

Booming, but Risky: The Ukrainian Banking Sector – Hot Spot for Foreign Strategic Investors

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This paper gives an overview and assessment of the evolution of the Ukrainian banking sector since the outset of transition, focusing on the most recent developments. While the 1990s saw turbulent changes against the backdrop of continuous economic contraction, the Ukrainian banking sector has been on a strong expansion path ever since the turn of the millennium, a path which appears to have been only briefly interrupted by the minor crisis of late 2004 and early 2005. Although the National Bank of Ukraine has certainly improved banking regulations and supervision, the country's credit boom (sevenfold real increase of credit volume between 2000 and 2005, albeit from a modest base) has raised serious concerns about credit risks. Financial fragility continues to loom large in an environment where the practice of "pocket banking" (credit institutions acting as extended financial departments of owner firms) is still widespread. Over the past months, foreign strategic investors have started to move in: Led by Raiffeisen, which purchased the second-largest Ukrainian bank in October 2005, takeovers and business expansions have raised foreigners' share in total banking assets from 13% to 26% within a year. Austrians account for somewhat less than half of all foreign-owned banking assets in Ukraine.

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1 Introduction

This study outlines and assesses how the Ukrainian banking sector has developed since the outset of Ukraine's transition process, emphasizing the most recent developments. Throughout most of the 1990s, Ukraine's economic reform and banking sector development lagged behind Russia's and remained more strongly dominated by the state and former state banking institutions. However, the two countries have also displayed many similarities in the way economic agents and the authorities acted in (and reacted to) given situations at different points in time. Most recently, however, developments in the Ukrainian banking sector may have entered a strong acceleration process.

The study basically follows a chronological approach. Section 2 attempts to situate Ukraine in the "big picture" of banking transition, identifying two waves of banking reform in the country. Section 3 deals with Ukrainian banking developments in the momentous first decade of independence. The crisis of 1998 outlined in section 4 preceded a fragile recovery after the turn of the millennium (section 5), which was eventually followed by a credit boom, a politically triggered near-crisis, which was quickly defused, and persistent, serious vulnerabilities (section 6). Section 7 then focuses on the recent strong inflow of foreign direct investment (FDI) into the Ukrainian banking sector and its likely implications.

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As Austrian credit institutions were among the first to move into Ukraine and today are major Ukrainian players, section 7 features a box specifically dedicated to their experience. Section 8 finally contains a summary and conclusions.

2 Two Waves of Banking Reform

Empirical evidence shows that transition, as the author sees it, generally involves two waves of banking reform. Almost all transition countries have gone through or are still going through these distinct banking reform waves (Barisitz, 2006a). The same applies to the Ukrainian banking sector. The first reform wave was based on the abolition of central planning (including central credit and cash plans), on price and interest rate liberalization and the creation of a two-tier banking system. It was accompanied by a general and deep transitional recession, which lasted most of the 1990s. The first wave included the liberalization of bank licensing and initially lenient regulation. The Ukrainian authorities probably thought that these measures would kick-start competition in a sector otherwise dominated by the former specialized state banks inherited from the ex-socialist monobank system. As a consequence, the number of credit institutions in Ukraine multiplied from about a dozen in 1990 to 133 in 1992 and 230 in 1995.

The first reform wave typically has also included up-front recapitalization measures and so-called “surface privatization,” i.e. partial, insider or nonconventional privatization of credit institutions. In the case of Ukraine, ownership in former state-owned banks was transferred by having clients (mostly former state-

owned enterprises) take large stakes and by distributing shares to the employees of these client enterprises and of the banks themselves. This brought about a strong initial dispersion of ownership without attracting new funds, thus resulting in weak control of bank managers by owners. Important managerial decisions continued to be influenced by close relationships between bank managers and client firms as well as government agencies. Generally, measures taken during the first wave of reform, which most transition countries have completed at this point, have favored the continued existence of soft budget constraints and weak property rights, establishing a temporary, but not stable equilibrium.

New crises were just a question of time, and in many cases materialized in the late 1990s. These crises triggered new, partly painful, restructuring measures, which in the author’s view generally turned into a second wave of banking reform (encompassing crisis-induced resolution and recapitalization, the upgrading of regulation and supervision, the introduction of hard budget constraints in banking and in-depth privatization measures, which put in place strategic owners). In most transition countries, at least one large bank went under in the process, which signaled the strengthening of budget constraints. The second reform wave appears to have been completed in all Central European and in at least some South-eastern European countries (namely Bulgaria and Croatia). It seems to have progressed far or to be almost over in Romania and Kazakhstan, but is certainly still in full swing in Serbia, Montenegro, Russia and Ukraine. Countries like Belarus and Uzbekistan essentially still have both waves before them.

3 Banking Transition in the 1990s

At the outset of transition in Ukraine, the largest Ukrainian banks were the specialized institutions stemming from the split-up of the former Soviet monobank Gosbank, i.e.: Prominvestbank (specialized in industry financing), Bank Ukraina (agriculture), Ukrsotsbank (residential construction, etc.), Ukreximbank (foreign trade) and Oshchadny Bank (savings accounts; former all-Union Sberbank). Unlike the rest, the last two banks have remained in state ownership. Since the first wave of banking reform the majority of credit institutions – apart from the (former) state-owned banks – have been small or very small and have functioned as so-called “pocket banks” or “agent banks,” i.e. as extended financial departments of owner firms (similar to the development in Russia). Pocket banks have often engaged in connected lending.

Back in the early 1990s, gains from hyperinflation² – the price level jumped by over 10,000% in 1993 for example – and from currency arbitrage were among banks’ major profit sources. Up to the mid-1990s, directed credit programs remained prominent. Then they were officially abolished, and the Natsionalny Bank Ukraini (National Bank of Ukraine – NBU) and the government embarked on a macroeconomic stabilization program which was successful in bringing down inflation to double digits and stabilizing the exchange rate. Some efforts were made to

tighten prudential regulations and increase minimum capital requirements, after which the total number of banks started to level off (table 1).

Following monetary stabilization in 1995 and 1996 and the introduction of the national legal tender, the hryvnia, in 1996, Ukrainian banks looked for and found new sources of earnings: Like their Russian counterparts, they came to rely on the interbank market or on foreign loans (while funding via deposit accounts remained concentrated, to a large extent, in Oshchadny Bank), then turned to investing in the quickly expanding government treasury bill market. Treasury bills soon became the main instrument to cover budgetary gaps. Foreigners also participated in the seemingly risk-free market (Dean and Ivashchenko 1998, p. 140).

Throughout the second half of the 1990s, the Ukrainian banking sector remained quite small. Total banking assets in mid-1998 amounted to about 18% of GDP, which was much lower than in most transition economies and approximately corresponded to the total assets of a medium-sized commercial bank in a developed market economy. This reflected repercussions of the protracted and deep Ukrainian recession, the relatively slow pace of reforms and the lack of public trust in banks, which stemmed from losses suffered by the population during the hyperinflation period and from the general fragility of the sector. Deposit-taking did, however, increase after inflation had come down to two digit levels.

² Such gains could be achieved e.g. by asymmetrically adjusting deposit and lending rates for inflation.

Table 1

Ukraine: Macroeconomic and Banking Sector-Related Indicators (1991–2000)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP growth (real, %)	-11.6	-13.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9
CPI inflation (year-end, %)	161	2,730	10,155	401	181.7	39.7	10.1	20.0	19.2	25.8
Exchange rate UAH/EUR (period average) ¹	0.385	1.928	2.322	2.113	2.768	4.393	5.029
Exchange rate UAH/USD (period average) ¹	0.322	1.473	1.830	1.862	2.450	4.130	5.440
M2 (year-end, % of GDP)	..	50.0	32.5	26.7	12.6	11.1	13.3	15.0	16.6	18.5
Number of banks (of which foreign-owned, year-end)	..	133	211	228(12)	230(12)	229(14)	227(22)	175(28)	161(30)	154(31)
Asset share of state-owned banks (%)	13.5	13.7	12.5	11.9
Deposit rate (average, year-end, % p.a.)	160	209	70.0	33.6	18.2	22.3	20.7	13.7
Lending rate (average, year-end, % p.a.)	184	250	123.0	79.9	49.1	54.5	55.0	41.5
Domestic credit to the private sector (year-end, % of GDP)	1.5	1.4	2.5	7.8	8.6	11.2
Nonperforming loans (year-end, % of total loans)	34.6	34.2	32.5

Source: NBU, various EBRD Transition Reports, *wiiv*.

¹ Prior to 1997: Ukrainian karbovanets/ECU and Ukrainian karbovanets/USD, respectively; 1997–1998: UAH/ECU and UAH/USD, respectively.

Two banks founded in the early 1990s as private startups strongly and successfully expanded their activities: Bank Aval, which assisted the authorities in administering pension payments, and PrivatBank, which specialized in serving large enterprises in the industrial center of Dnepropetrovsk (east-central Ukraine) (Barisitz, 2000a, p. 773). Although explicit directed credit campaigns had been discontinued, there were ample signs that informal practices went on. According to banking professionals, many loans were “unofficial but ... unavoidable” preconditions for “favors” from the authorities (Luhovyk and Korchak, 1998, p. 16).

4 The Crisis of 1998

Shortly after the outbreak of the Russian crisis in August 1998, financial markets lost confidence in Ukraine, and the treasury bill market experienced large-scale withdrawals of funds, which contributed to strong downward pressure on the hryvnia and precipitated a fiscal crisis. Though severe, the consequences of the Russian crisis on the Ukrainian banking system did not lead to a collapse, like the one Russia experienced, for two

main reasons: First, the authorities reacted cautiously, averting immediate government default by swiftly entering into restructuring negotiations with treasury bill holders. The depreciation of the hryvnia was not quick and massive, but rather spread out over a longer time; therefore, it was easier for banks to continue servicing their foreign exchange liabilities or to initiate negotiations with creditors. Second, credit institutions were less exposed to investments in treasury bills and foreign currency debts than their Russian counterparts (in relative terms). Moreover, banks had incurred only modest direct exposure to Russia (Barisitz, 2000b, p. 83).

After increased withdrawals from a number of banks in the fall of 1998, the situation calmed down again. At least one major credit institution was subject to a financial rescue operation involving a restructuring of its activities and sizable NBU refinancing loans. A considerable number of smaller marginal banks had their licenses repealed and the total number of credit institutions declined to 175 at end-1998 and 161 at end-1999 (table 1). But no systematic cleaning-up operation was carried out, and the

overall state of Ukrainian banking remained precarious after the crisis; several larger banks remained undercapitalized, some probably insolvent. Enforcement of rules and regulations continued to be weak and selective. Still, one can argue that the reaction of the authorities to the 1998 crisis marked the beginning of a so far protracted second reform wave in Ukraine.

5 Fragile Recovery since the Turn of the Millennium

After a decade of uninterrupted economic contraction, 1999 represented a turning point and 2000 was the first year of a steep recovery. The depression in Ukraine had been even more pronounced than in Russia, but this also applied to its economic rebound, which accelerated to double-digit annual growth in 2004, before slowing down in 2005 and early 2006 (table 2). Apart from the base effect and plenty of excess capacities, some of the driving forces of Ukrainian economic expansion have been the following: After the financial crisis of 1998, as part of the general monetary easing, the hryvnia continued to decline throughout the following year, which favored import substitution (food and light industry). Strong rises in world market prices for some of Ukraine's prime exports (steel, chemical products) as well as a recovery of demand from Russia stimulated export-led growth in 2000. Both effects constituted major favorable terms-of-trade shifts for Ukraine and resulted in sizeable current account surpluses. Later on, salaries and pensions entered an upward trajectory, domestic demand gathered momentum and the impressive Ukrainian credit boom contributed to financing the expansion (Barisitz, 2006b, pp. 161–162).

On top of experiences gathered the hard way over the previous decade, the problems of chronic Ukrainian payment arrears for Russian oil and gas (on which the economy so strongly depends) and Russia's recurrent energy price adjustments and supply cuts may have added up to provoking a more general change of incentives for policymaking – an impulse with continuing impact. Whatever the case, a more reform-oriented government came to power in Kyiv in early 2000 and initiated important adjustments: Macrostabilization was strengthened and based on a U.S. dollar de facto nominal anchor for the hryvnia, and, for the first time since the collapse of the U.S.S.R., a balanced Ukrainian budget was achieved. Subsidies were cut, tax rules simplified and enforced. The authorities took steps to extend financial discipline to the energy sector. They accelerated privatization and dissolved former kolkhozes (collective farms). Moreover, they enacted a new banking law. Although the tenure of this administration proved relatively short, its successors did not generally reverse economic reforms and partly carried them on.

Notwithstanding the undercapitalized and precarious state of large parts of the banking sector, the significant monetary easing resulting from the 1998 crisis contributed to a pronounced recovery of banking activity in 1999. The new Law on Banks and Banking Activity became effective in January 2001 and served to strengthen the NBU's supervisory powers and to improve the regulatory environment for banks: It raised minimum capital requirements, streamlined licensing procedures and defined and extended the NBU's authority in rehabilitating or liquidating

Table 2

Ukraine: Macroeconomic and Banking Sector-Related Indicators (1999–2006) – Part 1

	1999	2000	2001	2002	2003	2004	2005 ¹	H1/2006 ¹
GDP growth (real, %)	–0.2	5.9	9.2	5.2	9.4	12.1	2.6	5.0
CPI inflation (year-end, %)	19.2	25.8	6.1	–0.6	8.2	12.3	10.3	6.8
Exchange rate UAH/EUR (period average)	4.393	5.029	4.814	5.030	6.024	6.609	6.389	6.067 ²
Exchange rate UAH/USD (period average)	4.130	5.440	5.372	5.327	5.333	5.319	5.125	5.050 ²
M2 (end of period, % of GDP)	16.6	18.5	22.1	28.5	35.3	36.4	43.4	..
Number of banks (of which partly foreign-owned, end of period)	161(30)	154(31)	152(21)	157(20)	158(19)	160(19)	164(23)	165(28)
Degree of financial intermediation (bank assets/GDP, %)	19.6	21.8	23.3	28.3	37.9	43.5	51.1	58 ²
Asset share of state-owned banks (end of period, %)	12.5	11.9	11.8	12.0	9.8	8.0
Asset share of foreign-owned banks (end of period, %)	10.5	11.1	12.1	12.3	12.1	13.0	21.4	26
Share of foreign capital in regulatory capital of banks (%)	..	13.3	12.5	13.7	11.3	9.6	19.5	21.1 ³

Source: NBU, various EBRD Transition Reports, IMF, Raiffeisen Zentralbank, wiw, author's calculations.

¹ Preliminary data or estimate.

² (January to) March.

³ May.

banks. After years of difficulties in trying to ensure greater compliance of the former state-owned Bank Ukraina (which served the agricultural sector) with prudential regulations, the central bank finally overcame political barriers and sent an important signal by allowing it to fail and deciding to liquidate it in July 2001 (Loehmus, 2002, p. 18). The resolution of Bank Ukraina was facilitated by the establishment of the Fund for the Guarantee of Deposits of Natural Persons in September of that year.

State-owned Oshchadny bank (or Oshchadbank – Savings Bank) had also suffered from the 1998 crisis, and a World Bank-supported rehabilitation plan for the undercapitalized institution was agreed upon and launched in 2000. Restructuring Oshchadbank has proved to be time-consuming and has yielded mixed results so far. The institution was saddled with a large portfolio of bad loans to loss-making state-owned enterprises and continued carrying out

rollovers. Given lack of progress, the World Bank suspended financial assistance to the project in 2004 (Dubien and Duchêne, 2005, p. 54), but the following year, World Bank support was resumed.

Increasing competition has contributed to losses of market shares for Oshchadbank (while still the fourth-largest credit institution at end-2003, it only ranked seventh by March 2006) and for state-owned Ukreximbank, as well as for former state-owned banks saddled with dubious claims, e.g. Prominvestbank (the third-largest) and Ukrsootsbank. The two big private credit institutions unburdened by the past, PrivatBank and Bank Aval, became the largest banks of the country (table 4). It would appear that these two private banks were “co-opted” into the handful of “system banks,” which reportedly benefit from a special relationship with the authorities. All of these system banks feature among the top ten Ukrainian credit institutions

(table 4).³ As of mid-2006, there were still 165 banks in the country (table 2). Particularly the smaller ones continued to act as pocket banks of enterprise groups/conglomerates whose ownership structures have often been difficult to detect, notably where ownership has been “layered” or “packaged” through several companies or entities (IMF, 2003, p. 7). Many of these smaller banks typically tend to be single-branch institutions.

6 The Ukrainian Credit Boom, the Near-Crisis of Late 2004/Early 2005 and Persisting Vulnerabilities

Ukraine has recently experienced a credit boom fed by strong economic growth (since 2000), a credible exchange rate anchor which stabilized expectations, a (further) decline of inflation, which bolstered confidence, strong money demand growth, which paved the way for rapid remonetization and the structural reform initiatives of 2000 and 2001, which contributed to altering incentives for banking. But the most important driving force was the huge accumulated catching-up potential of the economy. While annual growth of commercial bank credit to the economy gathered momentum until 2003, when it reached a hefty 55% (in real terms), it decelerated sharply in 2004 (to 18%), but re-accelerated again in 2005 (to 41%) and in the first half of 2006. This equals an average annual growth rate of over a third since 2000 or a sevenfold real increase in six

years – albeit from a very modest point of departure (table 3).

The sudden deceleration in 2004 happened mostly in the second half of the year and was largely caused by politics: First, inflation picked up again in the wake of a relaxation of fiscal policies in the run-up to the presidential elections as well as in response to emerging capacity bottlenecks.⁴ This put the hryvnia exchange rate under pressure, triggering market interventions by the NBU. Then, political instability in connection with the tumultuous presidential election and change of government of November and December 2004, combined with the existing fragility of confidence in the banking sector, gave rise to a minor banking panic. Pressure on the currency increased and depositors, mostly in eastern Ukraine, stepped up withdrawals from bank accounts and changed their money into foreign currencies. Capital flight gained momentum. At their peak in early December, withdrawals attained 17% of total Ukrainian household deposits. The outflow of deposits caused banks to curtail growth of credit activity.

The NBU reined in the impact of these runs with a package of measures combining administrative restrictions on withdrawals, stabilization credits to some banks and stepped-up foreign exchange interventions. The latter altogether reached about EUR 2.5 billion (over the period from September to December 2004), draining around a quarter of the foreign exchange re-

³ These “system banks” are understood to include: Oshchadbank (savings), Prominvestbank (industry), Ukreximbank (foreign trade), Ukrsofsbank (construction), Bank Aval (pensions), PrivatBank (Dnepropetrovsk) (see Berger, 2004, p. 4).

⁴ Inflation rose from 8% in 2003 to 12% in December 2004 and further to 15% in August 2005 (year-on-year). Since then it has been receding again (to 7% in June 2006).

Table 3

Ukraine: Macroeconomic and Banking Sector-Related Indicators (1999–2006) – Part 2

	1999	2000	2001	2002	2003	2004	2005 ¹	Q1/2006 ¹
Deposit rate (average, end of period, % p.a.)	20.7	13.7	11.0	7.9	7.0	7.8	8.5	..
Lending rate (average, end of period, % p.a.)	55.0	41.5	32.3	25.4	17.9	17.4	16.2	15.7
Deposits (volume of deposits/GDP, end of period, %)	9.6	11.4	12.8	16.9	23.4	24.1	31.7	..
Credit (credit volume/GDP, end of period, %)	9.0	12.4	14.5	19.4	26.6	27.1	35.3	44.0
Credit growth (real, CPI-deflated, %)	24.2	36.0	34.5	48.1	54.5	18.5	41.0	49.0 ³
Share of nonperforming loans in total loans (%) ²	35.8	29.6	24.6	21.9	28.3	30.0	23.1 ³	..
Specific provisions/nonperforming loans (%)	..	38.4	39.2	37.0	22.3	21.1	23.5 ³	..
Return on equity (%)	8.7	-0.5	7.5	8.0	7.6	8.4	10.4	12.8 ⁴
Capital adequacy (capital/risk-weighted assets, %)	19.6	15.5	20.7	18.0	15.2	16.8	15.0	14.5 ⁴

Source: NBU, various EBRD Transition Reports, IMF, Raiffeisen Zentralbank, author's calculations.

¹ Preliminary data or estimate.

² IMF estimate; rise in nonperforming loans in 2003 partly due to new classification rules.

³ June (year on year).

⁴ May.

serves the NBU had held at the time. By February 2005, calm had been largely restored; pressures on the currency subsided, restrictions were lifted, bank accounts and reserves were filling up again (Astrov, 2005, p. 105). In short, the banking system had weathered the political turmoil reasonably well.

But the slowdown of credit expansion had carried over into the first months of 2005.⁵ Next to this slowdown, the temporary decline or stagnation of world market prices for key Ukrainian export goods (particularly steel and chemicals) as well as the economic uncertainty emanating from the new government's confusing re-privatization strategies and disputes contributed to the pronounced reduction of economic growth in 2005 (Barisitz, 2006b, pp. 162–163).

The current account balance deteriorated. Still, by the second half of the year, bank lending had resumed its high pre-crisis rate of expansion. The share of long-term loans (with maturities of more than one year) in total loans increased from below 50% in early 2005 to over 60% toward the end of the year. Lending as well as other banking activities appear to have further accelerated in the first months of 2006.

The loans-to-GDP ratio almost quadrupled from 9% in 1999 to 35% in 2005, a development which represented one of the most rapid expansions of this kind so far registered in transition economies (possibly only trumped by Kazakhstan) (table 3). The share of household loans in total loans grew from a couple of percentage points to over one-fifth. Like in

⁵ In the first half of 2005, real credit expansion came to 20% (year-on-year), which was only slightly higher than the comparatively low real credit growth rate in the year 2004 (table 3).

other transition economies, (hitherto non-existent) auto and mortgage loans as well as credit card lending have begun to multiply. The lion's share of the credit expansion has been financed by deposit growth. At the same time, credit institutions have also been acquiring growing foreign liabilities. The assets-to-GDP ratio more than doubled from 20% at end-1999 to 51% at end-2005 (table 2).

The credit boom has raised serious concerns about credit risk in the banking sector: While there is no doubt that the increase embodies a long-awaited real convergence process, Ukraine's loans-to-GDP ratio has reached a level well within the average range of the more advanced transition countries (like Poland or Bulgaria) and above average for transition countries whose institutional quality in the banking sector is similar to Ukraine. Moreover, any lending boom of a similar scale can be problematic because risk assessments of individual loans tend to suffer in times of very dynamic loan growth (Schaechter, 2004, p. 21).

While the economic recovery helped credit institutions overcome some of their problems, many banks remained in relatively weak financial conditions. Despite the new banking law, insider lending practices continued, and according to IMF estimates, 23% of total loans were nonperforming in mid-2005 (table 3). However, based on a survey of March 2004, the NBU estimated that 94% of loans classified as "substandard" (a subcate-

gory of nonperforming loans) were being serviced timely. Excluding them from nonperforming loans would yield an estimated rate of 7% of loans overdue (Ong et al., 2005, p. 72). Given the overall stability of the exchange rate in recent years as well as the prevailing hryvnia appreciation pressures and lower interest rates on foreign exchange loans, taking up foreign exchange loans has been quite popular, if risky: In early 2006, over 40% of all credits were denominated in foreign currency (about 85% of the latter in U.S. dollars, 13% in euro), and many of them were extended to unhedged borrowers.

The buildup of capital and provisions has not kept pace with credit expansion, and the capital adequacy ratio has tended to decline moderately; only 2004 saw an interruption of this trend, which was probably related to the temporary slowdown in credit growth. Ukrainian banks' profitability has remained below the levels observed in other transition economies. However, most recently (2005 and early 2006), return on equity (ROE) has risen despite a further decline in interest rate margins (lending minus deposit rates).

The EBRD's index of banking sector reform⁶ in Ukraine came to 2.0 for the period of 1999–2001, then improved to 2.3 for 2002–2004, and 2.7 in 2005. In the same period (1999–2005), the index indicating Russia's banking reform progress rose from 1.7 to 2.3. The EBRD index for

⁶ This indicator measures reform progress by the liberalization of interest rates and the credit allocation process, the volume of lending to the private sector, private ownership in the banking sector, the level of competition between banks, bank solvency, the establishment of a framework for regulation and prudential supervision. The indicator can take values between 1 and 4+, with 1 representing little progress, and 4+ corresponding to full convergence of banking laws and regulations with BIS standards and a full set of banking services (EBRD, 2004, p. 200).

Bulgaria advanced from 2.7 to 3.7, whereas Poland's track record is 3.3 versus 3.7. Notwithstanding its impressive advances in financial deepening, Ukraine is still seen to be trailing substantially behind some new EU Member States and acceding countries in terms of the depth of banking reforms so far achieved.

To counter weaknesses in capitalization and to stimulate consolidation, the NBU raised the minimum capital adequacy ratio from 8% to 10%, effective from March 2004. Foreign currency loan loss provisions and limits for related party lending were tightened. In late 2005, the NBU raised regulatory capital requirements for certain operations including foreign exchange transactions and external borrowing, and gave Ukrainian credit institutions a deadline until end-2006 to comply with the new requirements. This will probably exert some consolidation pressure on a number of weakly capitalized smaller banks.

Yet, various areas need to be further strengthened: banks' corporate governance and risk management capacities, creditor and property rights, the court system, transparency and banking supervision. The latter still seems to rely on highly formal methods instead of more risk-based approaches. Given the vulnerable environment and the long-standing ban on opening foreign bank branches (also observed in Russia), it is not surprising that – despite the boom – foreign banks' presence has remained modest until most recently. As of end-2004, there were 19 credit institutions in Ukraine in which foreign owners held majority stakes (many of them Russian); together, they accounted for about one-eighth of total banking assets. Of the for-

eign-owned banks, only Raiffeisenbank was among the ten largest banks of the country. ING Bank, Citibank Ukraine and HVB Bank Ukraine ranked among the top 20.

Should economic growth remain subdued for a prolonged period or should there be a new economic downturn (which could be provoked by delayed repercussions of the sharp increase in gas prices at the beginning of 2006, by further energy price adjustments or by another deterioration of the terms of trade), this could feed through into higher loan impairment levels.

7 Strategic Investors Move In

Despite (or perhaps because of) the challenging situation, some EU credit institutions have recently made important acquisitions in Ukraine. In doing so, these strategic investors have certainly banked on the size and still rich expansion potential of the Ukrainian market as well as its proximity to the European Union. A major incentive for investors is the fact that Ukraine is one of the few transition economies in which some large enterprises and credit institutions are yet to be privatized. The investors have thus been attracted by the (so far) relatively low level of competition and the generous profit prospects offered by Ukraine. Moreover, they have probably also expected positive long-term effects of the "Orange Revolution."

The pioneer among strategic investors was RZB (Raiffeisen Zentralbank), which had already been present in Ukraine with a subsidiary: In late August 2005 Raiffeisen International Bank Holding AG concluded negotiations on the takeover of 93.5% of the country's second-largest credit institution, Bank Aval, for a price of

Table 4

The Top Ten Banks in Ukraine (measured by their total assets, as at March 2006)

Rank	Credit institution	Majority owner (share in %) ¹	Total assets (EUR million)	Share in total banking sector assets (%)	Balance sheet capital (EUR million)	Number of branches
1	PrivatBank	private Ukrainian investors	3,826	11.5	380	2,005
2	Bank Aval	Raiffeisen International (93.5)	3,215	9.6	305	1,342
3	Prominvestbank	private Ukrainian investors	2,355	7.1	232	737 ³
4	Ukrsibbank	BNP Paribas (51)	1,859	5.6	157	921
5	Ukreximbank	state-owned	1,820	5.5	183	80 ³
6	Ukrsotsbank	Banca Intesa (85) ²	1,795	5.4	175	518
7	Oshchadbank	state-owned (savings bank)	1,601	4.8	131	6,500
8	Raiffeisenbank Ukraine	OTP ²	1,224	3.7	117	39 ³
9	Nadra	private Ukrainian investors	1,032	3.1	117	479 ³
10	Brokbiznesbank	private Ukrainian investors	792	2.4	100	146

Source: Association of Ukrainian Banks.

¹ As at mid-2006.

² Deal yet to be finalized.

³ December 2005.

EUR 850 million (USD 1.03 billion), which reportedly corresponds to a multiple of book value of 3.6.⁷ The acquisition was finalized in October 2005. It raised foreigners' share in Ukraine's total banking assets from 13% to around 21% (table 2) and signaled an improvement of the weak investment climate. The same goes for the successful re-auction of the large steel company Kryvorizhstal for almost EUR 4 billion to the British-Indian Mittal corporation in October 2005. These lavish FDI inflows replenished the country's foreign currency reserves.

A spree of banking takeovers ensued: In December 2005, BNP Paribas agreed on the purchase of 51% of Ukrsibbank (Ukraine's fourth-largest credit institution) for a price of EUR

420 million. In February 2006, Banca Intesa agreed to pay around EUR 900 million (about 5.2 times the corresponding book value) to buy 85% of Ukrsotsbank (the sixth-largest bank). However, the deal has not yet been finalized. In March 2006, Crédit Agricole announced the takeover of 98% of Indexbank, a medium-sized bank (ranked 25th; price of acquisition: EUR 220 million). In June 2006, OTP (Országos Takarekpenztar es Kereskedelmi Bank, Hungary) and Raiffeisen International arranged the sale of Raiffeisenbank Ukraine for EUR 650 million to OTP (table 4, see box below). In mid-July, Eurobank, the second-largest Greek bank, announced its acquisition of a 99% stake in Universal Bank, a smaller bank. Just two weeks later, Erste

⁷ This figure as well as other announced prices and multiples of book values published in the media and/or on banks' websites and mentioned below correspond to the pecuniary part of respective contracts. The money paid, however, does not necessarily cover the entire transaction, which may include nonpecuniary components (job guarantees, investment pledges, assumption of contingent liabilities, etc.).

Austrian Banks' Activities in Ukraine

Austrian banks were among the earliest to enter the Ukrainian market. They initially chose greenfield startups. Raiffeisen Zentralbank opened a representative office in 1994, which became a subsidiary under the name Raiffeisenbank Ukraine in 1998. In 1997, Creditanstalt Ukraine started business. In 2000, Bank Austria-Creditanstalt (BA-CA) and the Hypo-Vereinsbank (HVB) Group (of Germany) merged, which brought the takeover of BA-CA Ukraine by HVB. BA-CA Ukraine thus ceased to be an Austrian credit institution and was renamed HVB Bank Ukraine. Whereas Raiffeisenbank (and BA-CA Ukraine) initially had concentrated on serving international and Austrian firms active in Ukraine (including startups), it later broadened its range of activities to include cooperation with big Ukrainian commercial clients. Later on, the small but booming consumer credit sector became a major focus of attraction.

Thanks to strong organic growth, Raiffeisenbank Ukraine was the eighth-largest bank of the country by early 2006. Raiffeisen's acquisition of the second-largest credit institution, Bank Aval, more than doubled the number of Raiffeisen's branches and outlets across Central and Eastern Europe. In April 2006, Bank Aval was renamed Raiffeisen Bank Aval. Foreign banks' buoyant demand for Ukrainian credit institutions in the following months pushed up price-to-book ratios, which contributed to Raiffeisen's eventual decision to accept OTP's offer for Raiffeisenbank Ukraine in June 2006. Raiffeisen had originally intended to merge its Ukrainian subsidiary with Bank Aval, which would have created an outright market leadership position, but changed its mind and sold the subsidiary to OTP, due to apparent organizational difficulties in preparing the merger and to the attractive price (around 4.7 times the book value) offered.

Erste Bank's agreement of July 2006 to purchase a majority stake in Prestige Bank relates to a relatively small outfit reportedly founded in late 2005 by the former manager-owners of Bank Aval (the businessmen who had controlled Bank Aval prior to its acquisition by Raiffeisen). If one assumes this deal as well as OTP's acquisition to be finalized, as at early August 2006, the two banks in Austrian ownership active in Ukraine (Raiffeisen Bank Aval and Prestige Bank) together accounted for about 10% of the total assets of the sector (of which the overwhelming share goes to Raiffeisen Bank Aval). Thus, Austrians possess around 40% of all foreign-owned banking assets in Ukraine. Austrian banks' cost/income ratio came to about 55% in mid-2006, which is much lower than the sector-wide average.

The following details on the two banks are of interest (see also sections 3 and 5 and table 4): Bank Aval (founded in 1992), majority-owned (93.5%) by Raiffeisen International, boasted a share of 9.6% in total banking assets in March 2006 and possesses a dense network of branches (1,342) throughout the country. In 1994, Bank Aval had won a tender to service the State Pension Fund and the Ukrainian Post Office; in 1996 it won another tender to provide services to the State Customs and Excise Authority. Assisting in these institutions' transactions became a major focus of the bank's activities. Raiffeisen Bank Aval therefore commands a strong retail position. Once Erste Bank's purchase of 50.5% of Prestige Bank (total assets in mid-2006: EUR 99 million) is cleared by the Ukrainian and Austrian authorities, Prestige Bank is to be re-named Erste Bank Ukraine. In the next two years, at least 25 branch offices are to be established. The new owners aim at raising the bank's market share to 4% in the medium term (which would require a more than tenfold increase from its current level, 0.25%.)

Bank (of Austria) announced its agreement to acquire 50.5% of Prestige Bank (ranked 72th) for EUR 28 million and a pledge to invest up to EUR 117 million in the credit institution (Financial Times, 2006, p. 17). Foreign investors' share in total banking assets rose to about 26% in mid-2006. Increased FDI is certainly contributing to the enhancement of the sector's risk management practices and efficiency. In terms of this strong presence of foreign strategic investors, Ukraine has overtaken Russia, which is still dominated by a few large state-owned banks (particularly Sberbank, whose privatization is not imminent).

8 Summary and Conclusions

The paper provides an overview and assessment of the evolution of the Ukrainian banking sector since the outset of transition, focusing on most recent developments. The 1990s brought forth turbulent changes against the background of continuous economic contraction. In the early years of the decade, banks thrived on gains from hyperinflation and currency arbitrage, and subsequently treasury bills. The Russian crisis of August 1998 quickly spread to Ukraine, but cautious decisions by the authorities and reduced exposure on the part of Ukrainian banks averted financial collapse. A fragile recovery at the turn of the millennium eventually paved the way for a credit boom fed by accelerating economic activity, successful macrostabilization, rapid remonetization tendencies and structural reform initiatives. The boom brought a sevenfold real increase of the credit volume from (a very modest) 9% of GDP at end-1999 to 35% of GDP at end-2005, which bears witness to Ukraine's catching-up potential. The

share of household loans in total loans grew from a couple of percentage points to over one-fifth.

Although the authorities enacted a new banking law in 2001, subsequently strengthened regulation and supervision, and raised minimum capital adequacy ratios in 2004, many credit institutions remained in relatively weak financial conditions. Ukraine's credit boom was only briefly interrupted by the minor crisis of late 2004/early 2005, which was largely triggered by political instability in connection with the tumultuous presidential election and change of government of November and December 2004. Some local bank runs were quickly reined in by NBU measures which combined administrative restrictions on withdrawals, stabilization credits to some banks and foreign exchange interventions.

The (resumed) swift expansion of banking activity has raised serious concerns about loan risks. Financial fragility continues to loom large in an environment where traditional "pocket banking" (credit institutions acting as extended financial departments of owner firms) and connected lending are still widespread. Foreign currency lending came to 40% of total loans in early 2006. The build-up of capital and provisions has not kept pace with credit expansion. Various areas need further strengthening: banks' corporate governance and risk management capacities, creditor and property rights, the court system, transparency and banking supervision. The latter still seems to rely on highly formal methods rather than on more risk-based approaches. A potential new economic downturn (which might be triggered by a deterioration of the terms of trade) could

feed through into higher loan impairment levels.

But some of these weaknesses are being addressed microeconomically: Drawn by the size and still rich expansion potential of the Ukrainian market, as well as by expected long-term benefits of the “Orange Revolution,” foreign strategic investors have made major moves into the country over the past months: Led by Raiffeisen, which purchased the second-largest Ukrainian credit institution (Bank Aval) in October 2005, take-

overs and business expansions raised foreign investors’ share in total banking assets from 13% to 26% within a year. Among the new players are: BNP Paribas, Banca Intesa, Crédit Agricole and OTP. Austrian investors (i.e. Raiffeisen Bank Aval and the much smaller Prestige Bank, which was taken over by Erste Bank) have opted for acquisitive growth and account for approximately 10% of total banking assets in Ukraine, which is somewhat less than half of all foreign-owned banking assets.

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