Investor Commitment Tested by Deep Crisis: Banking Development in Ukraine

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Ukraine's banking sector was strongly hit by the global economic crisis which began in September 2008 and triggered an extreme output contraction (–20%) in the first quarter of 2009 and a sharp depreciation of the Ukrainian hryvnia (–35%). Loss of confidence in the banking sector and deposit withdrawals (about one-fifth of total deposits) were reined in by large-scale liquidity support by the National Bank of Ukraine, administrative measures and macroeconomic adjustment (unwinding of the current account disequilibrium) in the spring of 2009. However, credit growth (month on month) ground to a halt in early 2009 and confidence in the hryvnia remains fragile in a situation where about 50% of private sector credit stock is denominated in foreign currency. The authorities' bank recapitalization program, assisted by the structural conditionality of an IMF Stand-By Arrangement, should help banks cope with the persisting deep recession and strongly rising nonperforming loans. While political instability in the run-up to the presidential election early in 2010 could yet derail bank rehabilitation, credit institutions have substantially raised provisioning and started cutting costs and restructuring overdue loans. Continuing support by international financial institutions and sustained commitment by foreign (including Austrian) parent banks and corporations also represent key stabilizing factors.

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1 Macroeconomic Background

Before Ukraine was hit by the global financial crisis in late 2008, the economy showed signs of overheating characterized by skyrocketing but volatile steel export prices, soaring wages and private consumption, strong capital inflows, a credit boom, high inflation (almost 30% in mid-2008) and a widening current account deficit. The increasing fragility of the country's external position as well as persistent political instability seem to have been the main reasons why Ukraine has been among the countries hit hardest by the crisis.

Following the escalation of the global financial turmoil after the default of Lehman Brothers in September 2008, Ukraine's terms of trade plunged, capital flows reversed, eurobond spreads and capital default swap (CDS) premiums rose by a far greater extent than those of other countries in the region, and the Ukrainian hryvnia depreciated sharply. Against the background of tightened external financing conditions and the outlook of a severe slump in foreign demand from Russia in particular, but also from other countries, the government agreed on a two-year USD 16.4 billion standby loan with the IMF in late October 2008. IMF assistance is earmarked for balance-of-payments support. Disagreements over several issues included in the IMF program (i.a. concerning the budget deficit) resulted in a delay of the disbursement of the second tranche of the standby credit in February 2009 and temporarily heightened pressures on the Ukrainian financial market, but were resolved two months later.

Following an 8% real GDP contraction year on year in the last quarter of 2008, the Ukrainian economy shrank

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Table 1

Selected Macroeconomic Indicators

	2005	2006	2007	2008	Q1 09
Real GDP growth (annual change, %)	2.7	7.3	7.9	2.1	–20.3
GDP deflator (annual change, %)	24.5	14.8	22.7	29.1	22.4
Inflation (period average, CPI, annual change, %)	13.5	9.1	12.8	25.2	17.8[1]
Inflation (end-of-period, CPI, annual change, %)	10.3	11.6	16.6	22.3	15.0[1]
Budget balance (general government, % of GDP)	–1.8	–0.7	–1.1	–1.5	. .
Current account balance (% of GDP)	2.8	–1.5	–3.7	–7.2	–3.5
Net FDI inflows (% of GDP)	9.0	5.3	6.6	5.4	4.0
Total gross external debt (% of four-quarter rolling GDP)	47.7	48.3	53.7	59.7	63.8
Gross external debt of the banking sector (% of four-quarter rolling GDP)	7.4	12.5	20.2	22.8	24.2
Reserve assets (% of four-quarter rolling GDP)	23.4	19.7	21.2	18.2	16.3

Source: NBU, State Statisitcs Comittee of Ukraine.

[1] *January to June.*

by 20.3% year on year in the first quarter of 2009.[2] In an environment of collapsing domestic demand, inflation gradually came down and the current account – also supported by a 35% nominal effective depreciation of the hryvnia from September 2008 to March 2009 – adjusted rapidly. This correction, in turn – together with foreign exchange interventions, moral suasion and the imposition of some administrative measures by the National Bank of Ukraine (NBU), and the IMF support program in place – seems to have contributed to some currency stabilization in recent months. However, this stability remains tenuous, as witnessed by a depreciation of the hryvnia by about 15% against the U.S. dollar and the euro from early July to mid-September. The NBU cut key policy interest rates by 1 percentage point to 11% on June 15, 2009, and by 0.75 percentage points to 10.25% on August 12, 2009.

Table 2

Banking Sector Structure

	2005	2006	2007	2008	H1 09
Number of banks (of which partly foreign-owned), end-of-period	186 (23)	193 (35)	198 (47)	198 (47)	198 (51)
Total banking sector assets (% of four-quarter rolling GDP)	48.4	62.5	83.2	97.5	91,5[1]
Total banking sector capital (% of four-quarter rolling GDP)	5.8	7.8	9.7	12.6	11.9
Share of state-owned banks in total banking sector assets (%)	9.3	8.8	8.0	11.4	15.6
Share of foreign-owned banks in total banking sector assets (%)	19.0	32.0	37.2	46.5	47.0

Source: NBU, Raiffeisen Research.

[1] *First quarter.*

[2] *According to an estimate of the State Statistics Committee, Ukrainian GDP fell 18% year on year in the second quarter of 2009.*

Table 3

Selected Banking Sector Stability Indicators

	2005	2006	2007	2008	2009[1]
Credit risk					
Loans to the private sector (% of four-quarter rolling GDP)[2]	32.5	45.1	59.2	77.3	*75.8*
Real growth of loans to the private sector (annual change in %)	46.8	53.2	49.3	40.6	19.9
Real growth of loans to the private sector (exchange rate-adjusted, annual change in %)	0.0	0.0	48.4	9.9	−6.6
Loans to households (% of loans to the private sector)	24.9	33.4	37.6	38.2	35.6
Overdue and doubtful loans (% of total loans)	2.2	1.7	1.3	2.3	5.4
Nonperforming loans[3] (% of total loans)	19.6	17.8	13.2	17.4	29.9
Market and exchange rate risk					
Foreign currency loans to the private sector (% of private sector loans)	43.3	49.5	49.9	59.1	53.3
Foreign currency loans to households (in % of loans to households)	57.1	62.6	63.6	71.9	71.9
Foreign currency deposits of the private sector (in % of private sector deposits)	34.9	38.2	32.2	44.2	44.2
Deposit rate (% p.a.)[4]	8.5	7.6	8.2	9.9	*15.9*
Lending rate (% p.a.)[4]	16.0	15.1	13.9	17.6	*27.0*
Liquidity risk					
Private sector deposits (% of four-quarter rolling GDP)	30.1	33.9	38.8	37.6	*33.1*
Real growth of private sector deposits (annual change in %)	45.1	24.4	30.2	4.4	−14.6
Real growth of private sector deposits (exchange rate-adjusted, annual change in %)	0.0	0.0	29.3	−12.1	−29.2
Loan-to-deposit ratio (%)	108.0	133.1	152.6	205.5	226.6
Liquid assets (% of total assets)	23.3	20.1	19.7	14.1	14.8
Liquid assets (% of short-term liabilities)	40.2	37.8	39.9	33.0	32.6
Short-term liabilities (% of total liabilities)	58.1	53.1	49.3	42.7	45.3
Banks' external liabilities (% of banks' total liabilities)	13.6	21.4	28.1	32.8	29.8
Share of short-term external debt (% of banks' total external debt)	50.5	45.9	37.9	23.7	*17.6*
Profitability					
Return on assets (ROA, %)	1.3	1.6	1.5	1.0	−3.3
Retun on equity (ROE, %)	10.4	13.5	12.7	8.5	−24.5
Cost-to-income ratio (%)	63.8	58.1	58.4	50.1	49.6
Shock-absorbing factors					
Capital adequacy ratio (%)	15.0	14.2	13.9	14.0	14.5
Specific provisions to nonperforming loans (% of total loans)[3]	4.9	4.1	3.5	5.2	8.9
Specific provisions to nonperforming loans (% of nonperforming loans)[3]	25.0	23.1	26.3	29.6	29.8
Memorandum item					
Direct cross-border loans to the nonbank private sector (% of four-quarter rolling GDP)[5]	13.3	15.3	14.8	24.2	*24.4*

Source: NBU, IMF, IFS, OeNB calculations.

[1] *June 2009, figures in italics: March 2009.*
[2] *The private sector comprises households and enterprises.*
[3] *According to IMF calculations. Nonperforming loans are those classified as substandard, doubtful and loss.*
[4] *Weighted average over all maturities.*
[5] *Excluding trade credit.*

2 Banking Developments during the Global Financial Crisis

2.1 Strong Credit Boom (up to late 2008)

The very swift Ukrainian banking sector expansion in recent years was driven by the favorable pre-crisis domestic and external environment and by strong pent-up demand for banking services. Domestic loans to the private sector increased from about one-third of GDP at end-2005 to over three-quarters of GDP at end-2008. In addition, direct cross-border loans (excluding trade credit) to the private sector almost tripled in U.S. dollar terms during this period and reached one-quarter of GDP at end-2008. As the banking sector's external debt also rose sharply, foreign liabilities grew to about one-third of the banking sector's total liabilities at end-2008. Foreign-owned banks increasingly penetrated Ukraine: Their share in total sector statutory capital rose from about 20% at end-2005 to 37% at end-2008. Lower interest rates on foreign currency loans, incentives to exploit the interest rate differential provided by the de facto peg of the hryvnia to the U.S. dollar and capital inflow-induced appreciation pressures contributed to the increasing dollarization of lending in Ukraine. Driven by retail (notably mortgage) lending, the share of foreign currency loans (mostly U.S. dollar-denominated) to the private sector rose from an already relatively high level of 43% to almost 60% in the period of observation.

The sheer speed of the credit boom heightened credit risk and strained banks' risk management practices, while the currency composition of loans reflected high and rising foreign exchange risk (indirect credit risk), particularly with respect to unhedged borrower households. Increased dependence on foreign funding (including, in particular, funding by nonparent sources) left Ukrainian banks more sensitive to balance sheet and liquidity risks triggered by external shocks. Soon after the outbreak of the U.S. subprime crisis (August 2007), bank and corporate eurobond issuance dried up in Ukraine; banks' external funding shifted to loans, mostly from parent banks, and slowed down. The loan-to-deposit ratio skyrocketed to around 200% in 2008.

2.2 Serious Repercussions of the Global Financial Crisis (since late 2008)

The strong impact of the global financial crisis on the Ukrainian economy weakened the environment for banking. Although Ukraine was shut out of international capital markets, direct credit lines, predominantly stemming from parent banks and corporations, were largely rolled over. In this fragile situation, bad corporate governance apparently contributed to a run on the sixth-largest Ukrainian bank in October 2008, which was quickly reined in by a substantial NBU liquidity injection (about EUR 700 million). Given the high proportion of foreign currency loans in the Ukrainian banking system, the sizeable depreciation of the hryvnia in the final months of 2008 led to significant deterioration in the repayment of loans. All these factors gave rise to a general loss of confidence in banks, which triggered a drain of about one-fifth of private sector deposits (over one-quarter of hryvnia-denominated deposits and almost one-fifth of foreign currency-denominated deposits) between end-September 2008 and end-March 2009.

The stabilization of the Ukrainian currency in the early months of 2009 as well as the NBU's resort to a package of

banking-related emergency measures helped to (temporarily) stabilize the situation in the Ukrainian banking sector: Large-scale liquidity support comprising refinance credits amounting to some 7.5% of GDP was extended by the NBU. Controls were imposed on the withdrawal of time deposits ahead of the respective maturity date (these controls were lifted in May 2009), tight restrictions applied to retail as well as wholesale foreign currency lending, reserve requirements were effectively eliminated and the deposit guarantee level was adjusted from EUR 5,000 to EUR 15,000. Thus, the drain of private sector deposits was stopped in March and April 2009 and there have been some modest deposit inflows since. From end-March to end-June 2009, private sector deposits increased by 0.7%, (or by 1.8%, after exchange rate adjustment[3])[4].

Banks' reduced funding, authorities' foreign currency lending restrictions and tighter lending standards, as well as the deep recession and the resulting lower demand brought credit growth to a halt in early 2009, with sharp contractions in consumer and mortgage lending. Total private sector credit contracted by 2.4% from end-2008 to end-March 2009 (or by 1.2% after exchange rate adjustment). While hryvnia loans have shown some timid signs of recovery since March 2009,[5] foreign currency-denominated loans have continued to shrink in recent months. Total private sector loans declined by 0.3%, from end-March 2009 to end-June 2009, but grew by 2.9% in exchange rate-adjusted terms. In a sign of rising liquidity preference, banks appear to be increasingly placing available liquidity in NBU correspondent accounts or investing it in short-term government bonds (OVDPs). Due to the sharp decline in deposits, the loan-to-deposit ratio rose further, reaching to the very high level of 226.5% by end-June 2009.

Given the depreciated hryvnia and the slump of Ukrainian economic activity, nonperforming loans (according to IMF calculations) doubled to 29.9% of total loans in the period from September 2008 to June 2009. During the same time, specific provisions to nonperforming loans more than doubled to 9% of total loans. Accordingly, profitability – already relatively feeble in earlier years – plunged into negative territory (June 2009: ROE –24.5%). Some recently imposed administrative restrictions may help stabilize the hryvnia, but effectively require banks to maintain an open foreign exchange position equal in size to their foreign-currency denominated loan loss provisions. In another reaction to the crisis, some banks have cut costs drastically, selling or shutting down retail branches and slashing staff.

The authorities' recapitalization program is linked to the IMF Stand-By Arrangement by some elements of structural conditionality, including the issuing of legislation laying out the terms of financial support to banks, the completion of diagnostic studies covering systemically important credit institutions, the formulation of problem bank resolution strategies and the adoption of legislative amendments associ-

[3] *Exchange rate adjustment implies that exchange rate effects which increase or decrease the stock of foreign currency-denominated credits expressed in hryvnia terms are eliminated from the calculation.*

[4] *However, in July and August 2009 Ukrainian households' hryvnia deposits were again flowing out of the sector against the backdrop of renewed depreciation expectations.*

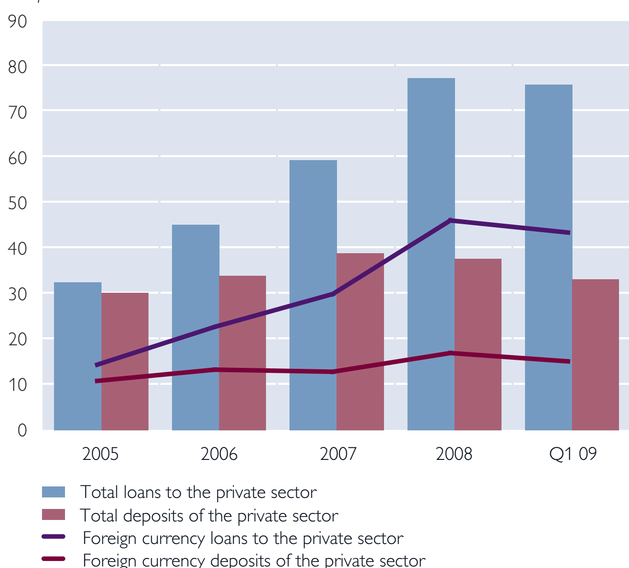
[5] *This recovery partly appears to be driven by stepped-up lending by state-owned banks to state-owned entities.*

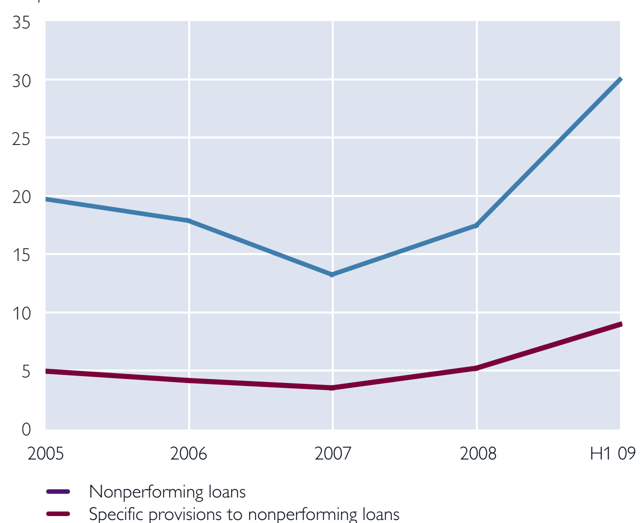
ated to the banking resolution measures and to the requirement to disclose the ultimate owners of banks. These conditions have been met. Outstanding issues include the implementation of consolidated supervision and the publication of detailed information on banks, in particular detailed balance sheets and income statements. No IMF funds are earmarked to finance the recapitalization program. To secure funding for recapitalizing banks, authorities requested an USD 750 million loan from the World Bank. All conditions for the first tranche of USD 400 million were fulfilled in late August 2009 and the disbursement will be made after approval by the World Bank Board of Directors.

Carried out in late 2008, the abovementioned diagnostic studies were based on stress tests assuming i.a. a 9% contraction of GDP, a 25% drop in house prices and a 30% hryvnia depreciation, and revealed large capital deficiencies in the banking sector (about EUR 4.4 billion, 38% of total banking sector capital at end-2008). In the light of more recent developments, the stress test assumptions appear to be somewhat optimistic. After the recapitalization of the two state-owned credit institutions in early 2009 (EUR 1.4 billion), shareholders of most private banks, including all foreign-owned banks, started to inject the capital deemed necessary. Accordingly, strong FDI inflows were recorded in April 2009. However, shareholders of five domestically-owned and systemically important banks[6] as well as of a number of smaller banks have been unable to raise, or initiate the raising of, additional capital. The authorities therefore

Chart 1

Banking Sector Developments since 2005





Source: NBU, IMF, OeNB calculations.

[1] *According to IMF calculations. Nonperforming loans are those classified as substandard, doubtful and loss.*

[6] *The technical criteria for defining systemically important banks were agreed upon by the Ukrainian authorities, the World Bank and IMF staff members.*

decided to take control of and recapitalize these five systemically important problem institutions (their recapitalization needs are calculated at EUR 2.3 billion, based on an update of the diagnostic studies' results). Smaller problem banks are to be resolved by bankruptcy, mergers and acquisitions procedures. In June 2009, the NBU put 15 banks into temporary administration. As a result, in the 12 months to end-June 2009, the share of state-owned banks in the sector's total assets almost doubled to 16%.

Box

Austrian Banks' Activities and Experience in Ukraine[1]

During the past five years, four banks operating in Austria (RZB, Bank Austria, Erste Bank and ÖVAG) have acquired subsidiaries in Ukraine in order to profit from the thriving Ukrainian economy. As of the end of the second quarter of 2009, those subsidiaries held total assets of EUR 10.5 billion (approximately 13% of the overall banking sector in Ukraine), which were made up primarily of loans. In the past, the Ukrainian banking market was characterized by a high demand for foreign currency loans, which was spurred by the quasi-peg of the Ukrainian hryvnia to the U.S. dollar. Austrian parent banks have provided the necessary hard currency funding, with the result that more than 60% of subsidiaries' loans were granted in foreign currencies. After the sharp depreciation of the hryvnia in the second half of 2008, foreign currency loans now account for more than 70% of the total value of loans.

At the end of the second quarter of 2009, Austrian banks' subsidiaries in Ukraine had issued loans to nonfinancial corporations and households worth approximately EUR 9.3 billion, while the cross-border direct lending exposure of Austrian parent banks to Ukrainian private nonbanks amounted to EUR 1.08 billion. Austrian subsidiaries' semiannual lending growth rates were in the double digits for 2007 and the first six months of 2008. In contrast, the second half of 2008 featured a marked slowdown in lending growth (+4.4% from end-June to end-December 2008 on a currency-adjusted basis), and the first six months of 2009 exhibited the first decline in gross loan books (–5.7% from end-December 2008 to end-June 2009, currency-adjusted), which reflects the cautious business policy of Austrian banks in the current situation. This is no peculiarity of Austrian subsidiaries in Ukraine, as the country in general constitutes an extreme case of rapid lending growth followed by a standstill in credit markets. However, Austrian banks have remained committed to their Ukrainian subsidiaries. This is i.a. evidenced by the fact that the amount of interbank lending from Austrian parent banks has slightly increased from EUR 4.599 billion in September 2008 to EUR 4.610 billion as at June 2009.

One reason for the careful stance of Austrian banks in Ukraine might be the deteriorating asset quality, which becomes apparent in the latest reports of their Ukrainian subsidiaries. During the first two quarters of 2009, the number of nonperforming loans increased sharply, reaching 10% to 20% of total loans, depending on the structure of individual banks' loan portfolios. The share of restructured loans is close to one-third of the entire loan book, as one Ukrainian subsidiary of an Austrian bank reports – a fact which bodes ill for the future path of nonperforming loans.

In the current crisis, Ukraine is presumably the most challenging market for Austrian banks in CESEE, because it is characterized by an extremely difficult macroeconomic situation combined with a complicated political environment. Moreover, the National Bank of Ukraine's efforts to stabilize the national currency at times create some regulatory uncertainty.

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3 Conclusion: Assessment of Current Risks

Looking ahead, a lot will depend on the further development of the external environment, especially with regard to external demand, terms of trade and external financing conditions.

3.1 Political Instability-Induced Risks

A clearly endogenous shock could be triggered by political turbulences in the run-up to the presidential elections scheduled for January 2010. The IMF Executive Board approved the release of the third tranche of the IMF standby credit in late July 2009; the next review, however, which will take place in November 2009, may be complicated by power struggles among political leaders. Should the disbursement be delayed (as in February 2009), a decline in market confidence in the hryvnia and renewed depreciation are possible consequences. After the recent stabilization of deposits, this could also lead to a renewed erosion of depositors' confidence in banks, triggering another round of withdrawals and heightening liquidity risk. Moreover, this would further increase already elevated indirect credit risk, given the prominent role of foreign currency-denominated loans in the Ukrainian banking sector. A shock (e.g. a further depreciation of the hryvnia plus another "wave" of the financial crisis) could also happen after the elections.

3.2 Severe Recession Compounds Existing Vulnerabilities

Even if there are no further shocks, the overall environment for banking sector activities will remain challenging in view of the severe recession the Ukrainian economy has entered. According to the latest forecast issued by the World Bank in mid-July 2009, real GDP will contract by 15% in 2009 (revised downward from –9%) and recover only hesitantly in 2010 (+1%). In such an environment, credit risk will rise further, owing to looming large-scale corporate defaults and households' strained debt-servicing capacity, given increasing unemployment and downward pressure on wages. Especially the corporate sector has to service both loans taken out at domestic banks as well as direct cross-border loans.

Foreign currency-denominated loans (more than 50% of private sector credit) are particularly exposed to default risk after the substantial depreciation of the Ukrainian currency, which points to elevated indirect credit risk. In this context, the high share of foreign currency-denominated credit to – probably mostly unhedged – households (more than 70% of total credit to households) is a special source of concern. The foreign exchange market and trust in the hryvnia remain fragile (as exemplified by the most recent bout of instability despite continuing exchange controls). All the factors mentioned imply a further deterioration in asset quality and nonperforming loans are expected to increase further. Debt restructuring – which was initiated in recent months and has, apparently, already produced some positive results – remains an important task for banks to counter defaults.

3.3 Important Shock-Absorbing Factors

While the outlook appears tough, the Ukrainian banking sector still boasts shock-absorbing capacities. So far, provisions have held their ratio to expanding nonperforming loans (with this ratio having even risen slightly from 26% in September 2008 to 30% in June 2009) and capital adequacy has remained on a satisfactory level (July 2009: 15.6%), thanks to the recapital-

ization measures already undertaken and to a tendency of shrinking assets. In recent years, the structure of banks' external liabilities has improved inasmuch as the share of long-term debt rose to 82% in March 2009. However, given the size of previous currency depreciation and the depth of the current economic slump, it cannot be excluded that additional systemically important credit institutions turn insolvent. Therefore, it is important that the authorities' recapitalization program remains on track. Its support by international financial institutions and the strong commitment displayed by foreign parent banks also represent key stabilizing factors. It is noteworthy that with the help of coordinated international support a systemic banking crisis in Ukraine has been prevented so far despite the depth of the overall economic and financial crisis, which is encouraging for the future notwithstanding the risks outlined above.

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