excessively high corruption, opaque ownership structures and connected lending, the most significant problems currently plaguing the sector include high and growing credit risk and high exchange rate risk. The country faces a dramatic credit crunch and even more alarming deposit outflows. Financial intermediation has practically collapsed, with the number of insolvent banks rising quickly. The major shock-absorbing factor is the IMF's and the international community's commitment to financially assist Ukraine.

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In this article, we provide an analysis of the current situation in the Ukrainian banking sector by taking into account macroeconomic developments. We discuss the main features of the banking sector, major risks it is facing and its future prospects. The investigation relies on both aggregate banking sector data as well as individual bank data. Section 1 provides a succinct overview of the current domestic political, geopolitical and macroeconomic environment – marked by high instability, vulnerability and weakness – in which credit institutions in Ukraine operate. Section 2 describes banking developments following the crisis of 2008–09, with the emphasis on recent events,

notably developments in 2014 and early 2015. We focus also on structural changes in ownership and the evolution of market shares by bank ownership. In section 3, we draw on previous findings to identify challenges currently facing the Ukrainian banking sector and assess some shock-absorbing factors. Giving an outlook, section 4 concludes the article.

1 Political, geopolitical and macroeconomic environment

Having a minimum degree of familiarity with the extraordinarily challenging political and macroeconomic framework conditions banks operate in appears essential in the case of Ukraine.

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1.1 Political and geopolitical conditions

In recent years, Ukraine has repeatedly witnessed tendencies toward political polarization and instability. Society has been dominated by politically powerful domestic businessmen (oligarchs) and financial-industrial groups, and society has featured a very high level of corruption and capture of public institutions.³ Over time, the country and its business groups seem to have fallen increasingly into the crosshairs of geopolitical competition pitting the EU/the West against Russia. The ouster of Ukraine's former President Yanukovich in February 2014 by the strongly pro-EU and pro-Western Euro-Maidan popular movement was followed by Russia's annexation of Crimea and by the outbreak of armed insurgency in the Donbass region of eastern Ukraine, supported by Russia. The receipt of IMF and international financial assistance, the presidential elections of May 2014 and President Poroshenko's subsequent assumption of office had (temporarily) stabilized the situation. Yet, the intensification of the armed conflict in the summer 2014 as well as internal political squabbles destabilized the situation again. The parliamentary elections in October 2014 gave the new government a strong mandate to carry out reforms, but the overall problematic geopolitical situation remains unchanged.⁴

The fact that – despite the strong deployment of the Ukrainian military – the Donbass rebellion has not been quashed and the standoff continues

points to a possibly lasting burden for the Ukrainian economy going forward. The loss of central control of important parts of the Donbass region and the uncertainty created by this conflict, which may or may not turn into a “frozen” one, are depriving the central authorities of tax revenues and are forcing them to spend additional resources on the military. At the same time, Kiev has stopped paying civil service salaries and pensions to rebel-held territories (see box 1 below). More generally, economic integration between parts of the Donbass region and the rest of Ukraine has weakened and is exacting high costs on both sides. Continuous uncertainty triggered by the conflict has contributed to recurrent tensions on the foreign exchange market.

1.2 Macroeconomic environment

Following strong GDP growth in the pre-2008–09 crisis years, Ukraine's economy plummeted in 2009. The economic slump (–15%) was among the deepest of CESEE countries. The recovery was first export led, helped by commodity prices bouncing back and export demand.⁵ In order to bolster confidence, the National Bank of Ukraine (NBU) opted for a de facto peg of the hryvnia at its post-crisis devalued level to the U.S. dollar. Domestic demand, particularly private consumption, soon took over and contributed to a renewed widening of the country's external imbalances. While GDP growth recovered to 4.1% in 2010 and 5.2% in 2011 (see table 1), the cur-

³ For more information on the political economy background of the Ukrainian crisis, see Vercueil (2014).

⁴ The ceasefire agreement of Minsk of September 2014 temporarily reduced the intensity of warfare, but hostilities flared up again in January and February 2015 and pro-Russian separatists gained some ground. Hopes are now pinned on the new ceasefire agreement of Minsk II of mid-February 2015, which has at least in the short term eased the situation again.

⁵ However, Ukraine is not only an important exporter (steel, chemicals, cereals and other farming products, mostly to Western countries), but also an importer (natural gas and oil, mostly from Russia) of raw materials and commodities. Therefore, the effect of commodity price rises can be ambiguous for Ukraine.

rent account deficit grew fourfold to over 6% of GDP, and was no longer covered by FDI inflows. Portfolio inflows and the partial drawdown of reserve assets contributed to covering the difference. Gross external debt that had climbed to over 80% of GDP in 2009, remained approximately at this level.⁶

In late 2011 and in 2012, prices of and external demand for the country's staples decelerated again and Ukrainian economic growth evaporated. Moreover, despite a substantial decline of inflation from high levels (end-2009: 12%, 2012: 0%), the upholding of the U.S. dollar peg against the backdrop of high real wage growth and slow productivity rises eventually led to hryvnia overvaluation. GDP stagnated in 2012 and 2013. Private consumption slowed down but continued to drive domestic demand, while investment contracted. Bank lending turned from a lagging factor in 2012 to a driving force of economic activity in 2013 and may have played a role in preventing a recession that year. However, the current account gap further swelled to over 9% of GDP in 2013, exceeding remaining FDI inflows fivefold. In contrast, portfolio inflows increased sharply (they doubled to 5% of GDP); there was also a small net inflow of bank credits (about 1% of GDP). At the same time, reserve assets continued to shrink. The widening budget gap contributed to the macroeconomic deterioration: the general government deficit mounted to almost 5% of GDP in 2013.⁷ The NBU continued to defend the exchange rate through a tightening of monetary policy, ad-

ministrative measures, and currency market interventions. The latter over time drew down international reserves, which shrank to USD 20.4 billion or 2.4 import months of goods and services at end-2013 (chart 1).

The impossibility to sustain the disequilibrium⁸ eventually triggered the NBU's decision in early February 2014 to give up the peg and float the exchange rate. This happened against the backdrop of extensive political unrest in Kiev in connection with the refusal of President Yanukovich to sign the Deep and Comprehensive Free Trade Arrangement (DCFTA) with the EU, which together with frustration about rampant corruption resulted in the president's overthrow in February 2014. In the following weeks, the hryvnia depreciated almost 50% against the U.S. dollar until the exchange rate re-stabilized somewhat in April–May 2014. This stabilization followed the monetary authority's increase of its key interest rate by three percentage points to 9½%, NBU administrative interventions as well as the Ukrainian interim government's signing of a new IMF Stand-By Arrangement for the country in late April. This arrangement comprised a loan package of USD 17.1 billion (to be disbursed in a two-year period), which also opened the door to EU, World Bank and other international assistance. The total international package of 2014 therefore envisaged a volume of USD 27 billion. The arrangement with the IMF allowed Ukraine to immediately draw USD 3.2 billion.

⁶ *Meanwhile, bank lending, far from being a driver of the recovery, contracted or grew very weakly in these years (see also below).*

⁷ *If one includes the operational deficit of the state gas company Naftogaz of Ukraine, the total fiscal shortfall attained almost 7% of GDP in 2013.*

⁸ *International reserves fell by another USD 5 billion over the following two months so that the level reached in February 2014 equaled less than two months of goods and services imports.*

However, severe tensions with Russia caused new uncertainty. The geopolitical conflict contributed to a collapse of capital formation (–29% in 2014), which ushered in a new deep recession. In June, Gazprom suspended gas exports to Ukraine due to accumulated payment arrears and price disputes. FDI net inflows dwindled to a very low level in 2014 and capital flight gathered momentum, contributing to a further slide of the hryvnia. Domestic bank credit growth slowed down sharply and turned negative when accounting for exchange rate fluctuations. Real wage and pension freezes, a public service hiring freeze and hefty retail gas price increases carried out in the framework of the IMF program⁹ triggered a turnaround and contraction of private consumption from the second quarter of 2014. Industrial production fell by 10.7% and GDP shrank by 6.8% in 2014. Only agricultural production, which suffered relatively less from the hostilities in the east, grew in 2014 (by 2.9%). The contraction of economic activity accelerated to 17.6% (year on year) in the first quarter 2015.

One of the reasons why this new recession is so deep is that – notwithstanding the incisive depreciation – the Ukrainian trade adjustment has (so far) only occurred through a cutback in imports, while exports have not recovered but instead further declined (although less so than imports). This, in turn, is largely attributable to supply-side constraints linked to the para-

lyzation of the Donbass' highly export-oriented regional economy.¹⁰ The military hostilities, ensuing damages to the infrastructure and regional productive capacities, and the imposition of some (reciprocal) Ukrainian-Russian trade bans have impaired production and exports. Chemicals, metals and machinery shipments have suffered particularly. Autonomous trade preferences granted Ukraine by the EU in connection with the DCFTA have recently enabled increasing deliveries of food products, steel and some other goods to Europe, but generally the positive economic impact of the agreement can only show up over time. Due to the hryvnia's depreciation and the recession, the current account gap declined substantially, but was still at an elevated 4.0% of GDP in 2014. Unemployment grew to 9.0% (ILO definition) on average in that year.¹¹ According to IMF estimates, the general government budget balance slightly declined to 4.6% of GDP,¹² the combined fiscal and quasi-fiscal deficit (including Naftogaz losses), however, expanded to over 10% of GDP in 2014.

The pass-through from the burst of depreciation and increases of administrative prices (including gas tariffs) in 2014 propelled CPI inflation from near zero in January to 12.0% at end-June 2014 (year on year). In order to better manage inflation expectations, the NBU raised its main policy rate by another 300 basis points to 12½% in mid-July. After the hryvnia had since May re-

⁹ A 50% hike of gas tariffs for households in May 2014 constituted a first structural step in bringing the country's heavily subsidized energy prices closer to market levels.

¹⁰ The Donetsk and Luhansk regions (not their entire territory is under control of pro-Russian forces) in 2012–13 together accounted for about 16% of Ukraine's GDP and for around one-quarter of the country's industrial production and exports (for more details see box 1).

¹¹ Although the ILO measure appears more adequate than the lower rate of registered unemployment, it may still underestimate real joblessness, because only people actively seeking employment (if not necessarily claiming jobless benefits) are counted, which excludes those that have given up looking for a job.

¹² This is notwithstanding the imposition of an emergency income surcharge of 1.5% to finance the military.

Table 1

Ukraine: selected macroeconomic indicators

	2009	2010	2011	2012	2013	2014	2015 (IMF forecast) ¹
GDP growth (in real terms, %)	-14.8	4.1	5.2	0.2	0.0	-6.8	-9.0
Industrial production (in real terms, %)	-21.9	11.2	7.3	-0.5	-4.3	-10.7	..
CPI inflation (end of period, %)	12.3	9.1	4.6	-0.2	0.5	24.9	46
Unemployment rate (ILO definition, average %)	8.8	8.1	7.9	7.5	7.2	9.0	11.0
General government balance (% of GDP)	-6.3	-5.8	-1.7	-3.5	-4.8	-4.6	-4.2
Overall balance of public sector ² (% of GDP)	-8.7	-7.4	-4.3	-6.6	-6.7	-10.3	-7.4
Current account balance (% of GDP)	-1.5	-2.2	-6.3	-8.1	-9.2	-4.0	-1.4
Net FDI flows (% of GDP)	4.0	4.2	4.3	3.8	1.8	0.3	1.4
Gross international reserves (end of period, USD billion)	26.5	34.6	31.8	24.5	20.4	7.5	18.3
in months of goods and services imports	5.7	5.7	3.9	2.8	3.3	1.5	3.3
Gross external debt (end of period, % of GDP)	85.8	83.1	80.5	71.9	72.5	102.4	158.4
Goods terms of trade (annual change, %)	-13.8	+0.3	+7.7	-3.1	-1.1	-2.8	0.4
Exchange rate UAH/USD (official, period average)	7.79	7.93	7.97	7.99	7.99	11.89	21.7
Exchange rate UAH/EUR (official, period average)	10.87	10.53	11.09	10.27	10.61	15.72	..

Source: National Bank of Ukraine, IMF, The Vienna Institute for International Economic Studies (wiiw).

¹ IMF (2015a, 2015b, 2015c).

² Including the operational deficit of Naftogaz of Ukraine.

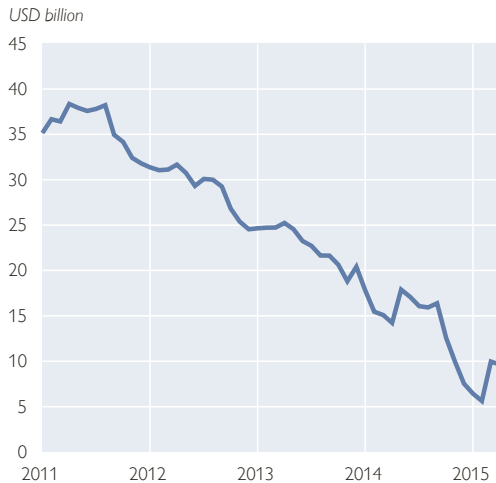
mained largely steady at its depreciated level of around UAH 11.5–12.0/USD, renewed domestic political tensions (see above) and the dragging-on of the armed confrontation in the east with apparently no prospect of ending soon triggered a further slide (of 8%–10%) of the Ukrainian currency in August 2014 to beyond UAH 13/USD (chart 1).¹³ However, as economic policies were generally implemented as agreed in the program, the country in late August received the second tranche (USD 1.4 billion) of the IMF loan, which supported international reserves. The latter came to USD 16.4 billion at end-September 2014.

Given that the NBU had only limited room for foreign exchange market interventions due to the IMF program conditioned on the flexible exchange rate policy, the monetary authority took recourse to increasingly rigid cap-

ital controls (see below). But despite the above-mentioned limitations it soon also resumed selling foreign currency to support the hryvnia. While these instruments contributed to holding the exchange rate around UAH 13/USD until late October 2014 (the time of the parliamentary elections), inflation continued to rise (largely as a result of the previous depreciation). At the same time, as mentioned above, the recession continued to deepen, the current account remained substantially in the red, confidence remained low, and capital outflows did not let up. In early November, the NBU suspended interventions again and, in mid-November, raised its key rate by 1½ percentage points to 14% – a level, however, that had already been overtaken by inflation months ago. The currency further depreciated to about UAH 15.8/USD at end-December 2014 and UAH 16.2/

¹³ As NBU Deputy Governor Rashkovan pointed out in a presentation at the wiiw Spring Seminar at end-March 2015 in Vienna (Rashkovan, 2015), the exchange rate of the hryvnia, capital flows and deposit movements tend to react very sensitively to bouts of escalation and de-escalation of warfare in eastern Ukraine.

Chart 1

Development of official foreign currency reserves and of the hryvnia exchange rate**Official foreign currency assets (incl. gold)****Exchange rate**

Source: National Bank of Ukraine, Thomson Reuters.

USD at end-January 2015. Prices were 28.5% higher at that point than twelve months before.¹⁴

Foreign currency reserves further sharply declined to USD 6.4 billion (only about 1.1 import months)¹⁵ at end-January 2015, mostly due to the renewed interventions and to debt clearance payments of USD 3.1 billion to Gazprom within the framework of an agreement reached on the temporary resumption of gas deliveries. The critically low level of foreign currency reserves, the feeble situation of the country's external accounts and the renewed flaring-up of the conflict in the east compelled the NBU in early February to (once again) stop defending the currency while, at same time, it

raised its key rate by 5.5 percentage points to 19½% (still far below inflation). As this was not sufficient to halt the slide of the hryvnia, the monetary authority further tightened currency controls (including the imposition of additional restrictions on foreign currency purchases, payments and transfers abroad)¹⁶ and in early March yanked up the rate by twice as much – to 30%. As depicted in chart 1, in the wake of some strong volatility, the exchange rate eased to around UAH 22/USD (UAH 24/EUR) in March.¹⁷

The sharp GDP contraction coupled with the substantial slide of the currency contributed to pushing the country's ratio of foreign debt to GDP to above 100%. In December 2014, the

¹⁴ These developments point to the high likelihood that the Ukrainian economy has become affected by an inflation-depreciation spiral.

¹⁵ This corresponds to international reserves' lowest absolute level in a decade.

¹⁶ Moreover, in order to cut import demand and support the hryvnia, the Ministry of Finance introduced import surcharges of 5% for industrial goods and 10% for agricultural products at end-February 2015.

¹⁷ Altogether, the hryvnia lost about three-quarters of its value against the U.S. dollar and two-thirds of its value against the euro since early 2014. The Ukrainian currency's plunge of 2014 and early 2015 was about twice as deep as that of the previous major crisis of 2008–09, when it had depreciated by about one-third.

IMF identified additional funding needs of USD 15 billion for Ukraine through April 2016 on top of the already earmarked USD 27 billion under the April 2014 international support package (Spiegel and Olearchyk, 2014). In January 2015, the Ukrainian authorities requested a new multi-year arrangement with the Fund. After Ukrainian delivery of some painful up-front measures (including a budget revision, pension cuts, and a sizeable increase of domestic energy tariffs), the IMF in mid-March replaced the Stand-By Arrangement (of which a total of USD 4.6 billion had been drawn) with a four-year Extended Fund Facility of USD 17.5 billion. A first tranche of USD 5 billion became available immediately upon the board's approval. Part of it went to replenishing the NBU's foreign currency reserves, which, after having further declined in February, recovered to USD 10.0 billion at end-March, before slightly dropping to USD 9.6 billion a month later (back to approximately their level of end-November 2014 or about 1.6 import months). The IMF program is complemented by pledges of EU macro-financial assistance (EUR 1.8 billion) and U.S. loan guarantees (USD 2.0 billion) as well as by other support. The authorities have also entered into debt restructuring negotiations with holders of Ukrainian public debt (USD 70.6 billion at end-2014) with a view to generating a haircut of USD 15.3 billion (22%) until mid-2015 – one of the IMF program's performance criteria. As of early June, an agreement with creditors has yet to be reached. The exchange rate has remained relatively stable (at the depreciated level of March),

while pass-through effects and further sharp domestic energy tariff adjustments¹⁸ contributed to fueling galloping inflation (45.8% at end-March, 60.9% at end-April).

2 Banking sector development

The structure of Ukraine's bank-based financial system differs from other CESEE countries as Ukraine's banking sector features a lower degree of concentration of business. At end-2014, 162 banks held a banking license, and the five largest credit institutions accounted for about 43% of total sector assets. The Ukrainian sector includes a big number of so-called "pocket banks" or "agent banks," i.e. credit institutions that in fact function as extended financial departments for owners or their firms (comparable to the situation in Russia). Accordingly, pocket banks often engage in connected or related-party lending (Barisitz and Gardo, 2009, p. 94)¹⁹. However, when we look at the regional perspective, concentration is visible. Banking activity is concentrated in the capital city as about half of all deposits and almost 57% of all customer credits are connected to this area. As of end-2014, the Dnipropetrovsk oblast (i.e. region) accounted for almost 9% and the Odessa region for about 5% of all deposits, followed by the Kharkiv and Lviv regions with shares of about 4% each. Around 13% of all credits were provided in the Dnipropetrovsk region, while Odessa accounted for about 4% of all credits, followed by Donetsk (3%). It is important to note that these numbers refer to the stock of credits.

¹⁸ Thus, gas tariffs for households were (further) increased in April by 2.8 times, retail electricity prices were raised by one-third.

¹⁹ A top NBU official has recently likened "oligarch banks" in Ukraine to "vacuum cleaners that suck up deposits in order to finance oligarchs' business undertakings" (Kurier, 2015).

Ukraine's banks have largely run through three phases of development since the global financial crisis of 2008–09 – phases dominated by asset growth and decline, and by credit cycles. A post-crisis restabilization of the sector (late 2009 to late 2012) was followed by a short-lived credit expansion (late 2012 to early 2014), which in turn gave way to a deep crisis-triggered contraction of banking activities (from early 2014).

2.1 Post-crisis recovery (late 2009–late 2012)

Following the extreme pre-crisis real growth of loans (in some years by about 50% annually, or by 10 to 15 percentage points of GDP per year)²⁰, lending dropped sharply in 2009 and 2010, before stabilizing in 2011 and 2012. Once the economy had rebounded, the currency had stabilized and confidence had returned, deposits started to expand dynamically. This was probably supported by the NBU's adoption of a new (depreciated) de facto U.S. dollar peg and by the decline of inflation from crisis levels, which rendered real deposit rates increasingly attractive. The share of foreign currency-denominated accounts, which had increased to almost half of total deposits in 2009, slightly receded again. Thus, while banks generally remained cautious in granting credits, the “loan overhang” – the very high loan-to-deposit ratio – was successively cut back from 216% at end-2009 to 142% at end-2012. Banks' net external liabilities sharply contracted to 4% of total liabilities in 2012. This mostly reflected the substantial shrinkage of cross-border funding,

while assets held abroad were somewhat stocked up.

However, as a legacy of the crisis, nonperforming loans (NPLs) had risen to new heights and largely remained there. Thus, according to the NBU definition, NPLs had quadrupled to about 15%–16% of total loans on average in 2011–12. IMF calculations using a broader and more internationally comparable definition arrive at a nonperforming loan share that is about twice as high.²¹ The share of foreign currency loans (predominantly U.S. dollar, see below) in total loans has traditionally been high in Ukraine. Despite the NBU's ban on foreign currency lending to unhedged borrowers imposed in late 2008, the share of foreign currency loans only came down slowly (table 2). After years of losses linked to provisions for high NPLs, modest profitability was only achieved in 2012. With overall cautious lending, banks tended to invest increasing funds in state securities (government bonds), thus stepping up their role in financing the budget deficit.

The post-crisis recapitalization of state-owned credit institutions (Ukreximbank and Oschadbank), the nationalization and rehabilitation of three troubled domestic privately-owned banks (Rodovid, Ukrgaz, and Kyiv Bank)²², and state-owned banks' (SOBs) proactive credit expansion strategies together raised SOBs' share in total banking assets to 18% at end-2012 (chart 2). Immediately after the crisis, foreign-owned banks' (FOBs) asset share started to decrease and these banks generally kept new lending quite modest. Some FOBs have tended to suffer

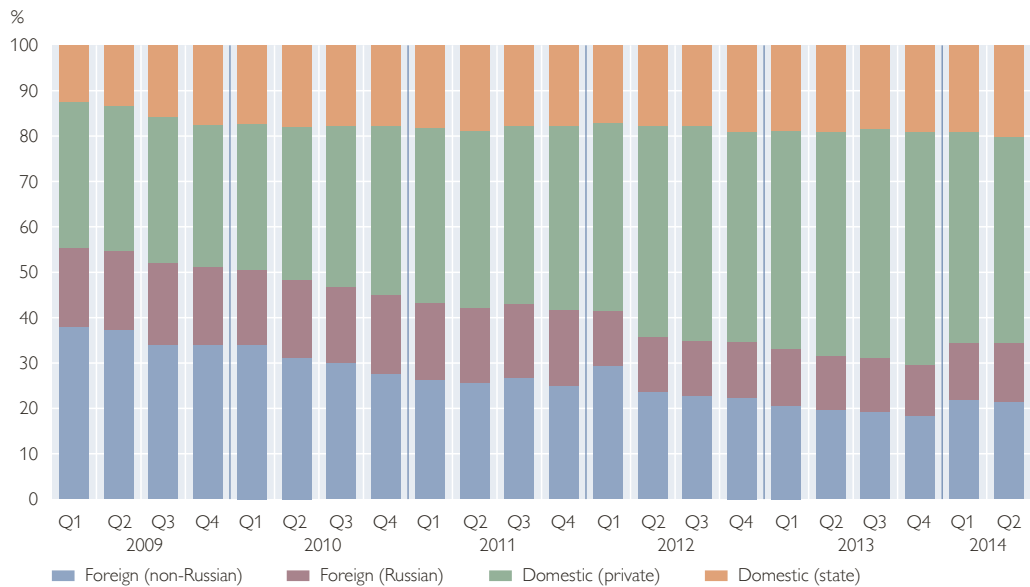
²⁰ For more information on the Ukrainian credit boom, see Barisitz and Lahnsteiner (2009, pp. 71–72).

²¹ In particular, the IMF also includes restructured loans as NPLs, which corresponds to best international practice.

²² Unfortunately, the post-crisis bank restructuring process is reported to have been messy and to have included asset stripping and misreporting (Standard&Poor's, 2011, p. 8; Barisitz and Lahnsteiner, 2012, p. 54).

Chart 2

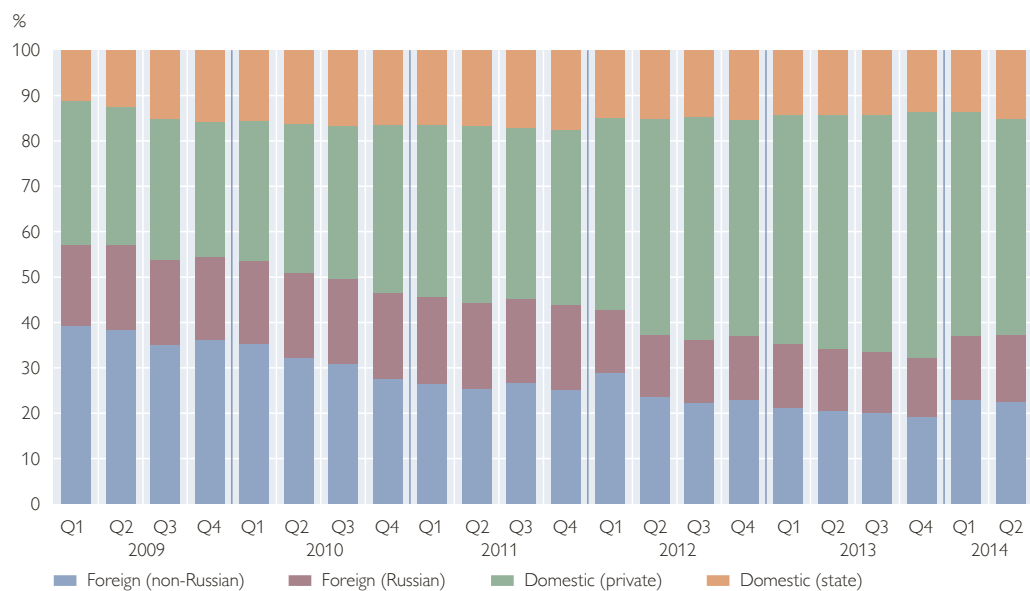
Share of banking sector assets by bank ownership



Source: Authors' calculations based on NBU data and ownership data collected from commercial banks' annual reports.

Chart 3

Share of banking sector loans by bank ownership



Source: Authors' calculations based on NBU data and ownership data collected from commercial banks' annual reports.

from a self-imposed legacy of particularly generous foreign currency lending. Re-emerging financial instability in the euro area coupled with weakening economic growth in western Eu-

rope and the strengthening of regulatory capital requirements for European banks, which were the parents of most FOB subsidiaries in Ukraine, soon contributed to deleveraging and de-risking

activities notwithstanding Ukraine's economic recovery in 2010 and 2011. Foreign-owned subsidiaries repaid parent funds and a number of FOBs exited Ukraine (table 3). In the three years until end-2012, the largest 20 FOBs in the country had lost an aggregate of more than USD 960 million (Alexander, 2014, p. 12).

Yet, in contrast to foreign-owned banks in general, Russian banks in Ukraine kept their market share largely stable. As depicted in chart 2, the asset share of FOBs – excluding Russian banks – sharply declined from almost 40% of total sector assets at end-2009 to above 20% four years later, while the share of Russian banks only decreased slightly. The same goes for lending shares (chart 3).

2.2 Temporary credit spurt (early 2013–early 2014)

Against the backdrop of Ukraine's disappointingly sluggish economic growth in 2012 and of rising political rivalry in connection with the upcoming presidential elections (originally scheduled for early 2015), and given credit institutions' improved liquidity situation, the banking sector – led by large domestic privately-owned banks – stepped up lending in 2013. Lending growth (in real terms and exchange rate-adjusted)²³ increased from 2% at end-2012 to 11% a year later, and still rose 4% by end-March 2014 (year on year). Credit expansion was led by lending to enterprises (which grew 14% by end-2013), but even retail lending growth turned positive (+3% by end-2013).

More precisely, while foreign currency lending to households remained prohibited and the respective outstanding credit volume continued to contract, hryvnia credit gathered momentum and expanded in double digits. Investments in government securities remained popular, as witnessed by the growing share of banks' net claims on the central government in their total assets (up from 6% at end-2012 to 8% in early 2014).

At the same time, foreign-owned banks continued to lend very cautiously and to deleverage. As can be seen in table 3, sales of subsidiaries and exits from the country went on. FOBs' (excluding Russian banks) share in total banking assets fell further to 17% at end-2013, while Russian banks' market share remained more or less stable at about 11%. Domestic privately-owned banks' asset share increased to 50%, which reflected their aggressive growth strategies and some takeovers of former FOB subsidiaries. Many of these domestic private banks are directly connected to politically influential tycoons and financial-industrial groups (Fungáčová and Korhonen, 2014, pp. 7, 10).

Largely because of the acceleration of lending, the NPL ratio (according to the national as well as the IMF definition) decreased slightly, but remained elevated. At the same time, the provision coverage of nonperforming loans fell slightly (from 65% to 62%). Strikingly, the ratio of large exposures to capital markedly expanded to reach 259% at end-March 2014, possibly indicating related-party lending as a driving force of the credit spurt.

²³ In order to simplify calculations, exchange-rate adjustment is here confined to using the U.S. dollar exchange rate as a proxy for all relevant foreign currency exchange rates to the hryvnia. We are aware that this implies an element of imprecision, but we feel that results are still approximate enough, given that the U.S. dollar, e.g. at end-2013, accounted for 86% of foreign currency-denominated loans to enterprises and for 82% of foreign currency-denominated deposits of households in Ukraine. In comparison, the only other two currencies worth mentioning, the euro and the Russian ruble, accounted for 13% and 1.4%, respectively, of foreign currency-denominated loans to enterprises, and for 17% and 0.5%, respectively, of foreign currency-denominated deposits of households.

Table 2

Ukraine: main banking sector stability indicators

	End-2009	End-2010	End-2011	End-2012	End-2013	End-June 14	End-2014	End-Mar. 15
Commercial banks (holding a banking license, number)	182	176	176	175	179	173	162	147
Number of banks not complying with selected banking regulations ¹	49	16	18	17	14	57	..	..
Total assets (liabilities) of banking sector (excl. NBU, ratio to GDP in %)	96.4	87.0	81.0	79.9	87.2	88.0	84.0	89.2
Annual growth (in real terms, %)	..	-1.9	7.0	7.1	12.8	..	-17.5	-24.9
Total deposits (from resident sectors, excl. interbank, ratio to GDP in %)	36.7	38.5	37.8	40.6	45.7	44.3	43.1	46.0 ⁴
Annual growth (in real terms, exchange rate-adjusted, %)	..	14.2	12.8	16.6	16.5	-18.1	-37.6	-44.4
Share of foreign currency deposits in total deposits (%)	48.3	42.5	43.0	44.1	37.0	42.5	45.9	53.4
Deposits of households: real growth (exchange rate-adjusted, %)	..	18.0	7.8	19.2	19.2	-21.8	-43.5	-50.8
Deposit rate, households (period average, %)	..	..	..	12.0	11.3	13.3	16.3	16.7
Total loans (to resident sectors, excl. interbank, ratio to GDP in %)	79.2	67.7	61.6	57.8	62.2	67.1	65.1	73.1 ⁴
Annual growth (in real terms, exchange rate-adjusted, %)	..	-7.0	4.6	1.9	11.2	-10.0	-30.8	-42.5
Share of foreign currency loans in total loans (%)	50.9	46.0	40.3	36.8	33.8	43.1	46.3	55.9
Loans to households: real growth (exchange rate-adjusted, %)	..	-20.2	-8.2	-6.6	2.7	-16.7	-33.2	-43.5
Share of foreign currency loans in loans to households (%)	72.4	69.1	56.9	45.2	35.0	42.1	47.9	56.9
Lending rate, enterprises (period average, %)	..	..	..	14.2	14.4	13.7	14.2	14.1
Nonperforming loans (% of total loans, NBU definition)²	13.7	15.3	14.7	16.5	12.9	14.6	19.0	24.7
Nonperforming loans (% of total loans, IMF calculation)³	37.6	40.3	37.7	26.7	23.5	27.7	32.0	..
Specific provisions (ratio to total loans)	8.9	10.2	10.1	12.7	13.6	13.7	19.1	..
Ratio of large exposures to capital (%)	169.2	161.2	164.5	172.9	172.1	243.6	250.0	651.3
Loan-to-deposit ratio (%)	215.9	175.9	163.0	142.2	135.9	149.3	151.2	158.8
Holdings of securities (other than shares) (% of assets)	4.0	8.5	8.0	8.1	10.4	11.1	12.5	12.9
Banks' net external liabilities (% of total liabilities)	16.9	11.2	8.0	4.0	5.7	9.3	8.1	10.1
Capital adequacy ratio (%)	18.1	20.8	18.9	18.1	18.3	15.9	15.6	8.4
Regulatory tier 1 capital to risk-weighted assets (%)	14.2	15.1	14.0	13.8	13.9	11.7	11.2	5.5
Return on assets (ROA, %)	-4.5	-1.4	-0.6	0.5	0.1	0.0	-4.3	-5.6
Return on equity (ROE, %)	-32.8	-9.8	-4.2	3.2	0.8	0.3	-35.0	-71.8

Source: National Bank of Ukraine, IMF.

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

² National definition; break in 2012: from 2008 until the third quarter of 2012. NPLs included doubtful and loss loans, as recorded in the balance sheets. Since the fourth quarter of 2012, NPLs have been compiled on the basis of banking supervision methodology, i.e. data on NPLs comprise credit transactions attributed to the quality categories IV and V.

³ Includes NPLs that are classified as substandard, doubtful, and loss. From December 2012 onward, as estimated by IMF staff using NPL data published by the NBU according to new methodology, which results in a series break.

⁴ Estimate.

Meanwhile, deposits continued to grow strongly (by 17% in 2013), particularly those of households, supported, as before, by attractive (real) interest rates and a de facto fixed exchange rate, even if the latter was becoming increasingly detached from the real economic environment, given the country's bulging twin deficits (see above). Therefore, the loan-to-deposit ratio further decreased slightly (to 136% at end-2013), but in more and more tenuous conditions. The lending boost did not raise banks' profitability

though, which remained very weak; ROE came to 0.8% at end-2013.

2.3 Drastic crisis-triggered banking contraction (from early 2014)

The strong devaluation (from February 2014), coupled with the sharp increase of inflation and the slide into a deep recession had a substantial impact on depositors, who lost confidence and started to withdraw hryvnia as well as foreign currency-denominated deposits. As table 2 shows, total deposits (in real terms and exchange rate-adjusted)

were, year on year, 4% lower at end-March 2014, 27% lower at end-September 2014, and 44% lower at end-March 2015.²⁴ Foreign currency deposits have been exiting banks at almost the same speed as overall deposits: At end-March 2015, foreign currency-denominated accounts had shrunk 37% year on year. Total household deposits suffered a particularly deep contraction in this period: They more than halved (–51%, in real terms and exchange rate-adjusted), also due to the plummeting of the real household deposit interest

rate (from about 12% at end-2013 to about zero in the summer of 2014 and –20% in March 2015).²⁵ Withdrawals were most pronounced in eastern Ukraine: in Luhansk, household deposits shrank by almost three-quarters in nominal terms in the twelve months until end-March 2015, and, in Donetsk, they decreased by about two-thirds (see also box 1). Russian-owned banks reportedly lost a larger percentage of their deposits than other credit institutions (Standard&Poor's RatingsDirect, 2014a, p. 4; Rashkovan, 2015).

Box 1

Crimean crisis and Donbass conflict – minor versus major impact on Ukrainian banking sector

While the Russian annexation of Crimea so far does not appear to have had a major impact on Ukraine's economy and banking development, the persisting armed confrontation in the Donetsk and Luhansk oblasts (regions) – together called the Donbass – has triggered substantial negative effects across many areas. Crimea accounted for about 3.7% of Ukraine's 2013 GDP, while its 2.4 million inhabitants represented 5.3% of the country's population. As of end-2013, the exposure of the banking sector to the region corresponded to about 3.4% of deposits and 1.8% of loans. In April 2014, the National Bank of Ukraine instructed all Ukrainian commercial banks to wind up their activities in the Autonomous Republic of Crimea and the City of Sevastopol. Practically all domestic credit institutions, including foreign-owned ones, subsequently closed their affiliates on the peninsula and sold their branches or transferred assets and liabilities onto balances of banks in mainland Ukraine. On June 1, 2014, the Russian ruble was introduced as the legal tender in Crimea. Russian banks, initially led by predominantly smaller outfits, quickly expanded on the peninsula. They were soon followed by foreign-owned banks in Russia (Wirtschaftsblatt, 2014).

In eastern Ukraine, the pro-Russian separatists control a territory which hosts a number of large industrial agglomerations (including the cities of Donetsk and Luhansk). This insurgent-controlled area of the Donbass comprises about one-third of each of the two above-mentioned oblasts. About 3.7 million inhabitants lived in this area at end-2013 (8.2% of the population of the country including Crimea). About 8%–10% of Ukraine's GDP (including Crimea) in 2013 was produced in (today's) insurgent-controlled Donbass. About 70% of the country's coal was extracted in insurgent territory (Denysyuk, 2014, p. 57). Apart from this area itself, other (government-controlled) parts of the Donetsk and Luhansk oblasts and territories beyond are affected by repercussions of the conflict (e.g. damaging of infrastructure, disruption of production, interruption of transport connections, tax losses, export declines, postponements or cancellations of investment).

²⁴ Part of the contraction of deposits, of loans and of other elements of banking activity since March 2014 can be traced back to credit institutions' retreat from Crimea (which happened mostly in the second quarter, although in this case some assets were transferred to the mainland and therefore not lost) and to the limitation or impairment of their activities in the oblasts of Donetsk and Luhansk (for more information, see box 1).

²⁵ The acceleration of withdrawals probably also reflects depositors' limited trust in the Ukrainian deposit insurance (for more details, see below).

Together, the entire Donetsk and Luhansk oblasts had accounted for about 14.9% of Ukraine's GDP in 2013, for 25.2% of the country's commodity exports (but only for 7.7% of its commodity imports) in the same year, and for 15.3% of Ukrainian capital investment in the first quarter of 2014 (IMF, 2014a, p. 8). These two regions moreover comprised 11.6% of the country's total bank deposits, 12.6% of its household deposits, and 6.9% of its credit volume at end-2013. In July 2014, local branches of the NBU in Donetsk and Luhansk were shut down, but bank settlement for eastern Ukraine continued in Kiev. In early September 2014, the NBU ordered domestic credit institutions to discontinue operations of their branches in insurgent-controlled territory, while online banking apparently continues to be possible (NBU Resolution no. 466 of September 6, 2014). But also in the parts of the two oblasts controlled by the Ukrainian army, for security reasons, many branches remain closed for the time being (Die Zeit, 2014, p. 32). In a decree signed in mid-November 2014, President Poroshenko ordered the closure of all public authorities and SOEs in insurgent-controlled areas. Payments of public salaries and pensions and even gas supplies have been halted. The speed of deposit outflows from the two oblasts has been substantially higher than on average in the country over the twelve months to end-March 2015: Ukraine: -44% (in real terms, exchange rate-adjusted); accordingly (estimate) Donetsk: -77%, Luhansk: -81%. The comparative contraction of credit activity shows the following results: Ukraine: -43%, Donetsk: -66%, Luhansk: -43%.

Moreover, the substantial depreciation and momentous deposit outflow took place despite the imposition of emergency exchange controls (which indirectly points to the limited effectiveness and, possibly, to the weak institutional quality of the latter): As a first administrative measure to check the outflow, the NBU in late February 2014 limited households' foreign currency withdrawals from their bank accounts to an equivalent of UAH 15,000 per day. A monthly cap was imposed on foreign currency purchases and transfers abroad for individuals, as well as a waiting period of at least six working days established for companies and individuals. Among other measures, the NBU temporarily revoked foreign exchange trading licenses of 22 banks for "excessive speculation against the hryvnia" (IMF, 2014a, p. 8; 2014b, p. 9).

After renewed bouts of instability in the financial and foreign exchange

markets, the NBU lifted the share of mandatory sales of foreign exchange receipts by exporters and recipients of foreign currency transfers (surrender requirement) to 75%. A ban was imposed on foreign currency purchases for the conversion of dividends transferred out of Ukraine, except dividends on shares traded on the country's stock markets. The central bank furthermore stepped up monitoring the "propriety" of entities' foreign exchange operations. All payments still pending for imported goods and services half a year or more after delivery were banned. In September 2014, among other measures, individuals' foreign exchange cash purchases were cut to a maximum of UAH 3,000 (EUR 175 at the time) per day (IER, 2014, p. 9). Unfortunately, these stiff interventions seem to have provided but temporary respite, and downward pressures on the hryvnia and on (foreign currency) deposits have persisted.²⁶

²⁶ Persistent strong retail foreign currency deposit withdrawals may seem surprising at first sight, given that in a situation of substantial hryvnia depreciation pressure, one would probably expect households to convert their Ukrainian currency savings into foreign currency deposits. In this sense, administrative restrictions may have been provoking the opposite of what they were intended to achieve: Households that no longer have unconditional access to their own foreign currency savings may prefer converting these into foreign currency cash – which also points to eroding confidence in credit institutions.

Given the heavy-handedness of the controls, a gray foreign exchange market sprang up, where the hryvnia was up to 15% weaker (Raiffeisen Research, 2014, p. 5). While the inflation-devaluation cycle has continued to induce deposit withdrawals, in the face of plummeting real wages (–24.6% at end-March year on year) and spreading poverty, depositors have increasingly felt the need to dissave in order to finance their day-to-day expenses (Raiffeisen Research, 2015, p. 5). Banks' difficulties in light of withdrawals of the above dimension have been mitigated by NBU liquidity support.²⁷

The reversal of deposit flows pushed the loan-to-deposit ratio back up to 159% at end-March 2015. While loans still expanded, if at a decelerating pace in the first quarter of 2014 (see above), they contracted substantially from the second quarter (year on year in real terms, exchange rate-adjusted). Accordingly, as of end-March 2015, the contraction of total loans had accelerated to 43%, and retail credit had shrunk by 44%.²⁸ The credit crunch was not primarily triggered by reduced liquidity, but by the renewed deterioration of credit quality (because of the fall of the hryvnia and Ukraine's slide into recession) and the worsening over-

all economic outlook. Thus, NPLs increased from 13% (national definition) or 24% (IMF definition) at end-2013 to 19% and 32%, respectively, a year later.²⁹

The depreciation (exchange rate valuation effects) pushed the already high share of foreign currency-denominated loans in total loans from 34% (end-2013) to 56% (end-March 2015). Even for retail loans, the ratio rose back to 57% – a highly problematic level, given many unhedged borrowers in the household sector, particularly with regard to mortgage loans (which make up more than one-third of household loans). In any case, the share of retail credit in total credit declined from about one-quarter at end-2011 to one-fifth three years later. The rise of NPLs and the weakening of lending contributed to a decline of capital adequacy from 18.3% at end-2013 to 14.8% at end-March 2014. After some recapitalization measures, capital adequacy recovered to 16% in late 2014, but then plummeted to 8.4% at end-March 2015.³⁰ Ukrainian banks' aggregate capital adequacy thus no longer complies with the regulatory minimum level of 10% set by the NBU. Although fully up-to-date data are not yet available, the plunge is probably due to a

²⁷ The Ukrainian Deposit Guarantee Fund (DGF), which was established in 1998, also plays a role for upholding financial stability. Bank customers are reimbursed up to a value of UAH 200,000 (as of early June 2015 about EUR 8,600) per individual depositor per credit institution. The DGF is moreover slated as resolution authority for insolvent smaller credit institutions (featuring less than 2% of sector deposits or assets). The DGF receives access to public financing if there is significant risk of a decline of funds below its mandated coverage of 2.5% of insured deposits (IMF, 2014b, p. 14). Such re-capitalization measures as well as provision of liquidity took place in 2014.

²⁸ In late December 2014, NBU governor Gontareva assessed that the Ukrainian banking sector was "currently no longer functioning" (Die Presse, 2014).

²⁹ Another credit quality indicator, the share of overdue loans in total loans, reached 14% at end-2014, which is almost twice as high as it had been at end-2013.

³⁰ The ratio of regulatory tier 1 capital to risk-weighted assets also dropped to a record low of 5.5% at end-March 2015 (table 2).

further dramatic deterioration of credit quality.³¹

The crisis situation caused serious problems especially for small and medium-sized banks and some of them were not able to cope. The number of credit institutions has been decreasing since March 2014 when the NBU started to clean the sector of problem banks, including many pocket banks unable or unwilling to recapitalize themselves (chart 4). Altogether 33 banks were recognized as insolvent in 2014 with UAH 140 billion of assets accounting for about 11% of total banking sector assets. There are UAH 25 billion of insured deposits to be repaid via the Deposit Guarantee Fund in these banks. The depositors are being repaid within several months. In the first six weeks of 2015, another seven banks with assets of UAH 59 billion (about 4% of total assets) and UAH 10 billion of insured deposits were declared insolvent.

More seriously, in early March 2015, Deltabank, the fourth-largest credit institution (accounting for about 5% of total banking assets), owned by a Ukrainian businessman, was declared insolvent (Kravchuk, 2015). The further multiplication of the ratio of large exposures to capital in the first quarter of 2015 to 651% probably mostly reflects better measurement. As mentioned above, with the deepening recession, credit quality and capitalization are bound to weaken further and therefore more bank failures are expected even if there are recapitalization

plans. The above-mentioned developments have also influenced the ownership structure of the banking sector. As depicted in chart 3, the share of state-controlled banks has increased at the expense of the private banks. Russian-owned foreign banks slightly increased their share, which might, however, be the result of revaluation effects (Raiffeisen Research, 2014, p. 6).

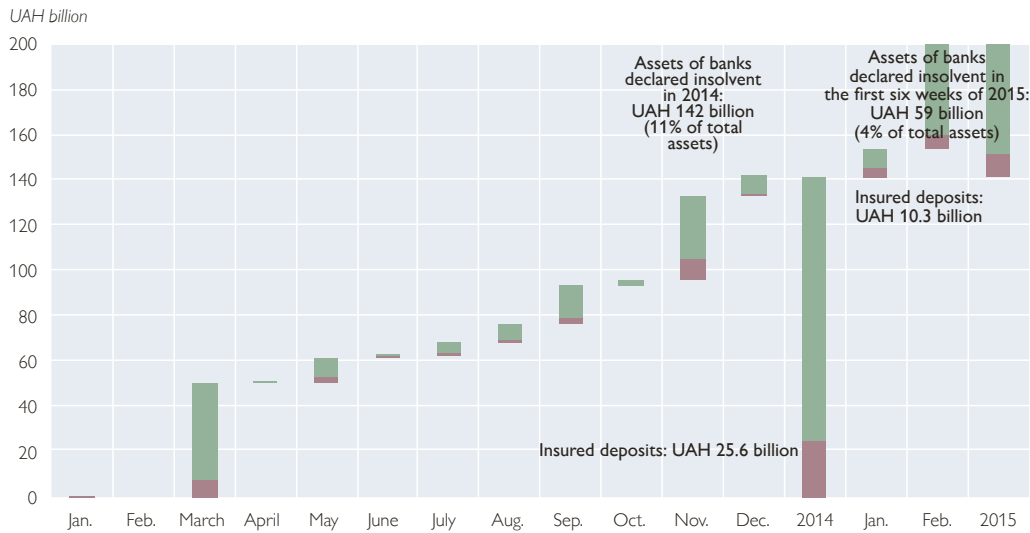
In contrast to shrinking lending activities, the share of banks' holdings of securities (other than shares) in total assets increased (to about 13% at end-March 2015); the share of claims on the NBU and the central government together slightly rose (to around 14%).³² At the same time, refinancing or liquidity-enhancing measures probably explain the increase of credit institutions' debt to the NBU from 6% (end-2013) to 8% (end-March 2015) of their total liabilities. As a result of all adverse developments, the banking sector's profitability turned (back) deeply into negative territory. At end-2014, return on assets plunged to -4% and return on equity to -35%; three months later, the respective indicators had further sharply deteriorated. This change occurred primarily on account of the recognition of large losses revealed, inter alia, by diagnostic studies referred to below. Loan-loss provisions rose from 3.2% of total loans at end-2013 to 9.8% a year later.

As part of the IMF program, diagnostic studies and asset quality reviews were undertaken for the 35 largest banks. Based on reported bank data for

³¹ In the framework of the IMF Extended Fund Facility, the NBU reached an agreement with the IMF to allow for some temporary regulatory forbearance. Accordingly, the central bank (in Resolution no. 313 of May 12, 2015) requires credit institutions to reach a capital adequacy level of at least 5% by February 1, 2016, of at least 7% by late 2017, and of at least 10% by late 2018 (Interfax Ukraine, 2015).

³² The NBU and SOBs provide most of the local currency financing of the fiscal deficit. As of mid-2014, the monetary authority held 63% of government hryvnia debt and domestic banks held 29% (Standard&Poor's RatingsDirect, 2014a, p. 4).

Chart 4

Assets and insured deposits of insolvent banks as at mid-February 2015

Source: National Bank of Ukraine.

May 2014,³³ IMF staff stress tests estimated that the NPL ratio (NBU definition) would – under the chosen baseline – increase by about half by end-2016 (i.e. to 21%–22%);³⁴ under an adverse scenario the NPL ratio would almost double (i.e. rise to 27%–28%). Assuming that banks were to sustain a provision ratio of 60% of NPLs, the sector would need to receive fresh capital in the range of 3.5%–5% of GDP to meet a tier 1 capital target of 7% (IMF, 2014b, pp. 12–13). However, with hindsight, the stress-testing methodology was based on relatively mild

macroeconomic assumptions and had not factored in repercussions (including the plunge of the hryvnia) of the persisting hostilities in the east. Unfortunately, it is all but certain that recapitalization and bailout needs for Ukrainian banks will be substantially higher. In its latest assessment of the state of the Ukrainian banking sector on the occasion of the IMF's approval of the Extended Fund Facility in mid-March 2015, IMF staff estimated that the sector was in need of a capital injection of 9%–10% of GDP (IMF, 2015a, p. 20; Donnan, 2015).

³³ As of early June 2015, no updated diagnostic studies have yet been published.

³⁴ As mentioned above, the NPL ratio had already reached 19.0% at end-2014.

Table 3

Foreign banks having left the Ukrainian market (2009–early 2015)¹

Year	Name of bank	Nationality	Action	Buyer information
2009	Home Credit Bank	Czech Republic	100% exit sale to Platinum Bank	Horizon Capital (45%), East Capital (25%), International Financial Corporation (IFC, 5%), FPP Asset Management (4%), bank management (17%)
2009	Dresdner Bank	Germany	Liquidation of representative office	
2010	Renaissance Credit	Russia	Acquisition by SCM (Ukraine)	Rinat Akhmetov (100%)
2010	HSBC	U.K.	Closure of representative office	
2011	Bayerische Landesbank	Germany	Closure of representative office	
2011	Kookmin Bank	South Korea	Closure of representative office	
2011	Conversbank	Russia	Acquisition by Global Financial Management Group (Ukraine)	Ukrainian private investors (100%)
2011	Bank of Georgia	Georgia	80% exit sale to private investors	Ukrainian private investors
2011	Vostok Bank	International (Platinum Bank)	100% exit sale to private investors	Ukrainian private investors
2012	Volksbank	Austria	100% exit sale to Sberbank of Russia	Central Bank of Russia (52.32%), free float (47.68%)
2012	SEB Bank	Sweden	100% exit sale to Fidobank	Consulting firm "Finans Analit Servis," Ukraine (79.9%); Ignace Marketing Limited, Cyprus (20%)
2012	Commerzbank (Bank Forum)	Germany	100% exit sale to "Smart Holding," Ukraine	Cyprus-based Yernamio Consultings Ltd, controlled by Vadim Novitsky (98.68%)
2012	Societe Generale (Profin Bank)	France	100% exit sale to Alfa-Bank, Ukraine	ABH Ukraine Limited, Cyprus (part of Alfa Group, Russia) (80.1%); Alfa-Bank, Russia (19.9%)
2012	Erste Bank	Austria	100% exit sale to Fidobank	Consulting firm "Finans Analit Servis," Ukraine (79.9%); Ignace Marketing Limited, Cyprus (20%)
2013	Swedbank	Sweden	100% exit sale to Delta Bank, Ukraine	Nikolai Lagun, Ukraine (70%); Cargill Financial Services, U.S.A. (30%)
2013	Astra-Bank	Greece	100% exit sale to Delta Bank, Ukraine	Nikolai Lagun, Ukraine (70%), Cargill Financial Services, U.S.A. (30%)

Source: Raiffeisen, various bank websites, Fungáčová and Korhonen (2014).

¹ In 2014 and early 2015, no exits of medium- or large-sized foreign-owned banks from the Ukrainian market were observed.

3 Assessment of current Ukrainian banking risks and shock-absorbing factors

Apart from multiple macroeconomic and structural shortcomings that the authorities are currently tackling, the salient problem affecting Ukraine's economy and banking sector is the country's strong exposure to geopolitical tensions and conflict with Russia. Notwithstanding successful presidential and parliamentary elections in 2014, there is also the danger of a potential

resurfacing of domestic political instability, given the economic hardship that the population is facing. The loss of Crimea, the continuing armed confrontation and hostilities in the east, and recurrent trade disputes and frictions with Ukraine's large northern and eastern neighbor have generated major uncertainty and severely harmed the country's investment climate.³⁵ Apart from preventing insolvency, IMF and multilateral support has not yet decisively changed the economic situation.

³⁵ President Poroshenko recently underlined the key importance of overcoming the crisis in the east for rekindling economic growth: "As long as the war continues, there will be no investment in Ukraine" (Vitkine, 2015, p. 4).

Weak global conditions and sluggish growth in the EU have not helped either. While the NBU has recently made visible progress in cleaning the banking sector of a number of smaller unviable entities, as of June 2015, the two most serious risks facing Ukrainian banks are partly connected and continue to reinforce each other: high credit risk and high exchange rate risk.

3.1 High credit risk

The high credit risk reflects elevated and rising NPLs (depending on the definition, they constituted between 19% and 32% of total loans at end-2014), which are being driven up by the ongoing recession and thus borrowers' worsening business prospects. Another influence comes from the huge devaluation of the hryvnia that primarily affects unhedged debtors – often households. On account of this devaluation, as of end-March 2015, foreign currency loans made up 56% of total loans and 57% of household loans in Ukraine.³⁶

3.2 High exchange rate risk

The high exchange rate risk stems from the already substantial fall (55%–65%) of the Ukrainian currency between February 2014 and March 2015, despite the imposition of cumbersome capital controls, and from continuing downward pressures. The latter are fueled by persisting external disequilibria (current account deficit, gross foreign debt), by the low level of international reserves and by generally weak confidence in the hryvnia. The background

to this fragility includes persistent geopolitical risks weighing on the country, and more generally, Ukraine's feeble financial standing, in that the country currently remains dependent on international (IMF) financial assistance to uphold its solvency. The most recent slide of the hryvnia in February 2015 has put further pressure on asset quality and bank profitability.

3.3 Liquidity risk

Liquidity risk is also sizeable, if so far not as difficult to master as the challenges referred to above. Notwithstanding administrative restrictions to deposit withdrawals, macroeconomic instability and low confidence in banks and deposit insurance have triggered mounting outflows from bank accounts and capital flight. However, despite the strong segmentation of the interbank market, negative effects have hitherto been mitigated by NBU liquidity injections into the sector (exceeding 8% of the banks' total liabilities as of end-2014).

3.4 Low profitability, entrenched related-party lending, and other challenges

Other challenges include chronically low or negative profitability, which has contributed to the exit of numerous foreign banks over the years or their intention to do so if they find buyers. In this connection, there is a risk of disorderly deleveraging.³⁷ Other chronic structural problems and sources of weakness are: substantial lending con-

³⁶ The currency composition of these loans was: total loans: 91.1% U.S. dollar, 7.8% euro, 0.5% Russian ruble; household loans: 95.6% U.S. dollar, 2.0% euro.

³⁷ This option is pointed out in a surprisingly straightforward manner in a recent report of Standard&Poor's, which is essentially repeated in a later report: "In our view, parental support in the form of additional liquidity lines or capital injections remains possible, but not certain, because providing support might ultimately be more costly than letting banks default. However, the parent banks do run reputational risk if support is not forthcoming." (Standard&Poor's RatingsDirect, 2014b, p. 11; 2015, p. 3).

centrations to single borrowers, high related-party lending³⁸, weak rule of law and protection of creditor rights, feeble corporate governance, deeply entrenched corruption and state capture³⁹.

As long as the military stand-off in the east continues, a fair share of the authorities' attention and energy will be absorbed by the conflict, which may at least distract from the in-depth structural and institutional reforms necessary. In the worst case, the conflict could serve as an excuse for putting off or slowing down effective implementation of important but politically delicate adjustments.

3.5 Shock-absorbing factors

After capital cushions have dwindled – the capital adequacy ratio almost halved to 8.4% in the first three months of 2015 –, IMF support and international financial commitment effectively remain the most important shock-absorbing factor for the Ukrainian banking system. Strong downward pressures on credit quality are likely to continue to increase provisioning needs. This will probably make necessary substantial additional capital injections from private bank owners and the state. Where private owners are not able to fill the gap, the government may have to step in and nationalize failing systemic institutions in order to avoid a systemic crisis. However, the government itself is in a very precarious financial situation, as witnessed by its attempts to negoti-

ate a large-scale restructuring of its foreign debt. Given the size of the overall amount that may be necessary to recapitalize banks, domestic sources alone will probably not be able to shoulder the entire burden. Here the most important shock-absorbing factor comes in: the IMF Extended Fund Facility and the unwavering commitment of the international community, particularly Western countries, and Ukraine's creditors, to financially assist the Ukrainian authorities. The question, however, remains if the funds provided by these sources will be sufficient.

4 Outlook

Most forecasts expect no meaningful recovery of the Ukrainian economy before 2016.⁴⁰ Recovery will be strongly dependent on the evolution of political and security factors, notably pertaining to the conflict in the east of the country. Of course, once the base effect of the severe slump of production in the Donbass has passed in the course of 2015, the latter's adverse statistical impact on economic activity will be less pronounced. If stifling capital controls are maintained, this will not have a positive impact on business activity. After having incurred losses in 2014 and notwithstanding the likely bailout of some systemically important institutions, the banking sector will not be able to generate sufficient margins in the second deep recession year of 2015 to buffer the increased credit risks. Hence, the banking sector is very likely

³⁸ *Opaque ownership structures and credit schemes have undermined attempts of the NBU to effectively limit banks' exposures to insiders (IMF, 2015a, p. 19). According to NBU estimates, connected lending comprises 60%–70% of the assets of some banks (Eschbacher, 2015).*

³⁹ *To give an illustration: According to Transparency International's Corruption Perceptions Index 2014, Ukraine is ranked as the least transparent country in Europe, and the fourth-least transparent country of the former Soviet Union (following Turkmenia, Uzbekistan and Tajikistan) (Transparency International, 2014, p. 9).*

⁴⁰ *The latest forecasts of the IMF, the EBRD and the The Vienna Institute for International Economic Studies (wiiw) (April–May–June 2015) for Ukraine's economic growth in 2015 are as follows: –9.0%, –7.5% and –7.0%, respectively. In 2016, the IMF and the EBRD expect the country to return to the growth path (+2.0%, +3.0%), and the wiiw expects stagnation (0.0%).*

to remain in the red, with some banks set to face serious troubles connected with possible closure. Accordingly, further banks may try to exit the market, including foreign banks, if they find a buyer for their assets. These developments might significantly change the Ukrainian banking landscape, with the state most likely to assume a more important role.

A turnaround for the sector can only be expected when the recession bottoms out (probably in 2016) and, more importantly, when geopolitical tensions ease, and therefore investor confidence finally returns. Yet even at that point, based on previous experience, banking activity will likely lag overall economic growth, due to the then probably still high NPLs that are bound to dampen new lending.

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