Reducing the Government's Share in the Banking Sector of Ukraine as a Way to Consolidate Liberal Reforms in the Country's Financial Sector

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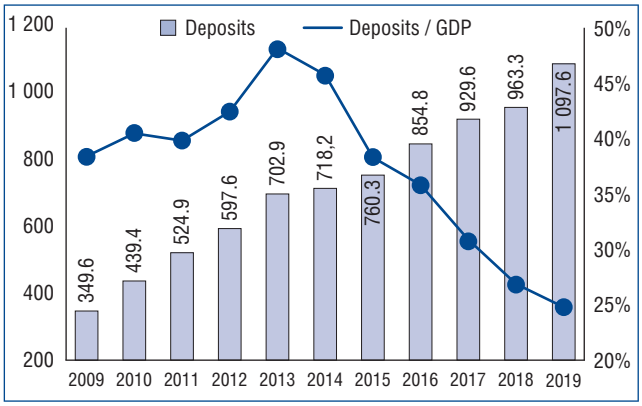
Ukraine's banking sector reforms from 2014 to 2019 produced rather ambiguous consequences for the country. On the one hand, there were positive achievements in supporting a relatively long-term macro-financial stability; in 2018-2019, Ukraine managed to significantly reduce the number of banks that leave the market due to bankruptcy. On the other hand, Ukraine's banking sector saw its diminishing role in financing the economy; the sector itself was overburdened with problem loans of previous years, while its consolidated efficiency indicators deteriorated due to increased share of state-owned banks in banking assets.

To restore the influence of banks on Ukraine's economic growth and consolidate macro-financial stability, Ukraine has to reduce the state participation in the banking sector and liberalise banking regulation. We believe that the future is with the liberal model of banking business regulation, as it is based on reducing involvement of the state in the banking sector and on minimising prohibitions and ineffective regulatory practices and procedures.

Dysfunction of the banking system. Much has been written about the achievements of banking reforms of 2014-2018. But some quite disastrous events linked to gradual dysfunction of Ukraine's banking system remain beyond the media and government organisations' attention. The analysis of data from 2009 to 2019 showed that the resource potential of the banking system in relation to GDP has decreased (Figure *Deposits (customer funds) in Ukrainian banks…*).[1]

In particular, during the reforms after the Revolution of Dignity (2013-2019), the ratio between bank deposits and GDP in Ukraine decreased from 48.3% to 25.0%. In practice, this means that Ukrainian banks in 2019 had about half as many resources relative to the scale of the economy than in 2013.

Deposits (customer funds) in Ukrainian banks (UAH billion) **and the ratio of deposits volumes to nominal GDP**
(%, right scale) (by year-end)

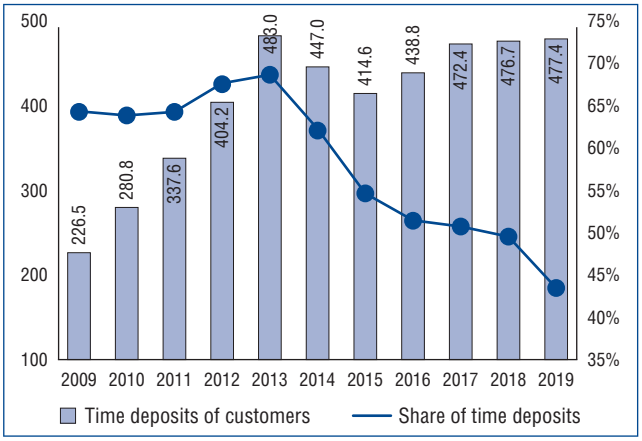


Objectively, such dynamics after 2013 can be explained by cleaning up of the banking sector from banks packed with junk and fictitious loans. But the

[1] Unless indicated otherwise, hereinafter the authors use the data from the official website of the National Bank of Ukraine (*http:/bank.gov.ua*). All estimates made by authors based on the NBU data.

banking crisis in Ukraine ended in 2017, and over the next two years, the resource potential of banks relative to the scale of the economy should have been growing. However, from 2013 to 2019, one could observe a steady downward trend in the quality of banking system's resource potential, which was measured by the share of time deposits in deposits of legal entities and individuals in existing banks (Figure *Time deposits and the share of time deposits in customer funds*).

Time deposits (UAH billion) **and the share of timel deposits in customer funds in Ukrainian banks** (%, right scale) (by year-end, disregarding the impact of legislative changes)



The above figure shows that from 2013 to 2019 the share of time deposits in banks reduced from 68.72% to 43.49%. During that period, there were legislative changes in the algorithm for identifying the maturity of deposits, but taking into account these changes, the share of time deposits in the banking system has fallen below 50%. That is, at the beginning of 2020, more than every second hryvnia in the bank accounts of legal entities and individuals were placed in on-demand accounts, which limited the volume of time deposit resources that could be used to finance businesses.

The fact that even 2 years after the banking crisis, quantitative and qualitative indicators of the banking sector's resource potential show a downward trend is quite alarming. In our opinion, one of the reasons for this is inconsistency between monetary policy and the policy of regulating the banking business by the NBU.

Specifically, the Law of Ukraine "On the National bank of Ukraine" has set a cascade of goals for the NBU, with achievement of price stability (low consumer inflation) being the primary goal and financial stability – the secondary one, followed by the issues of economic growth. This cascade of goals provided a legal basis for the NBU to focus on price stability and disregard the negative trends in the reducing resource potential of the banking system, which is a source of bank lending and investment in the real sector.

At the same time, over-regulation of the banking sector was a major reason for the reduction of resource potential:

- Rather conservative requirements for the calculation of reserves for lending transactions.
- Introduction of LCR and NSFR liquidity ratios, the support of which requires additional funds that cannot be used for lending. We believe that the NBU rushed to introduce new liquidity ratios, as there is no market for liquid non-government securities in Ukraine, and introduction of LCR and NSFR put Ukrainian banks on unequal terms compared with banks in EU countries where the markers of short-dated securities (bill notes) and bonds are quite developed.
- Faulty policy of reserving for foreign currency deposits and lack of incentives for banks to attract currency held by the population. According to various estimates, in early 2020 its volume ranged from 40 to 85 billion dollars.
- NBU's refusal to introduce separate regulations for large and small banks. As a result, small banks in Ukraine follow the same onerous rules of regulation and requirements for capital, liquidity and corporate governance as large banks.

Another important reason for the decline in the resource potential of Ukraine's banking sector was the increase of government involvement.

History and preconditions for increasing involvement of the state in the banking sector. Historically, after the denationalisation in 1990s, Ukraine's banking sector had two major players with a significant state's equity stake: Ukreximbank and Oschadbank. During the crisis of 2008-2009, they were joined by Ukrgasbank and Rodovid Bank, nationalised in 2009. Ukrgasbank has successfully survived to this day as a state-owned bank, while Rodovid Bank was set to become a "bad bank" – the recipient of bad assets. Eventually, it was sent down to the Deposit Guarantee Fund and liquidated.

The second stage of nationalisation occurred during the banking crisis of 2014-2016, when the government took over the largest bank in the country – Privatbank.

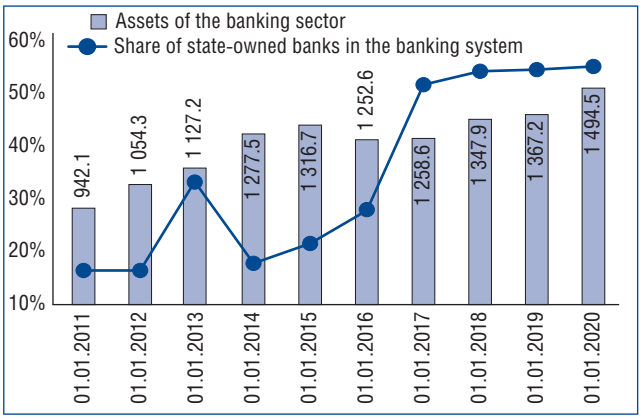
Until 2017, there was the state-owned Ukrainian Bank for Reconstruction and Development (UBRD), which in November 2016 was sold to Chinese investors. Over the past 5 years, the sale of UBRD was the only successful deal involving the bank with government stake. But the UBRD, established during Yanukovych's presidency, never started working – as of 1 January 2017, UBRD assets accounted for only 0.01% of the banking system.

The Settlement Centre was another public bank launched in 2013, but as of 1 January 2020, its assets accounted for only 0.3% of the total assets of Ukraine's banking sector. Just like UBRD in its day, this bank could not seriously affect the consolidated performance of the system and the consolidated indicators of Ukrainian public banks.

Dynamics of the share of public banks in the assets of Ukraine's banking system shows that it

reached its historical maximum in 2019 (Figure *Assets of the banking system of Ukraine and the share of state-owned banks in total assets*).

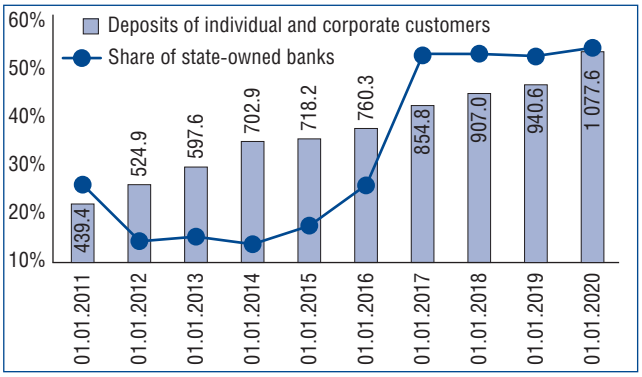
Assets of the banking system of Ukraine (UAH billion) **and the share of state-owned banks in total assets of the banking sector**
(%, left scale) (at the beginning of the year)



As of 1 January 2020, 55.2% of the banking system's assets belonged to public banks. A significant increase in the share of state-owned banks (from 28.0% to 51.6%) occurred in 2016 after the nationalisation of Privatbank. Three years after, the situation has not changed, as the share of banks controlled by the Ukrainian government continued to grow.

Similar trends can be observed in the dynamics of the share of state-owned banks in the deposits of individual and corporate customers (Figure *Deposits of individual and corporate customers in the banking system*).

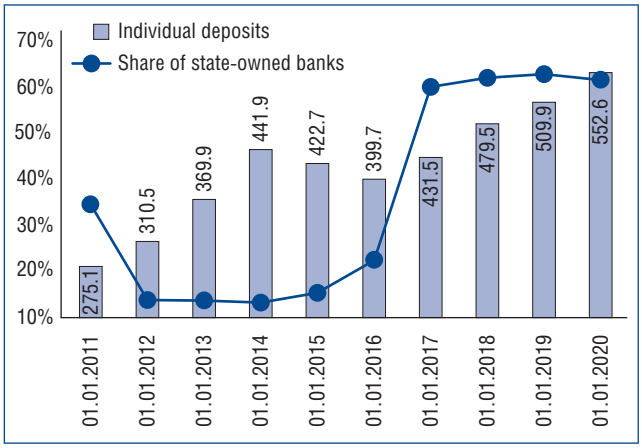
Deposits of individual and corporate customers in the banking system (UAH billion) **and the share of state-owned banks in the banking system's deposits**
(%, left scale) (at the beginning of the year)



It is worth noting that as of 1 January 2020, public banks controlled 61.4% of the retail deposit market and 54.7% of the deposit market in general (Figure *Individual deposits in the banking system*). That is, state-owned banks played a greater role in the retail deposit market than in the corporate deposit market.

This state of affairs is explained by the entry of the state-owned Privatbank and Oschadbank, which specialise in providing services to individuals and run

Individual deposits in Ukraine's banking system (UAH billion) **and the share of state-owned banks in individual deposits**
(%, left scale) (at the beginning of the year)



a wide network of branches. That is, there is a high dependence of the retail deposit market on the state of state-owned banks. Prior to Privatbank's nationalisation, the share of retail deposits in state-owned banks was 22.3%.

In general, banks with a government stake are rather influential in Ukraine, so the situation in the country's banking system and its consolidated performance will depend on four state-owned banks.

Performance of state-owned banks prior to corporate governance reform. In 2018-2019, state-owned banks in Ukraine underwent corporate governance reform. The government decided to introduce new supervisory boards, also with involvement of independent members. The Ministry of Finance's logic is quite clear, as increased presence of independent and foreign board members, who are familiar with management and requirements of foreign investors, should facilitate the sale of banks to foreign financial groups. As a transitional stage, the banks' funds were expected to include the EBRD and the International Finance Corporation (the World Bank Group).

These plans have partially materialised. In particular, Ukrgasbank has already announced the IFC's entry into the bank's equity: in June 2020, the government of Ukraine authorised the Minister of Finance to sign relevant agreement on IFC's entry in Ukrgasbank. However, after the conversion of a long-term loan of EUR 30 million into the bank's stock, IFC will control only 20% of its shares. At the same time, partial control should allow IFC representatives to join the Supervisory Board of Ukrgasbank.

Prospects for privatisation of Privatbank are currently minimal due to lengthy lawsuits involving the former owners, which can seriously affect the investment attractiveness of this bank.

Oschadbank and Ukreximbank have a fairly low operating profit and a serous burden in the form of outdated technologies and branches inherited from Soviet times. Their loan portfolios were often

overwhelmed with directed loans, issued on the instructions of the government and never repaid.

However, the competition between 4 state-owned banks remains one of key issues. They do not have a common management centre, accounting of treasury operations, consolidated accounting of interbank loans, and the like. In fact, they are not part of one financial group, although they should be by international standards. However, Ukrainian lawmakers have made exceptions for these banks.

A retrospective analysis of profitability of state-owned banks in 2015-2019 (Table *Profits (losses) and return on equity*) generates the following conclusions:

- Return on equity of state-owned banks was lower than ROI (return on investment, or in our case – return on authorised capital) across Ukraine's banking system (except for 2015 – the year of banking crisis);
- Privatbank's loss in 2016-2017 was due to revision of financial statements after its nationalisation; after that, the bank's activities were profitable, also including due to interest income on domestic government bonds, which the government contributed to the bank's equity;
- Profitability of Ukreximbank and Oschadbank has traditionally been very low, even in better years for the country's banking system. Their management used the same tactics for many years, showing small profit or loss, and then – once in 3-5 years – adjusted to political cycles, waiting for re-capitalisation from the Ministry of Finance.

Profit (loss) (UAH million) **and return on equity in state-owned banks**

Bank / indicator	2015		2016		2017		2018		2019	
	Profit	ROI, %	Profit	ROI, %	Profit	ROI, %	Profit	ROI, %	Profit	ROI, %
Privatbank	216.1	1.0	-164471.7	-324.4	-23914.2	-11.6	12798.3	6.2	32609.2	15.8
Oschadbank	-12273.1	-41.1	464.1	1.3	558.5	1.3	162.2	0.3	276.9	0.6
Ukreximbank	-14132.4	-65.2	-956.7	-3.1	784.0	2.0	852.3	2.2	1002.1	2.6
Ukrgasbank	259.7	1.9	289.0	2.1	627.8	4.7	768.7	5.8	1299.3	9.8
Across the banking system:	-77935.2	-36.6	-195658.5	-62.8	-28102.6	-5.8	17080.0	11.7	59633.5	12.7
Across state-owned banks:	-26166.5	-30.2	-164676.3	-126.3	-21938.1	-7.3	14617.9	4.8	35202.4	11.4

When assessing the data in the above table, one should take into account that ROE of less than 10% for Ukraine is considered a very low level of profitability.

Credit risk and state-owned banks in Ukraine. Another serious problem faced by Ukraine's state-owned banks is the increased level of credit risk, which affects the consolidated performance of the banking system. Analysis of the dynamics of non-performing loans (NPLs) by state-owned banks indicates that the highest level of NPLs was held by Privatbank at 81.1% as of 1 May 2020. It should be noted that Privatbank's history of non-performing loans is rather peculiar, as NPLs in Privatbank emerged as a result of its nationalisation.

Following the nationalisation, the loan portfolio subject to simulation of services was found non-performing by the NBU – this explains the figure of more than 80%. Today, the state-owned Privatbank and the NBU are working together to obtain compensation from shareholders and locate their assets. Such claims work hinders privatisation of Privatbank, so the issue of reducing the level of the bank's NPLs and its sale will remain blocked until the final settlement between the state and the bank's former shareholders, either through court or by amicable settlement.

The nature of NPLs in Oschadbank and Ukreximbank is also special, illustrating all the risks of state banking in Ukraine. In May 2020, the levels of NPLs in Oschadbank and Ukreximbank reached 58.0% and 60.3% respectively. A study of more than 100 court cases from the Unified Register of Court Decisions within the claims work of these banks revealed one and the same typical history of NPLs. The case is that the government asks these banks – either formally or informally – to issue loans to certain companies. However, after the change of government or at the onset of a new political cycle, such loans are no longer serviced, prompting relevant claims work, but, as a rule, it becomes virtually impossible to recover debts.

In turn, the emergence of NPLs automatically required the Ministry of Finance as a shareholder to recapitalise these banks, usually with government bonds. In other words, two old state-owned banks have consistently received budget support in the form of capital injections.

Particular attention should be paid to the distribution of NPLs across the country's banking system. Most NPLs in the sector were generated by Ukrainian state-owned banks and banks under the indirect control of the Russian government: as of 1 May 2020, the share of NPLs in them was 69.6%.

It is interesting to compare NPLs in state-owned banks and banks under the indirect control of the Russian government with the rate of NPLs in other banks (Table *Level of NPLs in banks*). For example, on 1 May 2020, the rate of NPLs in banks not controlled by governments was only 17.9%, which did not pose a systemic problem for non-state and non-sanctioned banks. In fact, the data in Table 2 partly explain low profitability and constant need for re-capitalisation of state-owned banks in Ukraine.

Level of NPLs in state-owned banks and across Ukraine's banking sector in general. %

Bank / Indicator	01.01.2018	01.01.2019	01.01.2020	01.05.2020
Privatbank	87.7	83.4	80.3	81.1
Oschadbank	63.2	67.3	56.9	58.0
Ukreximbank	59.8	59.3	58.3	60.3
Ukrgasbank	24.4	17.0	20.7	19.4
Total for VTB*, PIB and Sberbank	67.3	82.4	87.6	88.3
Across the banking system:	55.6	54.2	50.0	51.0
Across banks with government stake (Ukraine and Russia)	**70.7**	**70.8**	**68.6**	**69.6**
Across all banks, excluding banks with government stake (Ukraine and Russia)	**30.2**	**25.7**	**17.5**	**17.9**

*indicator includes VTB data until 1 January 2018 only.

Unfortunately, current system of management in state-owned banks cannot yet guarantee that "washout" of their funds through lending under "administrative pressure" will stop. The level of NPLs in these banks remains high, with the signs of new NPLs emerging after the change of government. Of 4 state-owned banks in Ukraine, only Ukrgasbank can be recognised as successful, as it at least partially achieved the goal of attracting a foreign investor. Privatbank also demonstrates some efficiency, but its future prospects depend on litigation. Oschadbank and Ukreximbank remain captive to credit risks of past years; they probably continue to serve as institutions for redistribution of funds between political clans that held power in the past.

Ways of reducing involvement of the state in the banking sector. Ukraine opted to strengthen the management systems in state-owned banks. But the reformers have overlooked many problems that need urgent solution. As a result of chaotic nationalisation of Ukrgasbank and Privatbank, the state currently owns 4 banks offering an identical set of services. In 2018-2019, the Ministry of Finance dropped the idea of restructuring these banks on the basis of a state banking group with consolidated accounting and reporting. From previous governments we inherited banks that:

- Got stuck in litigation with former owners;
- Have problems with dormant credit risks generated by past corruption;
- Require additional protectionist measures from the government in order to attract public companies or programmes as customers, which creates additional costs for the public sector;
- Spend money on competition against each other, despite having one shareholder.

Today there exist several scenarios regarding the state-owned banks.

1. A shock scenario, which envisages prompt abandonment of control over Ukreximbank, Oschadbank and, possibly, Ukrgasbank, as the first two will soon require additional capitalisation. The government can sell these banks at auction at any price, viewing them as assets that may require more spending rather than profitable investments. The main thing for the potential buyer is to be aware of credit risks that he assumes and agrees to finance. The disadvantage of this approach is the loss of control over the Ukreximbank's system of trade financing system, which operates through agreements with many Exim banks and export agencies around the world. Another disadvantage may be the loss of control over Oschadbank, which is tasked to serve the population and companies during hostilities. The conflict in eastern Ukraine continues, so this risk remains relevant.

2. A restructuring scenario, which envisages the beginning of exchange of assets between banks and introduction of their specialisation. For example, Ukrgasbank can play the role of a development bank; Ukrexibank can be transformed into a state agency similar to the US Exim bank with appropriate tasks; Privatbank and Oschadbank can be merged, forming a single public bank for individuals and small businesses. Over time, such a retail bank may be partially sold to portfolio investors through IPO on stock exchanges using depository receipt tools. The disadvantage of this scenario is the cost of restructuring.

3. Further focus on corporate governance in state-owned banks and their strengthening to make profit, which means the implementation of the programme that the Ministry of Finance and state-owned banks are currently working on. Most likely, this scenario will be the least productive in the context of reducing the share of state-owned banks in the banking system; over the next 5 years it will not yield results, apart from new re-capitalisations of Ukreximbank and Oschadbank. The disadvantage of this scenario is significant influence of state-owned banks on the banking services market and continuous budget expenditures to support them.

We prefer the second scenario, which can produce tangible results already in 3-5 years. Creating a new bank on the basis of Oschadbank and Privatbank can help the government to get rid of unnecessary assets at liquidation value, optimise its presence in the banking sector and attract portfolio investors with clear motives and market approaches to management. However, reduction in the share of state-owned banks may not necessarily involve the intensive privatisation of these banks.

Ways to liberalisation of banking regulation. Ukraine needs to build a system of banking regulation that ensures an optimal balance of security and simplified access to the market of banking services. One should remember, that just like Ukraine, other countries in the region are fighting for the right to open subsidiary banks. Therefore, in case of over-regulation of market entry, Ukraine will always lag behind its competitors. Requirements for shareholders and potential buyers of banks need to be simplified, taking into account legal provisions on combating money laundering, while the requirements

for providing unnecessary information about shareholders need to be removed.

Ukraine needs to introduce separate regulation for large and small banks. Quite often, the capital to asset ratio in small banks reaches 30-40% and they cannot make full use of available capital, while the NBU requires the regulatory capital at UAH 200 million (with recent plans to increase this threshold to UAH 300 million). In reality, the regulatory capital could be reduced to UAH 150 million, which is fully in line with European requirements for minimum capital (EUR 5 million).

The NBU should ease its requirements to the corporate governance system in small banks in order to reduce their costs on meeting formal requirements and improve the environment for their development. At the same time, attracting European banks that will be able to build their business in Ukraine on a minimal scale, will be useful for risk management systems in small banks.

The NBU needs to liberalise the system of accrual of reserves for credit operations. We need to finally approach this issue in a comprehensive manner and leave it to the auditors, who should help banks to form their reserves in line with the International Financial Reporting Standards (IFRS). Reserve requirements should be eased in the event of economic growth and low inflation or tightened in the event of declining GDP or business slowdown.

The National Bank and the government have to continue building the securities market, enable asset securitisation and work on instruments that will allow banks to manage liquidity, credit and currency risks. Regulatory liberalisation along with expanding operations with instruments that are new to Ukraine may have a positive effect on risks currently borne by banks. Also, intensive development of non-bank financial institutions is another way to reduce the share of state-owned banks in the financial market.

Therefore, Ukraine's banking (financial) sector needs to restore its functionality after a lengthy banking crisis. Current format of monetary policy and banking supervision does not contribute to rapid revival of banking intermediation. The pursuit of low rates amidst banking sector's dysfunction and falling demand for loans, even under soft loan programmes, point at wrong landmarks used in the sector's reform.

We believe that in reforming the banking sector, more attention should be paid to liberal ideas that are based on market ideology and assume that the best shareholder is the one that comes from the private sector. Excessive involvement of the state in the banking sector is an unacceptable luxury for Ukraine. Reforms should focus on market concepts, with minimal government intervention in the development of market institutions and with reduction in corruption risks.