Ukrainian Banks Face Heightened Uncertainty and Challenges[1]

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Following a sharp recession in 2009, the Ukrainian economy recovered in 2010 and 2011. In particular in 2011, domestic demand-led growth was accompanied by widening external imbalances. The economy's external vulnerabilities – related to the current account deficit (2011: 5.6% of GDP) and the elevated foreign debt stock (77% of GDP) – entail risks for the banking sector, as exchange rate pressures against the hryvnia's U.S. dollar peg have been recurrent and foreign exchange reserves declined in the second half of 2011. While the share of foreign currency loans in total loans has been steadily declining (thanks to a ban on extending new foreign currency loans to unhedged borrowers imposed by the National Bank of Ukraine in the fall of 2008), it remains sizeable (end-2011: 41%). Many of these loans are unhedged. The stabilization of nonperforming loans at a high level could be interrupted by a further deterioration of the economic situation or by a new bout of hryvnia depreciation. Moreover, the population's confidence in the Ukrainian currency is prone to volatile swings. As deposit inflows have picked up and loan growth has remained subdued, the loan-to-deposit ratio has receded, but is still relatively high (end-2011: 163%). With the funding structure shifting to domestic deposits, the banking sector's external position has improved (net external liabilities have fallen to 8% of total liabilities). In 2011, loan growth became positive in real terms again. Recapitalization efforts contributed to upholding capital adequacy. The banking sector's profitability improved, but nevertheless stayed in negative territory.

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1 Macroeconomic Background: Fragile Recovery Drifts into Uneasy Waters

Ukraine experienced one of the sharpest downturns in Central, Eastern and Southeastern Europe (CESEE), with GDP plummeting by 14.8% in 2009. The subsequent recovery was first export-led, helped by the bouncing back of external demand and of commodity prices. Then, from the second quarter of 2010, domestic demand gained traction and double-digit import growth started to outpace export growth by far. Economic growth accelerated from 4.1% in 2010 to 5.2% in 2011 before decelerating to an estimated 1.8% in the first quarter of 2012 (year on year). In the second half of 2011, real exports declined in annual terms, while imports continued to grow, albeit at a slower pace. The deceleration of external demand seems to be responsible for the most recent slowdown of GDP growth. Ukraine's current account deficit widened again and came to 5.6% in 2011, when the deficit was no longer fully covered by net FDI inflows. Due to the depreciation of the hryvnia and the recession, Ukraine's external debt peaked at 88% of GDP in 2009 before declining to 77% in 2011. Given the still high external debt stock, roll-over needs are considerable. Moreover, foreign exchange reserves do not cover short-term external debt on a remaining maturity basis.

By end-2010, the country had been able to build up its gross international reserves to about 25% of GDP; how-

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ever, they declined to 19% of GDP at end-2011 mainly due to stepped-up interventions by the National Bank of Ukraine (NBU) to support the hryvnia's peg to the USD in the second half of 2011. Exchange rate pressures were triggered by increasing risk aversion in international financial markets, resurfacing worries about Ukraine's external accounts, the weak trust of domestic households in the hryvnia, and presumably concerns about political developments in the country. In the first quarter of 2012, pressures on the currency eased temporarily, as witnessed by stabilizing foreign exchange reserves.

After an IMF program went off track in the fall of 2009, the IMF approved a new Stand-By Arrangement in July 2010. However, after the disbursal of two tranches, the second program also veered off course in early 2011, as the Ukrainian authorities have in particular remained reluctant to raise gas prices for households, a key condition for the IMF to continue the program. Negotiations with Russia to reduce import gas prices, which the Ukrainian authorities see as an alternative to raising domestic gas prices, have so far been inconclusive.

2 Banking Sector: From a Hesitant Rebound to a Build-Up of New Risks

2.1 Gradual Recuperation from the Crisis of 2008 to 2009

Following the steep precrisis real (CPI-deflated, exchange rate-adjusted) growth of loans, real loans to the private sector dropped by 11.7% in 2009 and by another 5.2% in 2010 before stabilizing in the first half of 2011. Lending to households had boomed particularly strongly (and had reached almost 40% of total credit) before contracting precipitously. At end-2008, foreign currency-denominated loans made up 59% of total loans to the private sector and almost three-quarters of credit to households. The major slump of the Ukrainian economy and the sharp depreciation of the hryvnia triggered the weakening of credit quality. Nonperforming loans (NPLs, officially measured as the share of doubtful and loss loans in total loans) multiplied from 3.9% at end-2008 to 13.7% at end-2009 and grew further to 15.4% in mid-2011.[3] The stabilization of NPLs at a high level as well as the rise in directed lending by state-owned banks, which had increased their share to almost one-fifth of total banking assets (see below), may have contributed to the stabilization of the credit volume in early 2011. Following the NBU's ban on foreign currency lending to unhedged borrowers in the fall of 2008, the share of foreign currency loans declined steadily to (still elevated) levels of 45% of total loans and almost-two thirds of household loans in mid-2011.

After large-scale deposit withdrawals in early 2009 had caused massive outflows, the rebound of economic activity and the stabilization of the currency coupled with a package of banking sector emergency measures (including liquidity support, temporary administrative restrictions, an upward adjustment of deposit guarantee level)[4] reined in deposit outflows. In 2010 and in the first half of 2011 deposits returned on the back of rising wages,

[3] *According to a broader definition (according to which NPLs comprise substandard, doubtful and loss loans), NPLs expanded from 16.4% to 40.3% of total loans in the above-mentioned period. In spring 2011, Standard & Poor's estimated the share of problem loans including restructured loans at about 50% of total credit (Standard & Poor's, 2011, p. 2).*

[4] *For more details on the package of measures, see Barisitz and Lahnsteiner. 2009. p. 73.*

the economic recovery and increasingly confident consumers. The share of foreign exchange-denominated deposits, which had increased to almost half of total deposits in 2009, receded somewhat again in the following years.

The loan-to-deposit ratio, which had been high in Ukraine, declined from a peak of 229% in the third quarter of 2009 to a still elevated 166% in mid-2011.[5] The increased customer deposit base as well as financial assistance from parent banks to their subsidiaries in Ukraine contributed to the restoration of liquidity in the sector in 2009 and 2010. At the same time, banks' net external liabilities declined from 26% of total liabilities at end-2008 to 9% in mid-2011, as in particular cross-border wholesale funding shrank. As of end-September 2010, about 63% of banks' foreign debt was attributable to parental funding (Standard & Poor's, 2011, p. 8). Foreign-owned banks had generally played a stabilizing role during the crisis of 2008 to 2009, as most of them had received substantial capital and liquidity support from their parent institutions, helping to lift the share of foreign-owned banks in total assets to 47% by the end of 2009. Provisions for rising NPLs in 2009 pushed banks' profitability into negative territory (return on assets in 2009: –3.6%). Apart from the two state-owned credit institutions Ukreximbank and Oschadbank, which had been recapitalized earlier, three troubled domestically owned banks, namely Rodovid, Ukrgaz, and Kyiv Bank, were nationalized and recapitalized by the state in 2009 to 2010. These three banks received a total of

Table 1

Selected Banking Sector Stability Indicators

	2007	2008	2009	2010	2011
Total assets (% of GDP)	71.3	91.2	97.0	88.8	79.9
Share of majority foreign-owned banks in total assets (%)	37.5	45.0	46.6	42.6	37.8
Share of majority state-owned banks in total assets (%)	8.0	11.4	17.2	16.9	17.2
Real growth of loans to the private sector, exchange rate-adjusted[1] (annual change in %)	48.4	12.3	–11.7	–5.2	7.3
Foreign currency loans to the private sector (% of total assets)	41.5	50.2	41.5	35.1	30.7
Foreign currency loans to the private sector (% of private sector loans)	49.9	59.1	51.2	46.6	40.7
Foreign currency loans to households (% of household loans)	63.6	71.9	72.3	69.1	56.9
Foreign currency deposits of the private sector (% of total liabilities)	17.5	18.2	17.3	18.0	19.7
Foreign currency deposits of the private sector (% of private sector deposits)	32.1	44.0	47.1	42.0	42.5
Real growth of private sector deposits, exchange rate adjusted[1] (annual change in %)	29.3	–10.9	–21.1	19.2	12.7
Loan-to-deposit ratio (%)	152.6	205.5	219.9	175.5	162.6
Net external liabilities (in % of total liabilities)	22.2	26.2	16.8	11.0	8.0
Nonperforming loans[2] (% of total loans)	–	3.9	13.7	15.3	14.7
Return on assets (ROA, %)	1.9	1.5	–3.6	–1.5	–0.6
Capital adequacy ratio (%)	13.9	14.0	18.1	20.8	18.9

Source: National Bank of Ukraine, Raiffeisen Research.

[1] *Foreign currency component at January 2008 exchange rate.*
[2] *Share of doubtful and loss loans.*

[5] *This decline as such is certainly not a bad sign, since the loan-to-deposit ratio can be identified as an early warning indicator of crisis (Reading, 2012, slide 11).*

UAH 17.2 billion (EUR 1.6 billion) of public capital injections. However, an audit of these three banks reportedly showed that about half of the above amount disappeared under fictitious transactions (Standard & Poor's, 2011, p. 8). Due to rehabilitations by the state and state-owned banks' proactive credit expansion, the share of majority publicly-owned banks in total banking assets rose from 11% at end-2008 to 18% in mid-2011. Total post-crisis recapitalizations from foreign and domestic owners contributed to lifting the sector's capital adequacy ratio from 14% to 19% in the same time span.

2.2 Credit Activity Starts to Grow Again

In the second half of 2011, overall credit activity started to grow again (year-on-year, in real terms), buoyed by continued expansion of private sector deposits and a slight reduction of NPLs (from second half of 2011). As of end-2011 and early 2012, the pace of the lending recovery had just caught up with and surpassed GDP growth (real exchange rate-adjusted credit growth at end-March 2012: +7% year on year). However, in contrast to corporate lending, lending to households continued to decline in 2011, but this decline was entirely attributable to foreign currency lending (which shrank by almost one-quarter in real terms in 2011 to 56.9% of total household loans), whereas retail lending in domestic currency expanded strongly. Total foreign currency loans to the private sector declined by 4%, and their share in total loans continued to decline to 40.7% at end-2011 (40.4% at end-March 2012).

Most foreign-owned banks adopted a cautious stance in the last quarter of 2011 and kept new lending very modest (Astrov, 2012, p. 136). This, however, is apparently not valid for Russian banks, which expanded their market share, as well as for state-owned banks. While the overall share of foreign-owned banks in total sector assets declined from 43% end-2010 to 38% at end-2011, the share of Russian-owned banks grew from 11% to 12% (which is almost one-third of the total foreign presence) (Raiffeisen Research, 2011, p. 63; Sologoub and Nikolaieva, 2012a, p. 7).[6] Private sector deposits continued to expand in the second half of 2011 as well as in early 2012. Rekindled depreciation expectations led to a slight increase of the share of foreign exchange-denominated deposits, though. The loan-to-deposit ratio receded further to 163% at end-2011 (and to 159% at end-March 2012), while net external liabilities continued to contract to 8% of total liabilities (7.3% at end-March 2012).

The quality of the loan portfolio improved slightly in the second half of 2011, as the share of NPLs (measured as doubtful and loss loans) declined from 15.4% in mid-2011 to 14.7% at the end of the year. Partially, this is due to the resumption of lending, i.e. the denominator effect; it also appears that NPL resolution, notably the writedown of impaired loans, is (finally) starting to make some headway. Given that high NPLs have represented a major challenge to bank balance sheets and the resumption of lending, with weaknesses in the Ukrainian legal, tax and judicial systems preventing a more aggressive resolution of bad loans (including diffi-

[6] *The most prominent example of Russian banking expansion in Ukraine is state-owned Sberbank, Russia's largest commercial bank. In 2011, Sberbank founded a subsidiary in Ukraine, which currently operates about 130 branches across the country and plans to open 30 new branches in 2012 (Russland Aktuell 2012).*

culties in recovering collateral and resolving foreclosure), the authorities formed a working group to oversee reforms in this area (IMF, 2010, p. 17). The new tax code, which entered into force in 2011, facilitates the writeoff of NPLs by clarifying their tax treatment.[7] Moreover, some banks successfully sold NPLs and collateral properties (FLIFI, 2012, p. 7). The debt collection business is considered to have major potential, but it has to contend with some legal obstacles, is still in its infancy and is often handled between related parties (Ernst & Young, 2011, p. 102). In late 2011, the government introduced new legislation on bankruptcy, which should improve the overall framework of dealing with insolvency, although it has yet to be put to the test.

The marginal amelioration of loan quality certainly played a role in the further reduction of losses in 2011. The negative return on assets declined to –0.6% that year.[8] Losses would have declined even further had operating expenses not risen by 29% in 2011, pushed by substantial wage adjustments (National Bank of Greece, 2012, p. 7). The largest part of sector losses (53%) was concentrated in two problematic systemic banks: Ukrsib, a subsidiary of BNP Paribas, and Ukrgaz, a nationalized bank. The rehabilitation of most other ailing systemic banks was completed in 2011 (Sologoub and Nikolaieva, 2012a, p. 6). The bank resolution process in general is reported to have been messy and to have featured asset stripping, misreporting and other illegal practices (see above example in section 2.1). It is hoped that the strong burden borne by the NBU in this respect will be alleviated by the transfer of the insolvent bank resolution process with the functions of receivership and liquidation procedures to the Deposit Guarantee Fund (Sologoub and Nikolaieva 2012b, p. 4–5). The parliament amended the legal foundation of the deposit insurance system in this direction.

Box 1

Austrian Banks' Activities and Experience in Ukraine since 2009

At year-end 2011, four Austrian banking groups (Erste Group Bank, Raiffeisen Bank International, UniCredit Bank Austria and Volksbank International) operated four subsidiaries in Ukraine. Total assets held by these subsidiaries stood at EUR 10.3 billion at year-end 2011 (representing a market share of one-tenth in the Ukrainian banking sector) and were primarily made up of customer loans.

In the past, the Ukrainian banking sector was characterized by high demand for, and supply of, foreign-currency loans. At year-end 2011, gross foreign currency (predominantly U.S. dollar-denominated) loans of subsidiaries of Austrian banking groups to private households and nonfinancial corporations amounted to EUR 5.2 billion, representing a share of 62.7% in Austrian banks' total customer loans in Ukraine. The volume of foreign-currency loans contracted by 14.4% year on year (growth rate adjusted for exchange rate fluctuations), while total loans remained almost constant at EUR 8.2 billion. The continued decrease of the foreign currency loan stock until today is mostly a result of the prohibition of foreign currency lending to unhedged borrowers by the NBU, which came into force in October 2008.

[7] *Information provided by Mykola Udovychenko, CEO of state-owned Ukreximbank, at the EBRD Annual Meeting in London on May 19, 2012.*

[8] *In the first quarter of 2012, the banking sector reportedly regained profitability, largely thanks to shrinking loan-loss provisions.*

The reason for this rather drastic step on the part of the NBU was the fact that the increased exchange rate risk on the part of unhedged foreign currency borrowers had materialized in elevated credit risk on banks' balance sheets, especially after the sharp devaluation the hryvnia had experienced in the course of 2008. Regarding Austrian banks in Ukraine, the NPL ratio[1] of foreign-currency loans read 56.0% compared to 44.6% of total customer loans as of year-end 2011. This ranges among the highest NPL figures of all Austrian CESEE and CIS (Commonwealth of Independent States) subsidiaries. Apparently, the deteriorating credit quality of the past led to more cautious risk provisioning, as the loan loss provision ratio of foreign currency loans recently increased to 26.1% as of year-end 2011 not only because of the reduction of the foreign currency loan stock, but also because of a +9.2% year-on-year increase in loan loss provisions. Moreover, both the NPL coverage ratio I (46.1%) and the NPL coverage ratio II (87.5%) of total customer loans have increased somewhat in the course of 2011.[2] At year-end 2011, 31.5% of total customer loans were in a restructuring process.

Nonetheless, after losses in 2009 and early 2010, Ukrainian subsidiaries again constitute an important contributor to the profitability of Austrian banking groups, as their profits represented 6.9% of total Austrian CESEE and CIS subsidiaries' profits in full-year 2011. In general, a strong capital position is needed to adequately reflect the risks in the Ukrainian banking sector: at year-end 2011, the average capital adequacy ratio of the Ukrainian subsidiaries stood at 15.6%. Similar improvements need to be achieved in terms of the subsidiaries' loan-to-deposit ratio (LDR), which stood at 137.7% as of year-end 2011, thus still above the LDR value deemed sustainable for new business of 110%. Despite several adverse developments in the Ukrainian banking sector, Austrian banking groups have remained committed to their Ukrainian subsidiaries during the crisis and have not withdrawn their parental liquidity support, which stood at EUR 4.0 billion at year-end 2011.

[1] *Here identified as the ratio of the sum of substandard, doubtful and loss loans to total loans.*

[2] *NPL coverage ratio I = Risk provisions on NPLs / NPLs; NPL coverage ratio II = (Risk provisions on NPLs + eligible collateral according to Basel II) / NPLs.*

3 Conclusion: Assessment of Current Banking Challenges

3.1 Weak Global and European Environment Entails Risks for the Banking Sector

The weak external environment and the Ukrainian economy's external financing needs, which are due to the current account deficit and the substantial external debt, are likely to continue to put pressure on the hryvnia and to erode international reserves, in particular as long as the IMF program remains off track. Volatile swings of the country's terms of trade (resulting from a strong dependence on bulk commodities on the export as well as the import side) can quickly undermine confidence. At 43%, the share of foreign exchange-denominated deposits in total deposits certainly remains relatively high, and depositors' trust in the hryvnia continues to be limited and prone to volatile swings. Though the share of foreign currency lending in total lending has declined in recent years thanks to the ban on such lending to households, it is still elevated (41%). A substantial depreciation of the hryvnia would certainly hit unhedged borrowers and therefore push up NPLs again. Given the current political cycle, it appears that devaluation risks may rise after the parliamentary elections in the fall of 2012.

European Banking Authority (EBA) requirements for European banks to raise their capital ratios raised concerns that these credit institutions could reduce their asset positions in emerging economies. In this respect, it is very important that banks – as recom-

mended by the EBA – strengthen their capital base and do not achieve the required capital ratios through an excessive reduction of lending in host countries. Local news reports state that BNP Paribas, which owns 85% of unprofitable Ukrsibbank (the fifth-largest Ukrainian bank at end-2010), may be planning to sell off at least parts of the business of this subsidiary (Emerging Markets Monitor Europe, 2012, p. 15). A sale of subsidiaries would, however, not necessarily lead to reduced credit supply if the new owner maintains the exposure. In general, however, banks' access to external funds will likely remain limited.

3.2 Stubbornly High NPLs and Credit Risk

Even if macro factors like currency depreciation and/or an economic slowdown that turn a greater number of standard loans into nonperforming loans do not resurface, the large existing stock of NPLs remains a major challenge for bank balance sheets and for a sustainable recovery of lending. While some positive signs of NPL resolution emerged in late 2011 and while recent changes to legislation (see above) have facilitated tax treatment of the writeoff of NPLs, a number of other legal and judicial obstacles remain: It has yet to be seen whether the new bankruptcy law will contribute to overcoming problems of insolvency processes.

3.3 Structural and Institutional Deficiencies

Ukraine suffers from a number of serious general institutional problems and shortcomings that continue to affect banking activity (weak rule of law and protection of creditor rights, modest efficiency of the judicial system, feeble corporate governance and endemic corruption). The transparency of creditworthiness of potential borrowers leaves much to be desired, given the lack of an adequate credit bureau infrastructure. According to anecdotal evidence, the scale of related party lending (connected lending) at several domestically owned banks (typically belonging to Ukrainian business groups) remains large and has even expanded further in 2011 (Sologoub and Nikolaieva, 2012a, p. 7). Many domestically owned credit institutions, large or small, still tend to function as "pocket banks" or "agent banks," channeling resources and serving the needs of owner firms or financial-industrial groups.

3.4 Shock Absorbing Factors

The banking sector's net external liability position has improved markedly since 2008; thus, the banking sector's dependence on external funds has been reduced. Capital adequacy stayed at an adequate level from 2009 through 2011 (about 19%) thanks to recapitalization measures and to a tendency of assets to grow at a slower pace than capital. Moreover, the impact of an expected mild recession in the euro area is not likely to be as severe on Ukraine in 2012 as on other CESEE countries further to the west, since Ukraine is less closely linked to the euro area and has more geographically diversified trade and investment links.[9] Finally, after shrinking markedly in the second half of 2011, foreign currency reserves stabilized in the first quarter of 2012 and still provide some room for maneuver. However, the room is limited, as Ukraine is running a

[9] *Russia is Ukraine's main trading partner and a major source of FDI. It expects stronger economic growth in 2012 and 2013 than the euro area and most CESEE EU member countries.*

current account deficit, has high external debt, and its foreign currency reserves do not cover short-term external debt on a remaining maturity basis. A resumption of the IMF Stand-By Arrangement could play an important role in strengthening foreign investor confidence.

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