

Logo and Other Information

**Ukrainian Banking System Snapshot
April 2009**

Executive Summary

After several years of boosting development in 2003-2008, Ukrainian banking system reached the point of possible rapid and painful collapse. Although in Ukraine the crisis happened at the same time with the world-wide financial problems, the main causes rather are the domestic factors. It therefore possible and advisable to find out both the triggers for the crisis and possible solutions, and to develop an approach that can have only limited correlation with those strategies employed by other countries and regions.

The purpose of this document is to discuss the problem factors, their existing and potential impact, and develop suggestions on how to treat these factors one by one and consolidated. The factors presented here are not in the order of importance. Some factors have a very strong correlation between each other, but we still believe they need to be segregated due to either different sources or solutions.

In addition, the document names legal initiatives, both pending and potential, that are required to treat the factors.

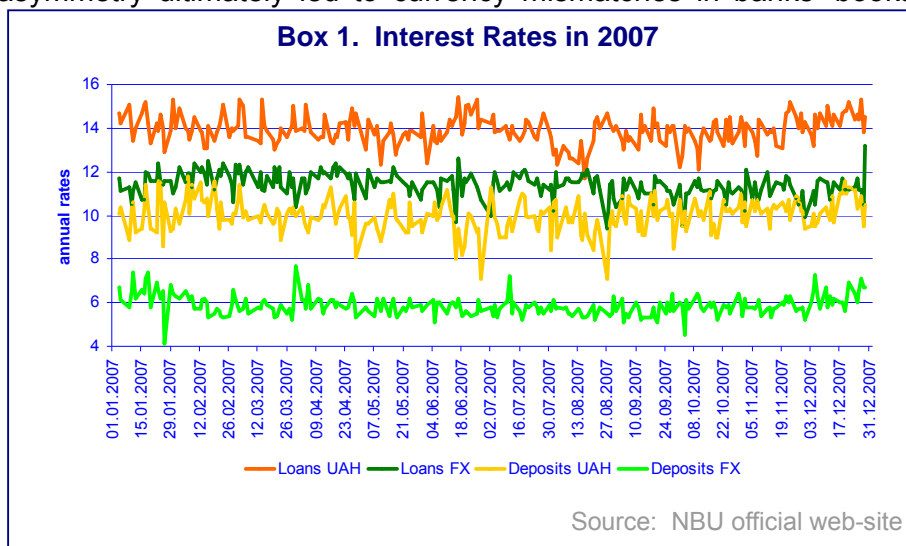
Dolarization and Exchange Rate Turbulence

A severe and rapid depreciation of Ukrainian hryvnia (UAH) in late 2008 – early 2009 serves as the most dramatic evidence of problems in Ukrainian economy and banking system. This factor can also be seen as the first domino wood stick that caused the other sticks to drop.

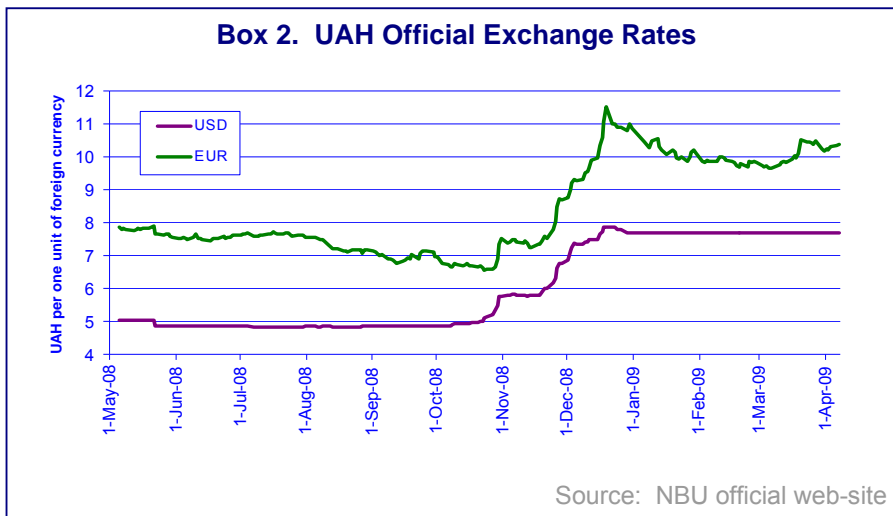
In 2003-2008 exchange rate policy exercised by the central bank – the National Bank of Ukraine (NBU) – received good portion of criticism from international agencies and domestic stakeholders. In April 2004 the NBU set the exchange rate to US dollar at 5,05 UAH and never changed it till May 2008. The exchange rate to euro during this period was floating using cross-rates USD to EUR available at European markets.

However, the interest rates in USD and UAH at domestic markets were different. For these entire years dollar denominated loans and deposits carried a rate lower by 2 to 3 percentage points comparing to UAH denominated loans and deposits. More over, for some maturity bands only dollar loans were available for a long time (e.g. mortgage and land loans¹). Such asymmetry ultimately led to currency mismatches in banks' books:

Ukrainians preferred to make deposits in UAH, but take loans in USD, EUR or CHF. Having a hryvnia incomes and dollar loans became a standard at both retail and corporate markets: due to stable exchange rate almost every one treated these currencies as one.



¹ Ukrainian State Mortgage Office started to offer refinancing for mortgages in hryvnia in 2005. However underwriting criteria were way more conservative compared to available at the market at that time even for loans in UAH. Compared to loans in USD, EUR and CHF these loans were not attractive at all.

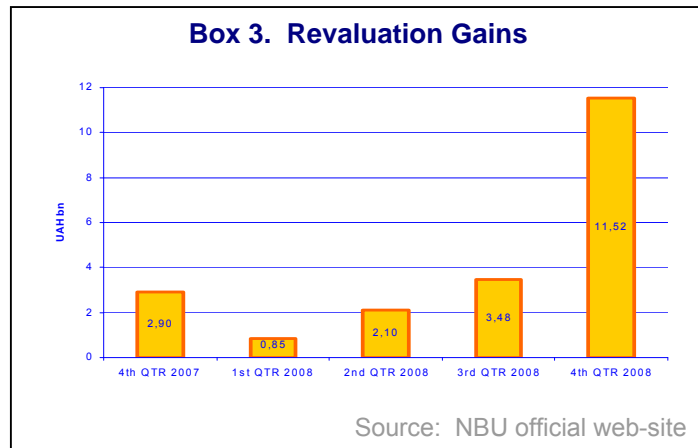


This fragile situation started to collapse once in late 2008 hrvnia began to weaken against dollar and euro. As of March 2009, Ukrainian hrvnia is reported to be one of the most devalued currencies in the world after 42% depreciation over less than three months².

This had immediate impacts on the banking system:

1. Revaluation gains reported by banks are subject to income tax payable in hrvnia. This creates liquidity burden on banks – just by holding FX-denominated loans (no matter performing or not) banks now have to find additional UAH to pay income taxes.

Please note that on the chart provided the revaluation gains include both FX revaluation and trading portfolio revaluations. The data is shown on quarter to quarter basis. Since in the 4th QTR of 2008 there was no active securities market, the entire UAH 11,52 bn can be reasonable expected to be attributable to FX revaluations only.



2. Borrowers with currency mismatches started to default on their payments. This caused credit quality to weaken (followed by the need to write-off bad loans and report losses), and created additional burden on banks' solvency and liquidity. As of Jan. 1, 2009 the FX-denominated loans reached about USD 35 bn, i.e. 36% of total loans.

Although there is no official data available on the level of defaults, the experts are confident that it reaches 15%-20% by number of outstanding loans and larger loans are more probable to default.

3. Credit rating agencies put bank rating in watch lists and downgraded some, causing cost of borrowing to increase (see table 1 on page 7).
4. Demand for new loans dropped due to new exchange rates applied to imports. Banks can not invest in either retail or commercial business not just because of poor customer profiles, but also because of no demand shown.
5. Both individuals and businesses tried to withdraw hrvnia denominated deposits from banks and convert them into foreign currency. This created an additional liquidity burden on banks. The NBU tried to prevent the run on banks by introducing a

² Research by Merrill Lynch. February 2009

moratorium on retail deposit withdrawals before maturity in mid-October. This limitation was lifted in mid-December. According to Mr. Alexandr Sugoniako, President of Association of Ukrainian Banks, in January 2009 the withdrawal reached UAH 21 bn, and in February 2009 – UAH 19 bn. As of March 1, 2009 total deposit balance (both commercial and individual) was UAH 318 bn, i.e. the deposit base was squeezed by more than 10% since beginning of 2009.

A very disappointing fact is that the regulator has not communicated to the market a clear and open vision and / or statement of what can be expected in the near and mid-term future as related to exchange rate policy. The market operates now on rumors and it leads to high fluctuations and speculations. This problem deserves a special attention and is discussed in a greater detail later in this document. In addition, the existing tension between the NBU and the Cabinet of Ministers (CoM) on macroeconomic, budget and fiscal matters stimulates negative expectations.

In March 2009, the NBU did not seem to feel comfortable to support hryvnia since Ukraine's export in last six months dropped severely and there was no more a constant hard currency inflow of funds to the country to replenish currency reserve. The fact that in January 2009 the trade balance converted to positive numbers of USD 396 mm first time since 2005 is caused mostly by negligible import rather than an increased export.

If the situation with exchange rate is left unattended, it will be one of the major reasons for future deterioration:

1. Credit quality impairment. Depreciation by 42% means that those borrowers who have got dollar loans against hryvnia revenues now have to pay almost twice as much in hryvnia. For most businesses such increase is beyond any profitability benchmarks and these businesses will not be able to serve the debt. The banks will have to start foreclosure procedures or other form of problem loan treatments. These businesses, at their hand, will have to find solutions to increase the cash generation.
2. Defaults on Eurobonds. In this case the banks are the borrowers and will suffer from the same problem as above.
3. Continued deterioration of confidence to the banking system and to the government. Rate turbulences are shaking the banking system. The population develops a vision that any bank can fail. The vision is inspired by lack of transparency in banking financial books (an average Ukrainian can hardly read bank statements) and lack of action and discussion from the government officials. This is the major cause why Ukrainians now prefer to keep their savings in cash outside the banking system and deserves a special section in this document.

Initiatives and Strategies to Treat the Factor

Dollarization factor has to be treated from two separate angles. First, the strategy has to be put in place of how to limit this problem for the future. Second, the solution to existing situation has to be found.

As with the prevention strategy, the NBU has all it is needed to regulate it. In fact, it has already started a series of prudential actions to make foreign currency lending less attractive or even impossible. Firstly, the NBU has lifted provision requirements to 100% of outstanding balance for any FX-denominated loan granted to a borrower with no cash inflows in the same currency. This amendment is applicable to any new loan made after February 2009. Secondly, the NBU is considering requiring banks to place the UAH equivalent of such provisions to a special correspondent account at the central bank to ensure the provisions will be available to absorb losses in the meaning of deposits payoff. Such economic measures to make FX loans less advantageous compared to UAH-

denominated loans has already yielded the desired effect – no bank offers now consumer loans in foreign currency. There are also a number of purely administrative initiatives that can be added to the prudential solutions, but these will only work during the turbulence and if introduced have to be lifted once the situation is restored

With this part of the problem the following legal initiatives are required:

- To enhance borrowers ability to generate cash inflows in foreign currencies to service FX-denominated loans. One of the obstacles here is an obsolete FX Control Decree that requires revision or even elimination. The businesses have to receive more freedom to work with their international partners. The controls have to be prudent and not obsessive, causing as less interference as possible.
- The NBU and the Government have to work out the instruments that would allow banks to hedge currency risk. Instead of placing prudential prohibitions on specific types of transactions, the regulators have to ensure there are instruments available to manage those risks.
- Exchange rate policy has to clearly stated and delivered to the general public (see also “Confidence in Banking System” section)

However, as with existing problem the solution is not such obvious and clear. After several month of unsuccessful attempts to support hrivnia using monetary reserves, the NBU has introduced a vehicle of selling USD and EUR directly to borrowers to meet past due and current payments. The NBU now sells the foreign currencies at rates close to, but still above official ones in a non-cash transactions and therefore relieves the burden from cash market. After two weeks of successful implementation the hrivnia has appreciated against USD by 5%. Nevertheless, the “privileged” rate is almost two-fold compared to initial rate for most of the borrowers and their capacity to repay loans is still questionable.

The NBU also suggested to the banks to offer loan holidays to the existing clients and urged not to raise applicable interest rates. However, Ukrainian laws allow floating rates and most banks have decided to place all burden onto their clients³. However, the existing legislation is vague about changing loan payment schedule and applicable interest rate. In particular, in 1992-1993 loan interest rates had three digits due to hyperinflation, but once the situation was settled, the borrowers found that banks were reluctant to reprise loans since the legislation is not clear who can initiate loan reprising if it is set as an ad-hoc option of the loan agreement instead of a recurring event. Another side of this problem is that borrowers in some banks can not pay the outstanding amounts before due. This situation from the legal standpoint is similar to prohibition to withdraw a deposit before due.

It should be mentioned that there were several proposals how to treat dollarization problem that lay outside the rule of law and property protection concept. In particular, the proposal was made to mandatory convert FX-denominated loans to UAH using the historical exchange rate, i.e. the official rate at the moment of initial recognition. Although such approach would be the best solution to the borrowers, it can create a precedent on which FX-denominated deposits can be converted using the same procedure.

With this part of the problem the following legal initiatives are required:

- While developing any strategy and approach the rule of law and property protection concept have to be ensured for compliance.
- The legislation has to be amended is a way that would clearly allow the borrower to initiate loan prepayments.

³ A notable phenomenon of Ukrainian banking crisis of 2008 is that many banks instead of cooperating with their clients started to rise nominal interest rates and introduce additional fees and payments. This was done irrespectively of currency of denomination, maturity band and type of loan.

Confidence in Banking System

The confidence in Ukrainian banking system has been severely damaged. Since the last major crisis in 1998 the government made a significant progress in building such a confidence, but in late 2008 it vanished almost instantly. Most recent pools⁴ revealed that confidence in banks scored only 26.8 points out of 200 possible. These pools have been based on Deposit Activity Index (DAI) methodology and the index itself scored only 49.9 points out of 200 possible.

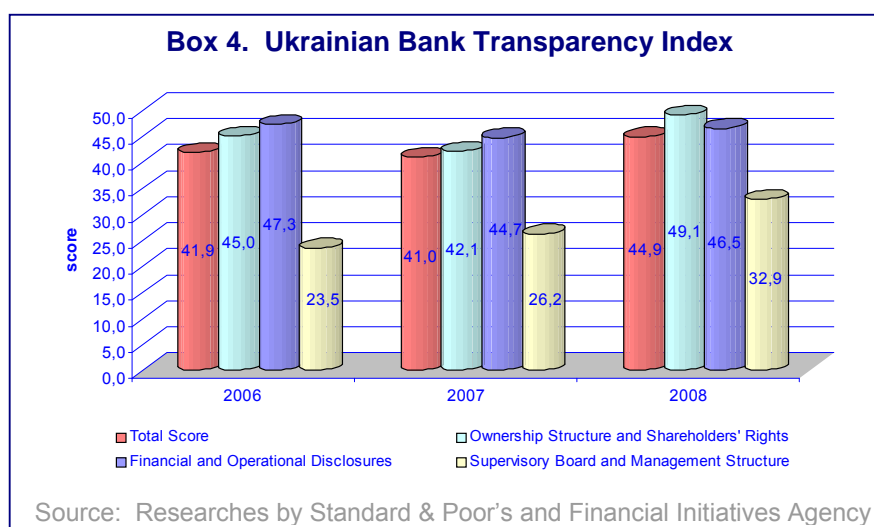
Besides strong support to the national currency, which now is not in place, another government initiative to build the confidence was individual deposit guarantee vehicle through establishment of Individual Deposit Guarantee Fund (IDGF). The Fund is now becoming an important player in the financial system and therefore is discussed in a greater detail in a separate section on page 9.

As of April 1, 2009 the individual deposits dropped to UAH 193,7 bn from UAH 216,3 bn as of beginning of the year and represented only 25,5% of total liabilities. Given that loans to individuals even as of Jan 1, 2009 amounted UAH 286,8 bn, it becomes obvious that Ukrainians after several years of being net lenders to the banking system now turned to be net borrowers.

Restoration of confidence is not possible without the two major components of trust – transparency and accountability.

The transparency has to be treated as a broad concept and not to be limited to just accounting disclosures only. Ukrainian banking system adopted the International Accounting Standards and International Standards of Financial Reporting (IAS and IFRS) a decade ago – in 1998, but indirectly – through NBU's mandatory accounting policies. These policies, also in compliance with major parts of IAS/IFRS, still have some changes adoption time legs and exclusions, i.e. there still are some gaps between NBU and IFRS requirements. Some banks now run two books – NBU's statements for domestic use and IAS/IFRS for parent companies.

Nevertheless, according to the independent researches, the overall transparency level remains rather low and hardly over 50% of maximum possible (best practice is 75%-80%)⁵. The independent researches show that while accounting disclosures in banks are adequate, the institutions tend not to place in public domains the ownership structures (especially the beneficial owners) and their management practices and procedures (especially future strategies and market assumptions). This creates a fertile soil for any sort of rumors



⁴ "Confidence Crisis or Why Is Capitalization Needed" by Vladimir Leonoff, Mirror of the Week, #13 (741), April 13-20, 2009

⁵ Transparency and Disclosure in Ukrainian Banks in 2007, 2006 and 2005 by Standard & Poor's and Financial Initiatives Agency.

and unclear information that severely impair the confidence in the system.

Another side of the medal is that once adequate disclosures are made these have to be received and understood by the public. In the last decade the IAS and IFRS became extremely sophisticated, especially in the parts related to financial instruments (there is no longer a specific standard on financial disclosures by banks). Additional disclosure requirements imposed by International Standards of Audit (ISA) and by Basel Committee on Banking Supervision are great, but there still is a question whether or not the users can properly understand the information and act on it.

Additional important component of transparency for the banking system is independent assessment of its creditworthiness. Typically this task is charged to credit ratings assigned by independent rating agencies. In this regard the news in 2009 were only negative – both the sovereign rating and individual bank ratings were at least placed into watch lists, and many of them downgraded. Some banks even cancelled rating solicitations causing rating agencies to recall the ratings. The table below shows the development of ratings for top-20 Ukrainian banks in the first quarter of 2009.

Rank per NBU	Name	Jan. 1, 2009			April 1, 2009		
		S&P	Fitch	Moody's	S&P	Fitch	Moody's
	UKRAINE Souvering	B	B+	B1	CCC+	B	B1
1	Privatbank	B-	B	B2	B-	B	B2
2	Raiffeizen Bank Aval			B2			B2
3	State Savings Bank of Ukraine		B+			B	
4	Ukrsibbank (BNP Paribas)		B+	B2		B	B2
5	Ukrsostbank (Unicredit)	B	B+	Ba3	CCC+	B	Ba3
6	State Export and Import Bank of Ukraine		B+	B2		B	B2
7	OTP Bank						
8	Alpha Bank	B		Ba3	CCC+		Ba3
9	Nadra Bank ⁽¹⁾	CC	CCC	B2	SD	CC	B2
10	VTB Bank (VneshTorgBank)		B+			B	
11	Prominvestbank ⁽²⁾			B2			B2
12	Forum (Commerzbank)		B+	B2		B	B2
13	First Ukrainian International Bank		B	B2		B	B2
14	Finance and Credit ⁽³⁾		B1 ⁽⁷⁾			B1 ⁽⁷⁾	
15	Ukrprombank ⁽⁴⁾						
16	Swedbank		B+	B2		B	B2
17	Ukrasbank ⁽⁵⁾		B-	B2		CCC	B2
18	Brokbusinessbank						
19	Kreditprombank		B-	B2		CCC	B2
20	Rodovid Bank ⁽⁶⁾		CC	B3		D	B3

(1) Nadra Bank - provisional administration was introduced by NBU on Feb 10, 2009
(2) Prominvestbank - provisional administration was introduced by NBU on Oct. 7, 2008, removed on March 17, 2009
(3) Finance and Credit - , NBU's watcher was introduced on March 18, 2009, applied for government recapitalization on March 24, 2009
(4) Ukrprombank - provisional administration was introduced by NBU on Jan 21, 2009, applied for government recapitalization on April 2, 2009
(5) Ukrasbank - applied for government recapitalization on March 13, 2009
(6) Rodovid Bank - applied for government recapitalization on Feb, 26, 2009
(7) Finance and Credit - rating attached to LPN

Source: Cbonds.info Information Agency

All these factors had a dramatic adverse effect on the confidence to the banking system. As it has been already mentioned earlier in the document, the banking system was very close to run on banks and only barely legal actions of the regulator to impose so called moratorium on deposit withdrawals helped the situation. It is also clear that both

commercial and retail customers will continue to try to take their savings off the banking system as their deposits mature.

The best way to start confidence restoration is enhancement of accountability. The accountability concept also has to be treated in a broad way – the accountability of financial institutions to their clients (duty of care) and accountability of government agencies to the public.

In Ukraine the breach of duty of care even before the crisis had little consequence for bank managers and owners. Also in early 2000's the NBU introduced a "fit and proper" test for proposed bank managers and included into this test the background check for previous reputation and employment records in the banking industry, there is clearly not enough legal ground to support it. The "good business reputation test" has also been introduced for proposed bank owners as part of merger and acquisition authorization, but it is based on NBU's internal policy and not on the law. In Ukraine there is no prohibition for professional practice in financial sector⁶. It is almost impossible to bar a person from holding a senior position in a bank after he or she failed in another bank. Cross-sector prohibitions are also not available – a person can jump from a bank into an insurance company with no limitation. It also has to be mentioned that bank managers are not liable by their own property for what they do as bank officials. While crisis these issues become even more serious.

Accountability of government agencies to the public has to be significantly improved. Now the financial sector regulators and the Government do not have any outreach programs in place to discuss their initiatives and approaches to mitigate crisis. Instead, such communication is rather spontaneous, conflicting, and incomplete and looks more likely an election campaign. The best example here is NBU's failure to ensure stability of hryvnia. The NBU is charged with this duty by the Constitution and by several laws. However, the failure to act properly had no consequence to the Governor or the Board.

Initiatives and Strategies to Treat the Factor

The transparency and accountability factor has to be treated by a number of both legal and outreach initiatives, in particular:

- There has to be a "white book" produced and communicated to present a joint vision of Ukrainian state agencies of how to approach the financial crisis. Lack of such vision can have a devastating effect due to ineffective use of scarce resources (financial and people) and wasting the time.
- Outreach programs have to be developed and implemented in the regulatory agencies to ensure the public receives timeliness and complete information of activities and approached. This shall remove "act on rumors" problem and increase confidence to the system as a whole.
- In order to ensure an equal level of transparency all financial sector companies (both banks and non-bank financial institutions) need to produce financial statements using the same standards, preferably IAS/IFRS.
- The Bans and Banking Law has to be amended to allow identification of beneficial owners and public disclosure of such information. Currently the NBU publishes every quarter on its official website a list of direct bank owners, but for many banks this information is not adequate since first line of ownership is not beneficial.

⁶ Theoretically such prohibition can be established through court decisions, but there has been no precedent in practice yet.

- Consolidated supervision, as well as additional supervision over financial conglomerates has to be introduced into the legislation and comply with respective EU Directives.
- The laws have to be amended to ensure bank managers and owners are personally liable to bank clients in case bank failures have been caused by unlawful action or inaction of these particular individuals. The concept of prohibition for profession in financial sector has to be improved.

The last two initiatives are interrelated with the next factor – Supervisory Practice.

Supervisory Practice

In Ukraine the financial sector is split into two uneven sections: the banking system is regulated by the National Bank of Ukraine and possesses almost 95% of total assets and capital; and non-bank financial institutions (credit unions, insurance companies, leasing companies, pension funds, etc.) regulated by State Commission of Financial Services (SCFS). There are two other regulatory agencies that play a role in financial sector: the Securities and Exchange Commission (SEC) which regulates issuers of shares⁷ and bonds; and already mentioned Individuals Deposit Guarantee Fund (IDGF) which is more a paying agent for covered deposits, but has some limited regulatory functions.

Consolidated supervision as defined in current European Union Directives does not exist in Ukraine. The recent attempts to introduce this concept failed for two major reasons: (1) types of financial conglomerates provided in Ukrainian legislation are significantly different from the types provided in EU Directives, and (2) the leading supervisory agency is not identified in Ukraine.

While steady economic development, both the composition of regulatory agencies and their practice were mostly adequate to Ukraine's needs. The NBU even started the project of moving to risk-based supervision and introduction of Basel II approaches in its supervisory regime.

From 1998 till 2008 the major reason for individual bank failures was fraud: either in the form of operational wrongdoings or in form of conflict of interest. Ukraine has a record of liquidation of a major bank – in 2001 a top-10 bank “Agriculture Bank Ukraine” was liquidated by NBU's initiative. All the other liquidated banks were much smaller. There

Table 2. Development of Individual Deposit Guarantee in Ukraine

Effective Date	Coverage (Principal and Interest), UAH	Individual Deposits in Banking System (as of preceeding month end), UAH mm	Share of Individual Deposits in Total Liabilities of Banking System (as of preceeding month end)
16-Nov-08	150000	193 600,00	27,20%
14-Aug-07	50000	130 454,40	32,10%
14-Feb-07	25000	108 299,40	36,60%
24-May-06	15000	79 462,35	38,60%
31-Jan-06	8000	73 419,76	39,50%
21-Apr-05	5000	49 536,29	37,70%
22-Apr-04	3000	36 026,42	38,40%
17-Sep-03	2000	26 404,47	36,30%
14-Nov-02	1500	19 088,60	35,40%
20-Sep-01	1000	N/A	N/A
10-Sep-98	500	N/A	N/A

Sources: NBU's official web site and IDGF resolutions

was no bank in the last decade that was liquidated due to credit crisis. In all liquidated banks the IDGF has covered the depositors in full⁸. More over, the compensation range was increased from 500 hrivnia in late 90's to 150'000 hrivnia in late 2008 (see table 2). This became possible after massive deposit inflow into the banking system since 2004 – the IDGF enjoyed a great increase in collection, too.

All these factors have previously played their roles in increasing the confidence in the banking system. The stress of November 2004 – the second round of Presidential elections, when massive falsification inspired political tension and lead to a rapid run on selected banks – proved the confidence even more.

Now with severe economic downturn and expectation that major banks will not be able to sustain the crisis, the supervisory practice has to be revisited and tailored to new challenges. In particular, the regulator has to be more proactive in identification and resolution of weakening banks and has to develop a menu of tools to restructure and rehabilitate a failing institution. Among other things, the liquidation and forced sale procedures have to be strengthened.

Forbearance and Selective Enforcements / Privileges

In the past the NBU has been criticized by bankers and politicians for abuses and forbearance in application of enforcement measures. In particular, the following bullets were criticized:

- NBU uses CAMELS rating system to place bank into supervisory regime groups. However, the banks rated “3” (middle rating, by definition these banks require close supervisory attention) might have gotten different treatments from the regulator, therefore convoluting supervisory rating system
- By law, all but one bank can be members of the IDGF. This one bank is the State Savings Bank of Ukraine – a 100% state-owned top-10 retail bank where the Government explicitly guarantees all deposits for all amounts. This creates uneven playfield for rest of the banks
- Unclear and not transparent practice of liquidity support as the lender of last resort during recent actions to support hrivnia using monetary reserves (see later in this document)

Also these factors are not critical now, they still create a very important precedent – if there was a possibility for forbearance and selective enforcement, and such possibility might remain in place now and therefore effectively kill the mitigation measures.

Bank Provisional Administration and Liquidation

The law gives the NBU a full right to remove any bank's existing management and appoint a provisional administrator or liquidator in case it feels there is a threat to depositors or liability holders. The law also says that administrators and liquidators can also be appointed by court or by bank owners. In any case, the administrators and liquidators are trained and certified by the NBU.

In the past the NBU has used both provisional administrators and liquidators. In particular, in mid-00s provisional administrators were appointed to several small banks and lead

⁷ By Banks and Banking Law, all existing banks have to convert to open-end joint-stock companies by end 2010. Non-bank financial institutions are mostly free in choosing form of ownership.

⁸ In some liquidated banks some depositors of dormant accounts have not been compensated yet – the liquidators can not locate these individuals, also the money were allotted in full.

these banks to effective mergers. There are also success stories with bank liquidators, including liquidation of a top-10 bank “Agriculture Bank Ukraine” in 2002.

However, all these stories happened in a growing economy and positive banking environment. Plus the administrators and liquidators had to deal with fraud issues mostly. Now the situation looks very different. And it is still not clear how many liquidators and provisional administrators have to be trained and certified to accommodate 180 existing Ukrainian banks.

Recently the NBU indirectly admitted shortage of cadre by introducing a new approach to banks’ day-to-day monitoring – the comptroller (“the curator” in Ukrainian). The comptroller is appointed to a bank where liquidity is weak and solvency is questionable. This person mostly is located off-site and must confirm all payments and settlements the bank wants to make. The comptroller has to serve as a back-stop for a failing bank, but it can not take any initiative on it, alike the provisional administrator or liquidator.

It becomes very clear that even those administrators and liquidators who do possess necessary on-hand experience and skills from the past, now can be faced with challenges beyond their competence level. These people would require special focused trainings.

In addition, there seems to be no predefined agenda for a provisional administrator once in the bank. As of April 2009 the NBU placed provisional administrators in 13 banks and removed from one bank (Prominvestbank) the administrator was removed after successful sale. In all cases the approaches and the sequence of events were quite different.

Table 3. Provisional Administrations in Ukrainian Banks

Rank by NBU	Bank Name	Date Introduced	Summary Statistics as of Jan. 1, 2009 (USD 000)	
			Net Total Assets	Individual Deposits
105	Arma	April 17, 2009	89 522	31 224
69	Dnister	April 17, 2009	185 835	77 216
83	Bank of Regional Development	March 23, 2009	145 811	67 052
20	Rodovid Bank	March 18, 2009	1 752 690	459 061
66	BIG Energy	March 18, 2009	197 641	77 803
78	Transbank	Feb 28, 2009	157 670	66 862
111	Odesa-Bank	Feb 19, 2009	81 545	21 736
72	Zakhidincbank	Feb 12, 2009	171 598	91 697
9	Nadra Bank	Feb 10, 2009	3 967 205	1 240 502
39	Bank Kyiv	Feb 9, 2009	634 729	289 943
144	Prichernomoriye	Jan 30, 2009	39 759	17 191
15	Ukrprombank	Jan 20, 2009	2 077 978	1 028 692
123	National Credit	Dec 19, 2008	62 165	20 852
TOTAL			9 564 148	3 489 831

Sources: NBU Resolutions and official web-site

There are several legal obstacles that impede success of provisional administrator. One of the biggest one is the need to seek approval from all stakeholders if he or she needs to transfer assets and/or liabilities from the weak bank to another institution. Such action is not feasible in practice and can be replaced by a requirement that any action taken by provisional administrator shall be done in good faith to protect the lawful interests of the stakeholders.

The last but not the least point is that the role of the IDGF in provisional administration is very low. Given the expected magnitude of the problem it is advisable to revisit the role of the Fund and its ability to intervening at early stages to deal with a failing bank. A very important issue is adequacy of resources available to IDGF. As it can be seen from the table above, in 13 banks with provisional administration individual deposits total UAH

26'036 mm⁹, whereas IDGF admits to have in its possession only UAH 3'280 mm as of April 1, 2009¹⁰. During March 2009 the grows was 2,5% or 80 mm, according to IDGF official statements. If not replenished, the Fund will not be able to cover even one large bank from the list.

Initiatives and Strategies to Treat the Factor

The supervisory practice has to be improved and enhanced. In this regard the following initiatives are needed:

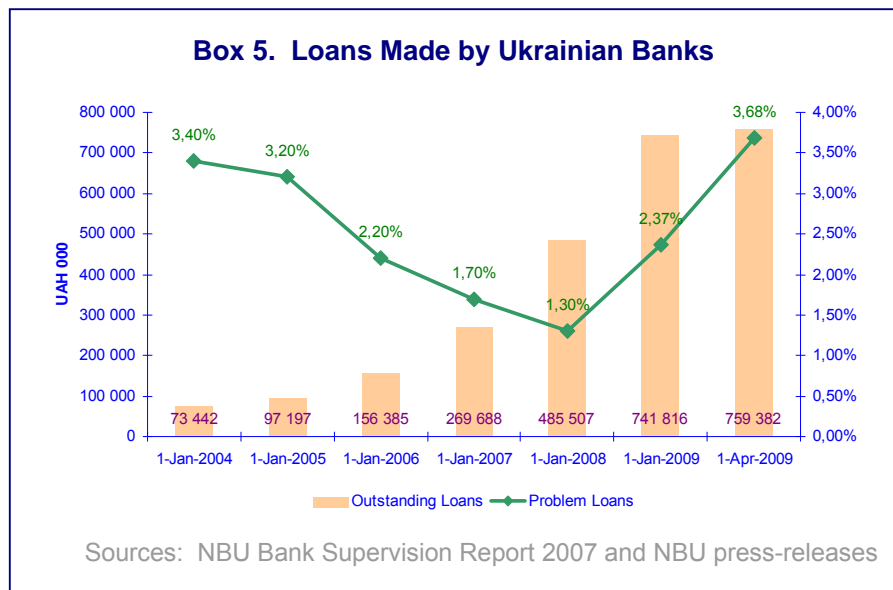
- Forbearance practice has to be eliminated. The best way of doing this would be increased transparency of the regulators and accountability to the public.
- Consolidated supervision has to be developed and implemented. The supervisors have to be empowered with the ability to ring fence the financial institution from unduly influence by any other company within the group.
- Ensure proper training and enhancement of bank provisional administrators and liquidators.
- Supervisory tools to address bank resolutions and rehabilitations have to upgraded and improved.
- Ensure IDGF gets involved into problem bank resolution at early stages. Just moving a bank from full member list to limited member list is not enough. The Fund needs to have an ability to ensure that bank's assets will be enough to pay off covered deposits.
- Establish additional vehicles to replenish IDGF's resources. Any failure to pay any deposit in a problem bank will damage the confidence even greater.

Credit Quality

As the crisis develops it becomes apparent that Ukrainian banks will not be different from their foreign colleagues and will have to recognize a severe adverse change in the assets quality, mostly loans. Below is the summary of the most important issues related to credit quality in Ukrainian banks.

Toxic Assets

Also there is no standard definition of toxic assets this term is widely used now to reflect those assets where the book value significantly exceeds the expected recovery due to problems with borrowers, pledges, or assets fair values. The other terms are also used, e.g. adversely classified



⁹ There is no data available of what portion of deposits is below coverage threshold of UAH 150'000.

¹⁰ On April 22 2009 Mr. Petro Poroshenko, the Chairman of Supervisory Council of the NBU, reported that IDGF has UAH 4'430 mm in assets.

assets or simply problem assets. There might be a slight methodological mismatch in the exact definitions, but the concept remains the same – these are the assets that put the bank at risk of failure.

In March 2008 the international rating agency Standard & Poor's assessed that in case of economic downturn potentially problem assets in Ukrainian banking system can reach 75%. Later, in August 2008, the estimation was lowered to 35%-50%. The agency used its internal methodology for the assessment purposes. The National Bank of Ukraine uses its own definition – problem loans – and covers only those loans that are absolutely doubtful to recover. The share of such loans in aggregate loan portfolio is remarkably low causing experts to challenge its fairness (see Box 5). In addition, the decrease of problem loan share in 2004-2008 potentially was caused by rapid growth of aggregate loans and not by loans workouts.

While these two assessments represent two opposite estimations of the damaged portion in Ukrainian bank books, the reality is that banks quickly develop a share of toxic assets that represent real threat to their soundness and going concern. It becomes obvious that Ukrainian banks will not be able to recover if these assets are not removed.

For the purpose of toxic assets contamination some bank experts propose to establish a “bad bank”, or “bank resolution agency” and use the ideas and procedures that were employed by the USA while savings and loans crisis in mid 80's and by Scandinavian countries. Such institution now is not envisaged by Ukrainian laws and therefore its establishment requires significant amount of legal and regulatory preparation.

Foreclosure and Collection Practice

For a number of years the foreclosure and collection practice remained almost untested by most banks. Credit portfolios used to double every year and almost no one cared about collecting a bad loan. In addition, relaxed credit underwriting standards and low use of credit bureaus allowed bad borrower to get constant stream of refinancing from different banks, therefore keeping loans “evergreen”.

Now with economic downturn, shortage of capital and liquidity squeeze, the problems with collection started to surface.

With this part of the problem the following legal initiatives are required:

- To strengthen legal confidence in the right to immovable property. In particular, it is necessary to put immediately into operation the State Register of Rights to Immovable Property. One of the reasons for the Register to be still unavailable, which creation was stipulated in the Law “On State Registration of Property Rights to Immovable Property and their Restrictions”, dated 2004, is the definition in the law of the body to be responsible for the Register's maintenance “the central body of executive power for land resources” (i.e. Derzhkomzem), therefore, the Cabinet of Ministers of Ukraine (CoMU) does not bear any responsibility for the lack of activity in this area. It is necessary to establish such a procedure, pursuant to which the CMU shall independently designate the body to be responsible for the Register and supervise its activity.
- To abolish artificial separation of buildings from land parcels, on which they are located. In particular, it is necessary to abolish “allocation” of land parcels for construction purposes on the lease terms. At the same time land for housing construction shall be transferred exclusively into ownership and for non-housing construction –on the right of superficies, too. Superficies has to be reformed.
- To cancel moratorium on agricultural land takings/alienation.

- To ban foreclosures of housing, which meets the minimum sanitary norms, where the debtor lives, except for the cases when the debtor mortgaged it
- To legalize collection practice (by removing conflicts with bank secrecy and allowing banks to sell credit claims to third parties, not just hiring them as agents) and to introduce penalties for improper and illegal collection practice. Increase public awareness of collection business.

Selling Claims

A legitimate collection practice in the world is to sell claims to another investor or collection company with a discount and recover at least part of the principal amount. However, in Ukraine this approach remains quite cumbersome due to the following reasons.

There has to be an initiative to review the existing rules that govern deals with claims. This will ensure smoother resolution of problem banks, as well as would allow banks to eliminate the cost of recovery.

One of the major obstacles that preclude deals with claims is value added tax. Banks and credit institutions do not pay VAT on interest income and recoveries since according to the legislation they are chartered lenders. However, if the loan claim is transferred to a company that does not have such a charter (e.g. to a collection company by drawing a bill of exchange), this company will have to pay VAT on the subsequent transactions with the claim. Once factored into the transaction price this obstacle makes selling claims disadvantageous for the bank.

Write-Offs and Charges

A very important side of credit quality problems is bank's ability to write-off the loan and charge them against tax-deductible expenses. In Ukraine the tax law allows this to happen only if certain conditions are met, mostly procedural. Therefore compliance requires time. In a failing market to wait means to lose value. The banks now have to choose between tax deductibility and capital prevention.

In addition to the above, if the bank sells a loan to another party, even a bad loan to a collection agency, any proceed from such sale becomes taxable. Therefore Ukrainian banks prefer to keep bad assets at their books fully provisioned and never try to charge them off. Given expected acquisitions and mergers, a portfolio of bad assets, even fully provisioned, can adversely affect the price of the bank.

The last but not the least issue vis-à-vis taxation is loan holidays. The tax law uses accrual method of accounting. The banks which offer loan holidays to their suffering clients are only comfortable to reschedule principal payments, since any accrued but not received interest is still taxable. The banks do not want and can not accept burden to pay taxes on restructured income and would rather refuse clients.

The Corporate Income Tax law has to be amended in a way that would ease the procedure for loans write-offs against tax deductible expenses. In particular, if the foreclosure procedure is completed according to the law (i.e. with the special government agency involved) it shall be enough reason for the bank to be able to charge loans against tax deductible expenses.. In addition, the sale of loans to collection companies also has to be treated as eligible sale for the purpose of loan write-off against tax deductible expenses.

Capitalization

In order to sustain crisis some banks would require additional capital. In most cases the capital will be needed to support liquidity, not just to absorb losses.

However, it shall be kept in mind that providing capital support in any case means acquisition of full-pledged ownership status and therefore sharing all existing and future risks, plus accepting the obligation to provide even more capital in case needed.

Since in many banks the existing owners are not able to financially support the institution any more, the Government wants to initiate a process of buying bank shares. The following are the challenges:

1. The Government for a long time did not make it clear whether or not there will be any eligibility criteria of what banks can apply to such support. Firstly, they talked generally and it seemed that this vehicle can be available to bank of any size and importance, the bank will just have to offer 50% plus one share to the Government exclusively or together with another investor. After about two months of discussion the list of eligible bank was finally developed together with eligibility criteria. It became clear that only large institutions can hope for Government capitalization in future.
2. The vehicle proposed by the Government is to issue debt to be purchased by the NBU and to use the proceeds to buy weak bank shares. Therefore effectively the banks will be supported by NBU's print money, not by nation's wealth.
3. It is not clear what exactly share the Government wants to buy – treasury shares or new issues. In first case it can be a window for existing owners to escape from the bank recovering their capital and leaving the Government to deal with all problems. Another side of the medal here is the price – nowhere in any official statement the Government made any indication of the purchase price. It is therefore not clear whether or not the price will be just notional (like with recent acquisition of Parex Bank in Latvia for 2 lats), or the taxpayers will be paying full face value for a distressed institution.
4. The Government wants to appoint the Ministry of Finance (MoF) to be the agency to run the purchased banks. However, the MoF has neither resources, nor ability to make due-diligence and to run the banks. The appointed officers have to receive an in-depth training, including on-the-job and study tours.
5. Many Ukrainian laws set force special regimes when they deal with enterprises with partial state ownership. So far these laws were not applicable to banks since there were only two banks with 100% state ownership. Once Government initiative is implemented, this would trigger laws application. Most of them require special procedures that are time consuming and could potentially place the banks in question in less favorable conditions compared to their peers.
6. The capitalization vehicle has to cover not only banks but also other sectors that are of a great importance to the economy. In this regard it would be much more feasible to house the capitalization unit not in the MoF but instead to establish a specialized Agency on Bankruptcy and Capitalization.

Before making any capital injection the Government has to ensure the funds allotted will not disappear. The best way of doing this is to remove the existing management and appoint an independent expert to run the bank (provisional administrator). However, even such action can be inadequate in case the real capital deficit proves to be much higher than expected.

Capital is needed for a going concern. More over, the institutions that grow have much higher demand for capital than those which fade out. In fact, most weak banks require cash inflows to support their liquidity and they care less about the form of such inflow – a refinancing support from the central bank as the lender of last resort, a capital injection from the government, or a removal of “hot debt” from the books to decrease the demand for liquidity. It is therefore worthwhile to consider the alternative way of providing banks with financial support:

1. The Government might consider buying bank bonds. Being a debt instrument, the bond is much more secure compared to share: (1) bond holder is not required to inject more funds into the institution if it weakens again; (2) bonds are much easier to price; and (3) bonds can be sold at any time with no need to change statutory documents and bylaws. But the most important thing is that a bond holder is a creditor to the bank, and the regulator will have to act to protect it, whereas the shareholder does not have such coverage. Therefore if the Government will buy banks’ bonds it will not create any conflict with the NBU and is certainly a less risky operation with the same immediate result.
2. There is an existing vehicle of so called “stabilization loans” to be provided by the central bank to a weak bank. In most cases these loans are not covered by any pledge or protection, however they do carry an interest rate, have maturity date and typically some conditionality attached. Instead of developing a new vehicle with Government capitalization it is worthwhile to consider restoration of stabilization loan practice. More over, from the substance standpoint in both cases – the capitalization according to the Government scheme and the stabilization loans – the NBU becomes the ultimate provider of the funds. In case of stabilization loans the critical is elimination of forbearance practice. It can be done by introduction of clear and sound criteria of what banks can apply for such loans.