

## **THE IMPACT OF THE BANKING CRISIS ON THE INVESTMENT CLIMATE IN UKRAINE**

Instability and uncertainty of legislation, vulnerability of private property, non-transparency of financial market and privatization processes, bureaucracy in state machinery and excessive intervention of government into economic life are the main reasons which make the integration of Ukraine into global financial system more complicated (ex. 1). They hamper the inflow not only of direct foreign investments but also the domestic ones into Ukraine, limiting the positive impulses toward creation of competitive economy.

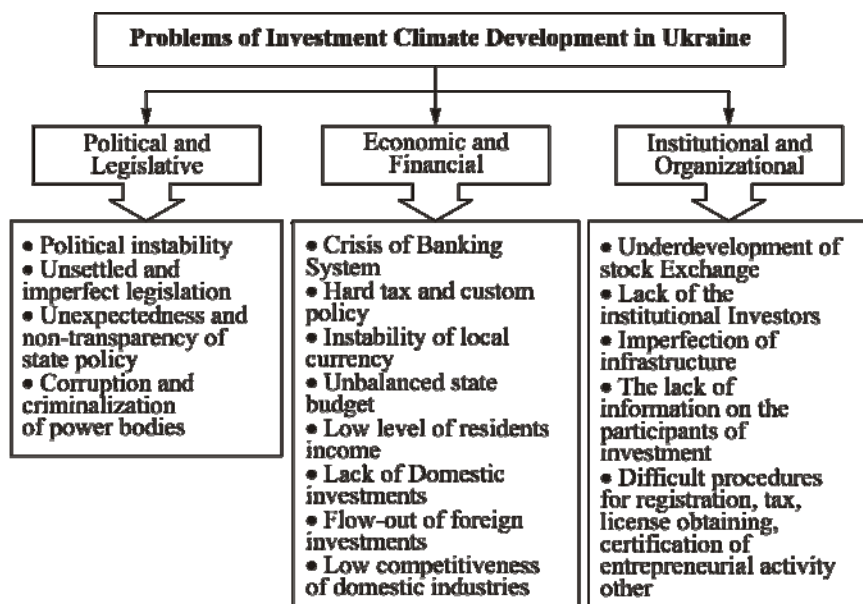


Exhibit 1. Problems of Investment Climate Development in Ukraine

There is a range of other factors which have the negative impact on improvement of investment climate in Ukraine. The most important of which are the following: The low level of capitalization of entities'

income and lack of economic (tax) stimulus for investments; Inefficient and unsystematic use of depreciation; Dissipation of budget resources and their usage mostly for consumption; Existence of the problem in corporate sector and vulnerability of investors' rights; Low market activity due to the fact that the most of the shares belongs to major holders, who are not interested in additional emissions; Lack of information about emitters of securities; The huge share of «black» business as the main source of accumulation and outflow of funds

As a result, the second part of 2008 and the beginning of 2009 showed negative tendencies in Ukrainian economy. Decline of production is observed almost in all areas of economic activity. In 2008 the total investments into the economy constitute 97,4 % of the previous, 2007, year level. The investments into the companies which work with mortgages, lease and other service for entrepreneurs decreased by 5,8 % and constituted 21 %. Investments into development of transport and telecommunication decreased by 17,6 %, into financial industry — by 11,8 %, into restaurant business — by 3,9 %, into the state administration — 5,9 %.

In 2008 the investments into agriculture and forestry increased substantially (42,3 % in 2008 vs. 18,4 % in 2007). The unit weight of such investments increased by 2,1 pct and constituted 7,1 %.

In the social activities the investment increased by 10,3 %, 13,0 %, and 6,7 % respectively into Science, medical services and housing and communal services

In 2008 investments into construction were UAH 35,5 billion, and this is by 119 % lower than in 2007. Their portion in total investments declines by 0,9 % and constitutes 15,2 %

The internal funds remained the main source of investments (56,7 %) (ex 1). The portion of credits and other attracted funds was 23 % in total volume of investments. At the cost of the state and municipal budget were used 9,2 % of capital investments. The portion of the residents funds for construction of the houses and apartments constitute 9,1 % of all investments.

As in previous years the most of investments were used for the development of industry (32,9 %). But in comparison with 2007 (table 2), the investments into fixed assets decrease by 5,3 %. This is because of lowering of investments into the processing industry (by 11,9 %), which constitutes almost 64 % of all investments into industry. Investments into mining and distribution industries went up 9 % and 15 % respectively.

Table 1

## CAPITAL INVESTMENT BY THE TYPES OF ECONOMIC ACTIVITIES

	Investments in 2008		
	mln UAH	as % to	
		2007	Total
<b>Total</b>	<b>233 081</b>	<b>97,4</b>	<b>100</b>
Agriculture hunting	16 890,1	142,3	7,2
Industry	76 617,7	94,7	32,9
Construction	12 469,1	106	5,3
Retail, repairing of cars, home appliance	24 694,5	109	10,6
Hotels and Restaurants	3221,9	96,1	1,4
Transport and Communication	32 558,4	82,4	14
Finance	4636	88,2	2
Mortgage, lease, engineering and other services to business	48 839,6	94,2	21
State administration	1819,4	94,1	0,8
Science	2321,7	110,3	1
Housing and communal services	5420,5	102,5	2,3

Source: calculated using the data [1]

In processing industry the most attractive for investing was paper industry and publishing and also chemical and petrochemical industries.

The negative tendencies were observed in metallurgy (reducing by 26,5 %), in production of other non-metallic mineral products (reducing by 15 %), in production of coke, processing of wood (reducing by 31,4 %) and light industry (reducing by 23,8 %). The portion of these industries in total volumes of investments constituted 48,7 %. Investments into the production of food & drinks, tobacco goods and machine building lowered by 9,6 % and 5,9 % respectively.

As for us the negative tendencies at the investment market are related to the crisis in the banking sector.

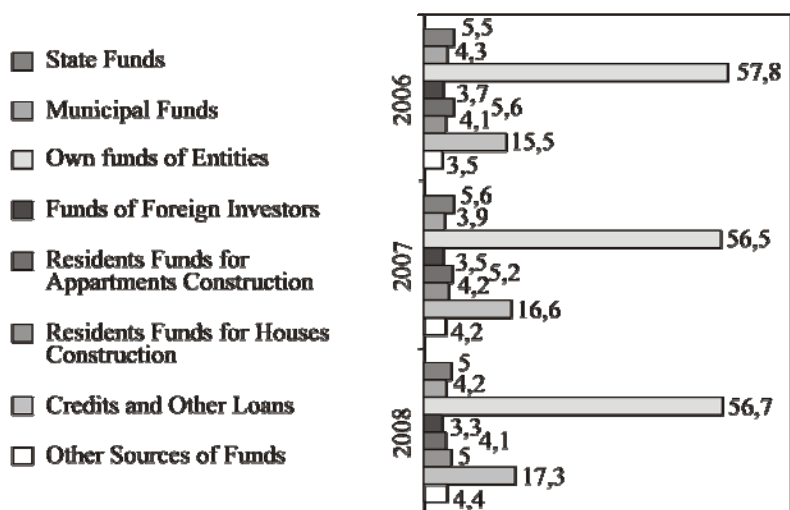


Exhibit 2. The Sources of Capital Investments

Source: calculated using the data [1]

At the end of 2008 the main indicators of banking activity (liquidity, profitability, and the quality of assets) went down. Substantial outflow of resources decreased the liquidity of the banks and increased the risk of their default. The regulator's actions did not help to solve the major problem of banks which was in resumption of trust to the banks, but these actions allowed a lot of banks to escape the defaults in those hard times.

In 2008 the banking credit programs for the corporations go up approximately in 1,5 times comparing to 2007. Now the interest rates for the credits to large companies are 20—25 % in UAH (a year ago they were 15—17 %). Bank loan for the small and medium size companies cost more than large ones: from 30 % to 50 % in UAH. But the borrowers which have revenues in foreign currency can receive loan at very attractive interest rate: 15—17 % in euro or US dollars (since December the banks have given loan in foreign currency for only the borrowers which have a stable foreign currency revenue).

Some banks use deposits as a collateral. The interest rate for such credits is higher by 1—3 percent points than the deposit rate. The advantages of such loans are obvious — they are cheaper than average: if the deposit rate is 18 % the credit rate is only 19—20 %. The average volume of loan is 65—90 % of the deposit. But the disadvantage

is that your money is frozen and you can obtain a half less as a credit. So such credits are popular only among businessmen which need short term loan (1—3 months) but have a long term deposit (a half or a year). In that case nothing is lost: the profit is the deposit interest for a year minus credit interest for 1-3 months.

Table 2

INVESTMENT IN THE CAPITAL ASSETS BY THE TYPES OF INDUSTRIES

	Investments in 2008		
	mln UAH	as % to	
		2007	Total
Industry	76 617,7	94,7	100,0
<i>Mining Industries</i>	<i>16 767,1</i>	<i>109,0</i>	<i>21,9</i>
<i>Processing Industries, Including</i>	<i>48 975,9</i>	<i>88,1</i>	<i>63,9</i>
Producing of food, drinks and tobacco goods	13 130,5	90,4	17,1
— Light industries	440,3	76,2	0,6
— Textile and fur industries	365,5	87,2	0,5
— Wood processing	768,0	68,6	1,0
— Paper and publishing industries	2558,1	112,6	3,3
— Coke industry, refining	2093,8	73,2	2,7
— Chemistry and petrochemistry	5106,6	112,5	6,7
— Chemistry	3500,2	115,7	4,6
— Rubber and Plastic Industry	1606,4	106,6	2,1
— Production of the other non-metal goods	7045,5	85,0	9,2
— Metallurgy and hardware	10 503,0	73,5	13,7
— Machine building	6189,3	94,1	8,1
Machine and other equipment production	1786,4	88,1	2,3
Production of electric, electric, electronic and optic equipment	1924,3	118,9	2,5
— Production of vehicle and equipment	2478,6	84,4	3,3
<i>Generation and distribution of electricity, gas and water</i>	<i>10 874,7</i>	<i>115,4</i>	<i>14,2</i>

Source: calculated using the data [1]

Deposits to the non-financial corporations constitute UAH 100 bln as for the end of March'09. According to the table 3 in agriculture sector the increment rate of deposit fell down to 5,6 %. Deposits of industrial corporations decreased by 4,2 %, and construction corporations' ones decreased by 25,6 %.

As for the terms of deposits the increment of the deposits within a year slowed down to 3,3 %, and the deposits with terms between 1 and 2 years decreased by 13,8 % and 12 % respectively. In March in comparison to February the non-financial corporations' deposit balances decreased by UAH 2,9 bln or by 2,8 % which was due mainly to the decrease of fixed term deposits. Greater decrease was observed at the long term deposit accounts (by UAH 2,3 bln), than at the short term ones, which was the evidence of the conservative behavior of corporations at the unfavorable economic times and the currency fluctuations. Long term deposits decreased almost in all type of economic activities.

*Table 3*

**DEPOSITS OF THE CORPORATIONS BY THE TYPES OF ECONOMIC ACTIVITY**

	Balances at the end of period in the total volume of deposits, %	Change year to year, %					
		2008			2009		
		June	Sep	Dec	Jan	Feb	Mar
Total	100	40,5	24,8	23,6	17,5	10,5	2,4
Agriculture	7,2	105,1	43,2	33,2	33,5	29,5	5,6
Industry	29,3	22,9	18,0	20,8	17,9	– 0,9	– 4,2
Construction	5,3	40,0	3,8	– 17,1	– 22,2	– 24,7	– 25,6
Other Activities	58,2	44,8	29,3	30,6	21,3	20,5	9,3

*Source:* calculated using the data [2]

The Balances at the deposits of households constituted UAH 1 934 bln as of the end of March'09. The deposit growth decreased by 5,8 % in March and by 11,8 % in February because of reducing susceptibility of the residents to deposits due to decrease in real incomes and increasing further uncertainty in economy. Decreasing of account balances in national currency continued (by 10,9 %) and in USD and

EUR 34,8 % and 24,2 % respectively. The increments in 1—2 year deposits decreased and constitutes 57,1 % and 13,4 % respectively. 1—2 year deposits reduced by 9,4 % .

The banking system had to limit the credit operation as well as to fight for survival either with external help which came mostly from National Bank or using the cost optimization. As a result the Ukrainian banking system was not a substantial source of investment resources for industry as it was in developed countries. Despite some strengthen of the role of bank credits, the participation of commercial banks in supplying economic development with financial funds is limited (table 4).

*Table 4*

**THE MAIN FIGURES OF UKRAINIAN BANKS CREDIT  
ACTIVITY (AS OF THE END OF THE PERIOD)**

Figures	2003	2004	2005	2006	2007	2008
GDP, UAH mln.	264 165	345 113	441 452	544 153	720 731	950 503
Volume of credits, UAH mln	67 835	88 579	143 418	245 226	426 863	734 022
Incremental Rate to the previous period, %	61	30,58	61,91	70,99	74,07	71,96
Ratio of Credits to GDP, %	25,68	25,67	32,49	45,07	59,23	77,22
Volume of sales in Industry in actual prices, mln	289 117	400 757	468 563	551 729	599 113	777 859
The role of credits in the production of industrial goods, %	23,46	22,10	30,61	44,45	71,25	94,36

*Source:* calculated by the data [3].

On the one hand the volume of credits continuously increases and it is UAH 734 bln as for the end of 2008, that is 71,96 % more than in previous year. But if we take a close look at the role of bank credits on the macroeconomic figures as GDP, industrial production volumes, we will see that the role of bank credits remains insignificant. In the period from 2003 till 2008 the portion of bank credit in GDP changed from 25,68 % to 77,22 %

By the types of economic activities (Table 5), the declining of economy was resulted in slowing down of credit growth: in the construction to 62,7 %, in the agriculture to 52,2 %, in the industry to 39,4 %. Comparing with previous month credits for the non-financial corporations increased by UAH 1,9 bln or by 0,4 % after two months decrease (by 0,3 % and 1,6 % in February and January respectively). The increase was mainly in transport (by 2,7 %), processing industry (by 1,7 %), agriculture (by 1,1 %) and construction (by 0,4 %) as a result of increase in economic activity.

The important issue is a quality of the banks credit portfolios. Problems with credit repayments make it impossible to repay the depositors, foreign partners especially taking into account the fact that long term credits as a rule were financed with short term resources. In accordance with the information provided by Ukrainian banks nowadays one of eight credits is a problem.

*Table 5*

**CREDITS GIVEN TO THE CORPORATIONS  
BY THE TYPES OF ECONOMIC ACTIVITY**

Figures	Balances at the end of period in the total volume of deposits, %	Change year to year, %					
		2008			2009		
		June	вересень	June	січень	June	березень
Total	100	55,4	50,5	70,3	64,4	58,2	50,6
Agriculture	6,6	49,4	54,0	76,3	72,4	61,6	52,2
Industry	26,8	48,0	43,9	60,1	57,5	45,0	39,4
Construction	9,4	83,3	67,6	85,4	72,8	74,8	62,7
Other activities	57,2	56,5	51,1	72,8	65,9	62,1	54,2

*Source:* calculated by the data [2]

According to the data in table 6 we can come to the conclusion that the largest increment of expired debts in December 2008 has Nadra Bank (64,69 %), Ukrsootsbank (61,81 %) and Forum Bank (52,41 %). Also OTP bank (44,27 %), PUMB (45,41 %) and Ukrrprombank (40,52 %) have a high temp of debts increasing. The lowest rate of individual bad debts increasing was observed in UkrgasBank (8,53 %)



and Swedbank (10,11 %). During the period Alfa-bank lowered expired debts by UAH 126 million or by 30,06 %.

*Table 6*

**THE STATE AND THE TENDENCY OF THE CREDIT PORTFOLIO  
OF THE BANKS COMPRISED THE «BIGGEST» GROUP IN ACCORDANCE  
TO NBU METHODOLOGY**

Bank	Credit Portfolio as of 01.12.2008 UAH mln	Credit Portfolio as of 01.01.2009 UAH mln	Growth Volume UAH mln	Rate of growth, %
UkrSibbank	46 611,01	50 412,43	3 801,42	8,16
PrivatBank	68 241,38	72 488,12	4 246,74	6,22
Raiffeisen Bank Aval	51 530,39	54 727,54	3 197,15	6,20
UkrSotsbank	40 280,99	43 688,70	3 407,71	8,46
Nadra	22 493,07	24 391,45	1 898,38	8,44
OTP Bank	14 957,74	31 241,44	16 283,70	108,86
Alfa-bank	25 517,53	28 037,19	2 519,66	9,87
VTB Bank	16 194,70	34 882,97	18 688,27	115,40
Finance and Credit Bank	14 743,64	15 739,84	996,20	6,76
Swedbank	12 665,58	13 999,42	1 333,84	10,53
Forum	15 449,74	16 861,62	1 411,88	9,14
First Ukrainian International Bank	14 153,92	15 412,28	1 258,36	8,89
Ukrgasbank	8 735,96	9 259,83	523,87	6,00
Ukrprombank	13 044,57	12 554,12	– 490,45	– 3,76
Oschadnybank	22 746,52	24 909,23	2 162,71	9,51
Prominvestbank	0	24 093,11	24 093,11	—
Brokbusinessbank	10 348,45	10 664,12	315,67	3,05
Ukreximbank	34 909,59	38 332,39	3 422,80	9,80

*Source:* calculated by the data [4]

In the group of the «biggest» banks the average rate of increment of sub-quality debts was 29,92 % as for 1st Jan 2009. So the quality of credit portfolio of OTP Bank slightly became worse — only by 10,6 %.

The table 7 shows us the deterioration of the quality of the credits portfolio for individuals in the bank which form the «biggest» bank group.

So the unit weight of expired and doubtful debts of individuals as for Jan, 1st has increased by 2,91 % in average and increased by 0,39 % during a month. The highest increment belongs to OTP Bank and Ukrsootsbank respectively 1,41 % and 1,21 % (December increment). The unit weight of expired and doubtful debt in VTB Bank is 2,85 % as for Jan, 1st and is not exceeding the average rate among the banks.

In order to regulate account payable the certain steps were taken, first of all by the regulators. The Decree of the NBU «On the some issue of bank activities» from 5 February 2009 #49 the procedure of problem credit restructuring was simplified. Nowadays banks are allowed to take decisions on the credit restructure for the individuals with taking into account their financial conditions. The alike subsidy NBU offered toward corporations by allowing prolonging credits without downgrading of borrowers.

Other steps were recommendations (under threat of penalties) not to increase the interest rates unilaterally, which provoked some complaints among bankers; and implementation of target currency auctions for the purpose to meet the needs of banks and individuals resulted from the necessity to pay down the debts denominated in foreign currency.

In the explanation letters NBU notify, that baseless increase of interest rates will be treated as a violation of the provision 49 of the law «On Banks and Banking» from 7th December 2000 #2121-III in the part of checking creditability of the borrower resulted in not paying interest and failing to return the principle of credits.

So the action of the regulators can be treated as a partial shift of the responsibility on the owners and the management and also as a attempt of NBU to avoid operating intervention (setting temporary administration) in the activity of some banks. Besides, weakening of the NBU control on the quality of the credit portfolio gives the opportunity to some banks to hide the real problems of the credit quality due to prolonging problem loans.

All the problems described above resulted in down grading of long run and short run sovereign ratings in foreign currency of Ukraine by S&P from «B/B» to «CCC+/C», and also long run and short run sovereign ratings in local currency from «B+/B» to «B-/C». The forecast is «negative».

Simultaneously the long run sovereign ratings were removed from the CreditWatch list with negative forecast, where they were put in on 16th Feb'09. The rating of expected default was confirmed at the level «4», which reflects the S&P assumption that the probability of repayment debts by Ukraine is 30—50 %. The assessment of the convertibility risk, which reflects probability of the National Bank or Government to limit the non-resident access to foreign currency for serving debts, was also decreased from «B+» to «CCC+». At the same time the ratings at national grade was lowering from «uaA+» to «uaBBB».

The forecast «Negative» for sovereign ratings shows that the ratings could be downgraded again if there will be delays on the debts repayments of the country and the difficult economic situation makes the government take the alternative steps to release cash flow before the election of the President in the beginning of 2010. The ratings also could be under the pressure of stress in the banking system, which can lead to nationalization of some banks. Vice versa the forecast for national ratings could be reviewed to the «Stable», if the government succeeds in the financial stabilization, which could be a base for a rehabilitation of economy in further years.

On the 12th of May this year the international agency «Moody's Investor Service» downgraded the long term liabilities rating of the Government in local and foreign currencies from B1 to B2. The forecast is «negative». As agency reports, the decision to downgrade the rating was taking because of deterioration of economic conditions in Ukraine and also the weakness of the banking system of the country.

According to the press release of Moody's the additional reasons to downgrade the ratings was uncertainty created by the NBU (National Bank) policy of regulation the movement of the capital aimed to limit turnover of the foreign currency. The Moody's analyst thought that such policy of NBU increased the probability of default of domestic borrowers in foreign currency.

Besides, Moody's decreased the ratings of marginal level of liabilities in foreign currency from Ba3 to B1, the marginal level of banking deposits in foreign currency from B2 to B3. The forecast on those ratings is «Negative». Also the rating for the marginal level of bonds in local currency was reduced from A3 to Ba1.

Creation of the favourable investment climate in Ukraine depends on the efficiency of usage of different implication instrument for the foreign investments into Ukrainian economy also including:

- ✓ The stability of national currency and rehabilitation of the banking system

✓ Introducing the mechanisms of Public Private Partnership for realization the investment projects which has a vital social importance  
✓ The stability of the legislative system and predictability of regulative steps

✓ Speeding up of the market transition of economy and further implementation of economic reforms

✓ Concentration of available resources in the industries with high priority for next transformation them into investments

✓ The reducing of the bureaucracy level and fight against corruption, deregulation of entrepreneurs' activity

✓ Attraction of investors on the terms of agreement conclusion for products distribution, concession, creation of industrial parks.

During development of the banking system as a whole, all the branches of power and NBU should be united. Development of the banking system is possible under the following conditions: Support of the stable development of the country; Elimination of disproportion in the structure and the temps of the development of the economy of Ukraine and its banking system; Conducting efficient macro policy; Balancing budget policy, which is based on the well-timed preparation and approval of the real budget and their fulfillment; Development of the systematic and complex legislation to avoid the conflicts; Development of the financial markets

The stability of the banking system greatly depends on the level and quality of management of risks which are inherent to the system. The main risk is a credit risk, particularly related to the operations with insiders. At the moment the bank's sensitivity to the other risks is substantially low, and they are not a great threat for the banking system. For the improvement of the reliability of it the following are needed:

⇒ Providing cash inflows to the banking system

⇒ Improvement of the quality of the assets

⇒ Increasing the profitability of the banks, also due to widening the list of non-risky operations

⇒ Optimization of cost structure and more reasonable approach toward interest and overhead expenses

⇒ Creation of conditions and assisting in organizing the viable system of universal banks

⇒ Consolidation the banking sector through the process of bank reorganization and creation of banking association

⇒ Providing the harmonious existence of the big, middle and small banks on the basis of the equality of requirements regarding following to the prudence control

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**Остапишин Тетяна,**  
канд. екон. наук, доцент,  
заступник завідувача кафедри банківської справи  
ДВНЗ «КНЕУ імені Вадима Гетьмана»

### ***ФОРМУВАННЯ РЕСУРСІВ БАНКАМИ УКРАЇНИ***

Достатня за обсягом та належним чином збалансована ресурсна база банків є важливою передумовою підтримки достатньої ліквідності, прибутковості та довіри з боку учасників ринку банківських послуг. Зміцнення ресурсної бази сприяє підвищенню можливостей окремо взятого банку та банківської системи в цілому у задоволенні поточних та інвестиційних потреб суб'єктів господарювання та домашніх господарств у додаткових фінансових ресурсах. В свою чергу, це сприяє активізації розвитку економіки та покращенню добробуту населення.

Однак на сьогоднішній день в Україні відчутний негативний вплив економічної кризи на формування ресурсної бази банків. Падіння ефективності виробництва, недостатній життєвий рівень населення та, як наслідок, низький рівень його платоспроможності; низький рівень монетизації економіки; невиконання банками договірних умов, а як наслідок падіння довіри до банків — все це