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Developing Sound Banks in Transitional Economies Structural Reforms in Ukraine

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1. Introduction[1]

There are remarkably parallel developments in many of the banking sectors of early-stage transitional economies which carry so much similar baggage from Communist central-planing. More often than not, what is spawned, are fragmented, poorly capitalized banks with highly concentrated lending portfolios (often to insiders) and lax provisioning for emergencies. Government bank supervision, having no history, is embryonic and has limited effectiveness. Banks, in this environment, have little incentive for upgrading.

Unfortunately, but somewhat predictably, major and minor financial sector crises have occurred in several of the transitional economies. Bulgaria is still trying to repair the large extent of damage to the real economy (estimated at 14 per cent of GDP), triggered by the banking sector breakdown last year. And even the Czech Republic, in certain ways a leader in the transition, has experienced dislocation to the real economy as a result of banking failures.[2]

This paper explores the methods that the Ukrainian government (supported by international technical assistance providers) is developing to minimize the probability of a damaging, systemic banking crisis. The contention is that with highly lucrative existing sources of income for banks receding (and profits under increasing pressure), banks will more aggressively expand their balance sheets — but not necessarily in a healthy manner — as well as engage more in riskier off-balance sheet activities, such as foreign exchange trading. Thus, in the coming period, the fragility of the Ukrainian banking system could increase, leaving the system at greater risk.

The first two sections briefly review banking under the Communist system, and in the first period of the transitional governments. Then follows an in-depth discussion of Ukraine which explores at some length some of the elements needed for a more comprehensive strategy. An appendix deals with the question of banking sector strategy in more general terms.

1.1. Banking in the Communist System

The story of banking in the closing years of the Communist economies is well known. The so-called "banking system" passively accommodated the central production plan. Banks had no independent role in credit allocation. Enterprise deposits were blocked accounts which the government could and did confiscate. But since spending allocation was determined by the central plan, "cash in the bank" did not influence production. As part of the whole system of "soft budget constraints" banks in Communist economies could be more properly characterized as an arm of the finance ministry.

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[1] The author is Senior Banking Advisor, US AID Kiev. The views expressed are not attributable to US AID. The author would like to thank Alan Roe The World Bank, James Horner Barents-KPMG and Peter Sochan Citizens Network for their valuable comments, but remains responsible for the content.

[2] Caprio, Gerald, and Daniela Kingebiel, *Bank Insolvencies: Cross Country Experience*, "Policy Research Working Paper", No. 1620, The World Bank, July 1996. According to the authors, in the early 1980s, the direct effects of the Argentine crisis amounted to over 50 per cent of real GDP and for Chile 40 per cent. The largest loss was the 1980s US savings and loan crisis which was estimated at $150 billion. This, however, amounted to only 3 per cent of US GNP.

Neither risk management nor prudential concerns were at issue in this environment. Nor did the Communist bankers need to hone their credit evaluation skills because they had no role in selecting projects. There was no need for a risk-oriented bank supervision function (as opposed to one which is a watchdog over centrally allocated funds flow), nor for effective legislation delineating property rules, collateral standards and bankruptcy procedures.

Even after commercial banks were hived off following banking reforms during the mid- and late-1980s, there was still very little competition in the financial system. Newly formed state banks had portfolios highly segregated by both region and industry. Enterprises were not allowed to do business with more than one bank (a control mechanism which carried over until recently in Ukraine). Interest rate and credit allocation were still largely determined centrally. Moreover, only the national savings bank was empowered to take deposits and lend to households, maintaining separate monetary circuits between households and enterprises. In this environment enterprises had a bias for holding real assets — often in the form of large inventories — in order to hedge against, and have resources to deal with chronic shortages of the centrally-planned system.[3]

As the Communist economic system became increasingly dysfunctional during the 1980s, there was dynamic development of an informal sector in the real economy, both outside and inside the confines of the planned economy. The former was characterized by small scale traders and household construction services; the latter by what could be characterized as institutionalized moonlighting. Thus, at the time of the centrally-planned communist system's disintegration, the real sector was at the edges developing genuine market relationships, while the financial sector remained largely repressed in most countries. Banking, as we understand it, simply did not exist.

1.2. Banking in the Early-Stage Transitional Economies

As might be expected, while the contours of the banking system may have changed, fundamentals from the Communist system do not die so easily. In many transitional countries it is taking some years for the government to stop using banks as ministry of finance funding funnels to politically favored industries (agriculture, energy), although in general this mechanism of the “soft budget constraint” is slowly disappearing. (And in many of the more advanced Central and Eastern European countries has all but stopped.)

There is another variant on this theme of directed lending, however, which is still an important problem for many countries of the former Soviet Union. This is the problem of “pocket banks.” In the early stage of the transition, the chaos and uncertainty of the government's continuation of automatic funding encouraged state enterprises to take matters in their own hands — they simply started their own banks. Thus, instead of being a ministry of finance extension, “pocket banks” became extensions of their founding enterprise's treasury. In neither case, however, did these so-called banks play a market intermediation function, allocating funds to the most efficient businesses according to price (interest rate).

A second characteristic of many of the early-stage transition banking systems is ease of entry and very low capitalization requirements. Unlike some industries, in banking small is not necessarily beautiful. For example, effective hedging of portfolio risk requires a critical

[3] With central economic control loosening, there was a buildup of inter-enterprise credits. In a situation, where financing is restricted and there are severe distribution bottlenecks, firms protected their suppliers and customers either by overt funding, or generous collection terms, or a lenient attitude towards arrears. The vertical integration of the centrally-planned economies made this problem particularly intractable.

mass of loans. Banking is an inherently unstable industry because of the kind of business banks conduct — a business in which information is both hard to come by and to assess, and the "good" which one "buys" from a bank, a money loan, is not paid for until sometime in the future.

This information problem makes banking a volatile industry and one almost uniquely susceptible to contagion. A run on one bank can spread quickly and jeopardize sound banking institutions. Mature banks have a whole science of asset/liability management to guard against this inherent problem of the banking industry, including diversification of the asset portfolio, diversification of sources of funding and matching time distribution on the two sides of the balance sheet. While a critical scale is not the sufficient condition, it is certainly a necessary condition to be able to diversify portfolio and hedge against systemic volatility. Sufficient size is also necessary to make financially viable investment in computer equipment which utilizes sophisticated tools.

A further profound problem for banking development in the early-stage transitional economies is that the "rules of the game" are not known or keep changing — more baggage from the Communist system. The centrally planned economies were overlain by an authoritarian, paternalistic political superstructure. The Communist governments could act with impunity in every sphere. In the financial sphere, enterprise and household deposits at banks could be confiscated. In the early days of the transition, before formal breakup of the USSR, in a confiscatory currency redenomination, limits were put on amount and timing of the money exchange. More subtly, but equally powerful, inflation too is a form of confiscation of financial savings.

Legislation which lays down the "rules of the game" in the financial sphere is understandably inadequate in many transitional economies, given the limited time which has elapsed. It is not difficult to understand why this level of uncertainty and lack of strong prudential oversight by the government, in the inherently unstable banking industry, would give rise to a plethora of banking practices, some of which are well outside the accepted norms of banking practice in developed market economies.

In addition to all of these industry specific structural problems was the overlay of an unstable macro environment, particularly in the early days. (Even now, Ukraine is still registering declining real economic growth, according to official statistics.) The situation is thus an inherently volatile industry, banking, is placed against a landscape of a new economic system going through enormous gyrations. The result is an enormous decline in financial intermediation. Some part of this disintermediation has manifest as inter-enterprise credits and arrears. Ironically, what probably kept systemic risk within bounds in some countries was that hyperinflation eroded the value of the banking system's impaired loans portfolio.

1.3. Separating the Wheat from the Chaff

What is currently needed in many countries of the region is market tiering, which rationalizes the banking system — separates the wheat from the chaff. There are several ways evolution to a more efficient, sounder system can be accomplished. The most desirable is for strong banks (including foreign banks and other strategic investors) to take over weaker banks through mergers. For strong banks to have such an incentive there must be franchise value in the failed bank, for example, a branch network, property. (For Ukrainian banks, however, it is difficult to see in most cases this would be strong enough to impel a strong bank to take over the problems as well.)

Another form of market solution is that the system is rationalized through a systemic banking crisis as we saw dramatically last year in Bulgaria. As noted earlier, banking is an

industry uniquely susceptible to contagion. When a shoe store fails, this does not jeopardize the future of other shoe stores in the neighborhood. When a bank fails, however, the situation can be different. The initial failure can spread to credible banks and sweep them away in its wake. There is reason to think that this form of market solution would not give an optimal solution. More probable, a systemic banking crisis could cause considerable damage to the economy; be very costly to the government; and not always lead to a stronger, more efficient banking system.

An alternative approach is to orchestrate the rationalization of the system through a government program which addresses, among other things: a) fragmentation of the banking system; b) the fragile condition of many banks; and c) the lack of incentives for banks, themselves, to upgrade their practice. Supporting all of the above, is the need for further advances in the development of the legal infrastructure.

Rectification of these weaknesses, however, is a gradual process. In fact, the current consensus, among specialists, who have worked on developing banking sectors in transitional economies is that structural reform and developing the fundamentals for the countries of the former Soviet Union will take much longer than originally expected. For policy makers the development of optimal bank regulation and supervision is not an easy matter. To say it is desirable to “orchestrate” banking sector rationalization begs the question of how significant a role government should play. Since it is virtually impossible to “get it right” until an extensive body of experience develops, should the inclination be to err on the side of too much or too little government intervention?

In a compelling paper, Honohan and Vittas, World Bank economists, look at this question through the lens of the recent theoretical work which stresses the network characteristics of banking and finance[4]. Their conclusion, based on the network framework is that it is desirable to use a “light hand” in adding to what might be termed the basic institutional infrastructure.

In Ukraine, emerging all too recently from a central planning environment, in which the state not only interfered but controlled, an inclination to the light touch seems a sensible way to proceed although this should be caveated. For, according to statistics, real growth of the official economy in Ukraine has been falling for five years. By some measures, the cumulative decline of the official economy is a startling almost 70 per cent.[5] While the savings and loan crisis in the United States only cost 3 per cent of GDP and thus, was “contained” (it did not have a significant deflationary impact on the real economy), in the context of Ukraine, even a much smaller output cost could derail the fragile economic recovery.

Moreover, the banking sector is very small, for reasons described below. There is a great deal of public mistrust and cynicism about banks' ability to act as a safe recipient for savings, despite the fact that the National Bank of Ukraine (NBU) has successfully brought inflation down to respectable levels now for some period. A systemic wide crisis would

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[4] Honohan, Patrick and Dimitri Vittas, *Bank Regulation and the Network Paradigm*, “Policy Research Working Paper”, No. 1631, The World Bank, August 1996. The network characteristics of banking discussed are 1.) the externalities which inhibit Pareto optimal solutions (and justify the government's role); 2.) the observation that the system is robust to partial failure, offering multiple paths if one is blocked; 3.) its complexity, so that intervention in one area will typically produce both far-reaching and hard to predict effects. They conclude, “The three considerations pull policy design in opposite directions; although networks are not fragile, the pervasive externalities do call for intervention, but the complexity makes successful intervention hard to design”.

[5] This is partially offset by the upsurge of growth in the shadow, unofficial economy which is estimated at about 50 per cent of GDP.

undermine still further public perception of banks and could forestall financial reintermediation for years to come, further complicating economic growth. Given this current environment in Ukraine, while a fist, or even a heavy hand, is to be avoided, at the same time, the government should be encouraged to take a proactive role in developing the prudential regulatory structure, as well as a more long-term strategy for the banking sector.

2. Ukraine

2.1. A Snapshot of the Banking Sector

There are currently about 188 banks with NBU approved licenses (and another 51 banks in some stage of reorganization or liquidation). The banking system can be divided into several categories[6]. The largest banks evolved from the original Soviet monobank system described earlier. Two banks are still owned by the state, the Oschadny Bank (savings banks) and the State Export Import Bank.[7] There are three former state-owned banks; Bank Ukraina (the agriculture sector bank), Prominvest (the heavy industry bank) and Ukrsotsbank (social and municipal services).[8] These three banks are still used by the government for directed lending, although with decreasing frequency.

The remainder are private banks which did not develop from the old structures. As noted earlier, with the breakdown of the centrally planned economy, many of these banks were initiated by enterprises to secure funding. At the end of 1994, only twenty-seven banks out of a total of 220 had more than $500,000 in statutory (equity) capital. Almost 100 banks had less than $100,000.[9]

As recently as April of this year there were still more than 50 banks with less than $1 million in statutory capital. It is possible that many of these entities may not survive in their current form, if the National Bank's statutory capital requirement of one million ECU, which comes into force in January 1998, is rigorously enforced. At the other end of the scale, however, are roughly 50 banks which are reasonably well capitalized and offer true banking services. Many of these will form the nucleus of a market-based system.

Foreign financial institutions still play a small role. A National Bank of Ukraine (NBU) regulation restricts ownership to 15 per cent of the statutory capital of the banking system. At the current time foreign banks account for about 6 per cent. Ukraine is relatively liberal, in a

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[6] For a more complete discussion see Sochan, Peter, *The Banking System in Ukraine,* “Studies and Analyses”, No. 65, CASE, March 1996 and Roe, Alan et al., *Ukraine — Risks and Transition: A Review of the Financial Sector,* The World Bank, June 1995.

[7] The State Export-Import Bank dates from January 1992 when the FSU Vnesheconombank stopped processing Ukrainian foreign trade payments. Oschadny bank was formed in 1991 from the FSU Sberbank (Savings Bank)

[8] Three FSU specialized lending banks were transferred in 1990 into joint stock banks. Their shares at that time were owned mainly by state enterprises and government entities. In 1993 the government indicated that shares (and dividends) of state enterprises would be controlled by the Ministry of Finance. The banks responded by transferring shares from the enterprises to their own employees and to the employees of the state-owned enterprises. Thus an opaque and diffuse ownership structure has emerged. With so wide a dispersion of ownership, it is not clear how accountable management is to the stockholders.

[9] “Monthly Bulletin”, National Bank of Ukraine.

formal sense, in delineating the activities foreign owned or controlled banks can engage in. In mid-1997 there were fourteen banks with less than 50 per cent foreign ownership. There are four wholly owned banks; Credit Lyonnais and Societe Generale (French), Deposit Credit Bank of Ukraine (Polish), and Inkombank (Russian). ING and Credit Suisse are expected to have licenses soon.

2.2. Macroeconomic Backdrop

Hyperinflation has taken its toll on the banking system. At the end of 1996 the total assets of the entire Ukrainian banking system were only about $7 billion. This is at best equivalent to a small size US bank. By contrast, Komercni Banka, the largest bank in the Czech Republic (which has a population only 20 per cent the size of Ukraine), has assets of $15 billion.[10] Hyperinflation, coupled with a dramatic decline in real, official GDP is not a propitious situation for a banking sector to thrive.

The accompanying tables give a picture of the extent of financial disintermediation in Ukraine over the last few years in the wake of a hyper inflationary episode. By the end of 1996, broad money (currency plus bank deposits) was equal only to 11 per cent of GDP. Moreover, by 1996, the currency component of the money supply was even larger than domestic deposits, and velocity (the turnover of money) increased substantially — all indications of the public's growing disenchantment with the banking system. The only positive note through the end of last year was that as the currency stabilized, foreign currency deposits have dropped as a portion of total bank deposits. During the first quarter of 1997, official statistics indicate some improvement in financial intermediation, but whether this reversal is sustained remains to be seen.

Table 1

Depth of the Ukrainian Financial System (in per cent of GDP)

(end of period)	1992	1993	1994	1995	1996	1997-Q1
Currency	10	9	7	5	5	6
Domestic Currency Deposits	36	17	12	5	4	5
Foreign Currency (FX) Deposits	4	7	9	3	2	2
Total Money (M2)	50	33	27	13	11	13
FX Deposits/Total Bank Deposits	10	28	42	37	34	28
Currency/M2(Domestic Currency)	22	34	36	50	55	54

Sources: “Monthly Bulletin”, National Bank of Ukraine; “Ukrainian Economic Trends”, EU Tacis

[10] *Business Central Europe,* “Wall Street Journal”, October 1996.

Table 2
Regional Comparison: Depth of the Financial System, 1994.
(Money (M2) as a percentage of GDP)

	OECD	Latin America	C.E.E.	NIS
Currency	6	5	17	8
Bank Deposits	67	18	25	12
Total Money (M2)	73	23	42	20

Source: *World Development Report 1996*, The World Bank.

Last year was a critical period and in some sense a turning point. Real growth continued its sharp drop (10 per cent), but inflation finally decreased from 400 per cent and 180 per cent in 1995 and 1996 respectively, to less than 40 per cent by year-end 1996. This year promises a further significant inflation decline. Monetary stability laid the basis for the introduction of a new, redenominated currency in September 1996 which was non-confiscatory in design and has kept its value to date (partly reflecting an upsurge of foreign portfolio inflows into Ukrainian government securities). But that also means that banks will no longer be able to depend upon inflation to reduce the value of impaired loans.

Part of the success in stabilizing prices came from the development of a government securities market which financed about one-third of the government's budget deficit last year. This instrument through most of 1996 carried a substantial risk premium reflecting; the government's poor track record hitherto in monetary stabilization; the government's uneven history too in honoring obligations; the fragility of the banking system and the difficulty in accessing the solvency of individual banks.[11] Thus, even as inflation abetted, there was still a substantial lag in the deceleration of interest rates. Banks were able to enjoy a more than respectable return through investment in government securities.

This year, however the situation is changing. Banks' profits are coming under increasing pressure because the easier ways of making handsome margins on-lending are disappearing. As the table illustrates, commercial bank interest rate margins have fallen precipitously. The return banks could enjoy on Treasury securities are also less lucrative, as is lending through the interbank market, where pricing follows the NBU refinancing rate (which has also dropped in real terms).

[11] Only Ukrainian banks are permitted to participate in government securities auctions and to act as custodians. Thus, for investors, with little information about the condition of individual banks, there is significant custodian risk.

Table 3

Commercial Bank Interest Rate Spread

(Quarterly average)

	Lending Rate	Deposit Rate	Difference
1995-Q1	195.6	135.6	60.0
1995-Q2	113.1	69.6	43.5
1995-Q3	77.0	32.6	44.4
1995-Q4	105.2	35.4	69.8
1996-Q1	108.0	48.7	59.3
1996-Q2	83.4	33.5	49.9
1996-Q3	64.3	26.4	37.9
1996-Q4	63.8	25.9	37.9
1997-Q1	59.8	22.3	37.5
1997-April	52.4	19.1	33.3

Source: “Monthly Bulletin”, National Bank of Ukraine.

At the same time, because of the sorry history of hyperinflation, some recent, well-publicized large private bank failures, and most recently the addition of a government treasury instrument directed at the retail sector, the public still does not put a great deal of trust in the banks, even with inflation coming down dramatically. Nor, for that matter, do banks trust each other. This implies that if the banks want to aggressively expand their deposit base to support asset expansion, they would have to pay a significant margin on deposits and interbank borrowing.[12]

Finally, NBU supervisory oversight will be tightening. Some excellent, rigorous prudential regulations have been and are being developed. With the changes to International Accounting Standards (IAS) in 1998, banks will be forced to adopt stronger provisioning for impaired loans. All these factors suggest that in the coming months banks' profits could be under increasing pressure.

Some banks will probably try to maintain profits by aggressively expanding balance sheets, including business lending. According to newspaper reports, during the first five months of 1997, business loans on an annualized basis increased more than 50 per cent[13]. The danger, of course, is that these loans are not to healthy creditors, particularly when one considers the still declining economic growth; the lack of experience bankers have had in making loans; and the difficulties in assessing the financial health of a company. Also observed since mid-1997 is an increase in bank purchases of corporate securities, a function most probably too, of the interest rate decline on government securities.

All of these factors suggest that the current problems of “adverse selection” (the worst borrowers, with nothing to lose, will be the ones willing to pay a high risk premium) could become more serious. The conclusion is that in the coming months there could be a decided acceleration in the growth of the system's impaired loans — even if government directed lending through the banks (and price distortions) were to cease altogether. A final danger is

[12] In addition, under the “kartoteka” system businesses were only permitted one bank account (to make tax collection easier, among other things). The financial impact must have been to add to the risk premium since depositors could not hedge their investment by placing deposits in several institutions.

[13] “Eastern Economist”, June 3,1997.

that with profits under pressure, banks may engage still more in riskier off-balance sheet activities — guaranties for loans and for joint ventures (particularly construction projects), buying deeply discounted suppliers credits, and particularly, for activities connected with foreign exchange.

Although banks have been active participants in the foreign exchange area for some time, the difference this year is the presence in the market of substantial foreign portfolio inflows. This means that even though the currency is projected to remain relatively stable over the medium-term, on a day-to-day basis, with so much offshore money coming into what is still a very thin market, volatility could increase. International financial institutions have enormous resources. What would be a small marginal loss for an international financial institution, making a bad bet on the hryvna, could be a crippling experience for a Ukrainian financial entity (many with lax internal controls).[14]

3. The Current Approach

The National Bank of Ukraine, which to date has been the primary government entity overseeing the banks, developed a program in the early 1990s concentrating on the financial infrastructure and legal underpinnings of the banking system. In collaboration with the International Monetary Fund, a matrix of donor assistance was put in place early on to develop basic central bank functions — different aspects of bank supervision, development of the electronic funds payment system, development of an IAS-based chart of accounts, development of a primary market in government securities. Additionally, the NBU took the initiative in developing the new NBU Law and the Law on Banks and Banking.

The World Bank's Financial Sector Structural Adjustment Loan (FSAL) program, was begun roughly three years ago. The FSAL added elements to work on the former state banks and the savings bank. Finally, the EBRD took responsibility for developing an upgrading program for the private banks in the form of a bank credit facility for small and medium size enterprises.

3.1. National Bank of Ukraine: Financial Infrastructure

3.1.1. Bank Supervision

The NBU has collaborated with US AID for two years in a technical assistance program to develop bank supervision. Professional bank supervisors from the US regulatory agencies, the US Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision have both lived in

[14] Moreover, for many international players, Ukraine will be a by-play from the much larger Russian market, adding yet another element of unpredictability and volatility. Although the Ukrainian market will have its own life, fickle investor attitudes towards Russian fixed-income assets are already spilling over into Ukraine. For example in mid-1996, during the Russian election campaign, reputedly millions of dollars came into Ukrainian government securities for a short period. This is not unusual when a smaller country is geographically and culturally close to a larger country. For example, the Canadian dollar too was very much impacted by movements in the US dollar, really into the last decade.

Ukraine for extended periods and made short-term trips to advise on specialized functions such as bank licensing.

Progress to date in developing professional bank supervision capacity has been slow. There has been constant rotation of the Deputy Governor in charge of the function, leading to intermittent commitment from senior management. Moreover, the NBU Bank Supervision still does not have all the tools at its disposal for either analysis or enforcement. The former awaits conversion of the banking system to international accounting standards; the latter awaits the uncertain passage of the new National Bank Law, and the revised Law on Banks and Banking.

In an attempt to speed the pace of development, the NBU reorganized the supervision function in mid-1997. The head of the bank supervision function is now at the Deputy Governor level and separate departments were created for the individual functions (such as on-site supervision) with new directors. Together with the momentum, which began to build late last year, there is reason to think that the pace of development of the NBU bank supervision function could speed up considerably. An evaluation awaits, however, the forthrightness which with the NBU will be willing to act in an even handed manner to implement excellent prudential regulations recently passed.

In terms of the different aspects of bank supervision which are part of the US AID program:

On-site Supervision: The Bank Supervision Department (BSD) since late 1996 has developed a more systematic schedule of inspections. Ukrainian inspectors are working with foreign advisors from the US regulatory agencies. They are following a methodology borrowed from the US system but significantly altered to reflect Ukrainian circumstances.

Off-site Supervision: A Uniform Bank Reporting Requirement (UBPR) is being developed together with an early warning system. These should be functioning by the end of the year and, will serve as input for the work of on-site supervision, feeding into scheduling of on-site examinations. This work, however, will only have credibility after the banks convert to international accounting standards in 1998.

Problem Bank Work: The Bank Resolution Unit was first set up as part of the NBU Bank Supervision Department in September 1996. Still, in its early stages, the Bank Resolution Department is just in the process of delineating its mission. The objective of the US technical assistance program is to build an integrated approach. Banks, in which on-site inspections indicate serious problems, would be transferred to this unit for further attention. There will be a wide range of approaches from rehabilitation to liquidation. Within the Bank Resolution Department there will be an organizational separation between rehabilitation and liquidation.

Deposit Insurance: The Strategy Department of the bank supervision function is still developing a framework and doing quantitative work on the implications of different scenarios. An advisor from the National Bank of Romania, which US AID has brought to Ukraine, and a second advisor from the CASE Foundation in Poland are working with NBU counterparts to develop a sound law. However, implementation of a credible system of deposit insurance can only come after a) international accounting standards are adopted so an accurate financial assessment can be made; and b) the amended banking laws are passed by the Ukrainian Parliament which will give the NBU authority to handle rehabilitation and/or liquidation of insolvent banks and strengthen NBU prudential regulatory powers.

3.1.2. Accounting

It is not possible with Gosplan bank accounting to make an analysis of individual banks because of the distortions to the income and balance sheets[15]. The major differences between the statutory Ukrainian approach and International Accounting Standards (IAS) include:

- cash as opposed to accrual basis;
- net income is calculated before charges for taxes, loan-loss provisions;
- loan loss provisions are understated;
- interbranch transactions are not netted out which inflates balance sheet totals;
- inflation adjusted financial statements are not presented;
- subsidies not consolidated.

The NBU has finalized a chart of accounts and compatible reporting forms for the commercial banks. On January 1, 1998 banks will have to make the changeover to the IAS accounting procedures. Starting in July 1997 there is a six-month period in which the NBU has selected twelve pilot banks to test the new procedures. The NBU Accounting Department will be supported with advisors from US AID and EU Tacis and by representatives of the "Big 6" accounting firms based in Kiev.

The choices for the pilot banks underwent some degree of scrutiny but due diligence was very limited because there has not been rigorous, risk-oriented on-site inspections of potential candidates. An attempt was made to include a spectrum of banks in the pilot program chosen both on size and activity considerations in order to have a representative sample. There will be banks from four regions of the country participating. The work to develop new reporting forms compatible with the IAS-based chart of accounts is being handled primarily by the NBU Bank Supervision. There has been reasonably close collaboration between the NBU's Supervision and Accounting functions.

The National Bank is making steady progress in developing its own chart of accounts, based on International Accounting Standards with the help of an IMF advisor. This work too should be finished by early 1998.

3.1.3. Electronics Funds Payments System (E.F.P.S.)

The National Bank of Ukraine has arguably one of the best electronic funds payment systems in the region. The system is composed of an electronic payment system for interregional accounts, and for regional clearinghouse accounts. The system was greatly aided by a multimillion grant from US AID. Additionally, US advisors from the Federal Reserve System worked with the NBU to develop a disaster-recovery plan. The banking sector now has the technical capacity to execute payments in a matter of minutes rather than the days, and even weeks as was previously the case. The computer system is currently being modified and expanded to accommodate a depository for the registration of government securities. There is also a plan to use the E.F.P.S. to set up a collateral registry for moveable property.

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[15] This discussion borrows from Kockler, Thomas, *Overview of the Russian Banking System,* Chase Manhattan Bank Emerging Markets Research, May 30, 1997.

The World Bank gives the following information: 1994 accounts of Bank Ukraina using the statutory Ukrainian approach showed taxable profits of almost $400 million. IAS methodology, incorporating NBU provisioning for the same year showed profits of only $235 million. Roe, Alan, *Banking and Finance in Ukraine, An Update of Developments During 1995,* The World Bank, mimeo.

3.2. Systemic and Sector Restructuring Issues: The World Bank FSAL

The World Bank began to send Missions to Ukraine in 1994 to develop a Financial Sector Structural Adjustment Loan (FSAL). For some time the work languished. However, since mid-1996 reasonable progress is being made. Solid accomplishments to date include strengthening of prudential oversight with new NBU regulations on capital adequacy, loan classification and provisioning. Passage of the enterprise profits tax law, with partial tax deductibility of bank loan-loss provisioning is also a step forward. Before the end of the year there is some chance that all conditionality will be met so that the FSAL loan could be presented to the Board of the World Bank.

There are five parts to the FSAL conditionality:

- First (and foremost) is a stable macro environment as evidence by compliance with the IMF program. Of particular interest is the maintenance of liberated and positive real interest rates. Structural adjustment in the banking system does not exist in a vacuum;
- Next is the legal framework for banking activity. The current law covering the central bank and the banking system was passed in 1991[16]. The National Bank Law must be in first reading by the Verkhovna Rada (the Ukrainian Parliament) before the World Bank will conduct an FSAL pre-appraisal mission. The Law on Banks and Banking has not even been finalized and its passage is probably at least a year away. Among the most important features included in these Amendments to the Law on Banks and Banking are those empowering the NBU to close a bank and execute its liquidation. These stipulations will be critical in moving ahead with the NBU problem bank strategy. First reading of this law in the Verkhovna Rada will be an FSAL conditionality for either World Bank Board approval of the loan or for second tranche release;
- A third set of conditions overlaps with the IMF work and concerns the development of the financial infrastructure, and in particular, bank supervision and IAS accounting which were discussed at some length earlier;
- Another section discusses specific problems of the banking sector: a) Strengthening bank licensing procedures; b) A restructuring program for the state-owned savings bank. This will be based on an audit which began in summer 1997; c) Strengthening NBU enforcement procedures and capacity for dealing with problem banks; d) A deposit insurance system, as discussed earlier;
- A final part of the World Bank FSAL conditionality has to do with the three, larger, former state banks. The World Bank FSAL requires development of a program to limit a systemic spillover from liquidity problems of larger banks, and setting up workout units in these institutions. It also has statements about possible reassertion of equity ownership from the state, as well as putting bank purchases of premises from the government on a commercial basis. Finally, as a condition for World Bank Board

[16] The law not only regulates the NBU, but also contains authority for commercial banks and the savings bank. It is woefully inadequate. The powers of the NBU to supervise commercial banks are not well delineated. Drafting of separate new laws for the National Bank and the commercial banks was initially started almost four years ago; the National Bank Law still awaits first reading by the Verkhovna Rada, while the Law on Banks and Banking is still not even in final draft form. One of the most important problems with the current legal structure is that it is unclear whether the NBU has the authority to intervene in banks. Banks are established under oblast commercial laws and receive specific licenses from the NBU to operate in banking activities. Thus, the NBU does not have clear authority to seize assets of insolvent banks. This severely hampers the NBU's enforcement powers.

presentation there is the condition that the government agree to a scheme for relieving the three former state banks of non-performing loans made on instruction from the government. The amounts involved are estimated at roughly $250 - $450 million. Reportedly, the government has provided for at least some portion of this settlement in the 1997 budget. The World Bank premise is that even though directed lending from the government still continues, albeit at a much slower pace, the size of the impaired loan portfolio at the former state banks is currently, relatively small in terms of the impact on the real economy. The former state banks, have serious problems but are solvent and over time their share of the market will gradually shrink. These banks and their problems will essentially wither away. This may prove too optimistic a view.[17]

3.3. Upgrading the Private Banks: The EBRD Small and Medium Enterprise (SME) Credit Line

While developing an effective government regulatory authority and restructuring the banking system to strengthen its collective solvency are necessary, these are not sufficient conditions for a sound banking system. Banks also need a business culture which places a premium on good banking practice and an incentive structure encouraging adoption of market-based banking norms. Self-regulation is every bit as important as government regulation. To that end, a bank upgrading program of technical assistance was melded into an EBRD credit line which started in 1994, and was implemented in 1995.

The objectives of the SME line of credit were thus, twofold. First, was to catalyze bank lending to the most promising SME businesses. Second, was to help upgrade participating banks. In this second aspect, the program structured a technical assistance program which contained several modules for participating private banks, including credit training, auditing, MIS development. The notion was that this cadre of banks could serve as an example to a wider range of banks and encourage other banks to upgrade.

However, in this respect, tying a project to upgrade banks to a small business credit facility has not so far worked. As discussed further on, certain features of the Ukrainian banking culture are not what are normally considered acceptable norms in market-based banking practice. As yet, Ukrainian banks are not taking the initiative to alter practices in order to conform more with western, market-based banking.

Moreover, the design, and the timing of the program arguably, may have even provided negative incentives for due diligence in selecting and monitoring banks in the EBRD credit line.[18] Of five banks, which originally qualified, the bank which received the entire first

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[17] A guesstimate is that total loans of these three institutions are somewhat under $1 billion. In the worst case scenario, even if 100 per cent of the loan portfolio were impaired, this would still only amount to roughly about 1 per cent of GDP. Not only is this dwarfed by the problem of government wage and payment arrears, but it is much smaller than the output proportions confronted by many other transitional economies. Nonetheless, as noted earlier, given the starting point in Ukraine — the disarray of government finances, the depressed economy and the lack of confidence in the banking system — even a relatively modest loss by these former state banks, in terms of the amounts, could have serious, wider reaching implications.

[18] A World Bank research paper discusses the banking crisis in Latvia. It says, “The banking crisis in Latvia came to a head, precipitated in part by the insistence of the Bank of Latvia that all banks should prepare and present to its Banking Supervision Department financial statements that had been audited on the basis of IAS...*A factor which may have pushed some banks into ill-advised lending was the ease of availability for certain foreign credit lines that were guaranteed by the Government. The banks approved for channeling these credit lines often did not have adequate mechanism in place*

tranche is the now insolvent Grado Bank.[19] There have also been questions raised about the financial condition of a second bank in the facility. Some lessons can be gleaned from this experience:

- **It is difficult to combine a program to upgrade the banks with a small business lending facility in the early stages of the transition.** There can be conflicting incentives between the need to make loans to small businesses, and the objective of reinforcing the safety and soundness of the banking system.[20] One obvious conflict is that unless the small business facility is actually utilized — loans are being made to small businesses — in a short period, its originator (EBRD in this case) might consider canceling the facility. From the bank's point of view there is pressure to show that loans are being made, because cancellation in the eyes of the international financial community is probably worse than not having the facility at all.
- **It is difficult to do proper due diligence of a Ukrainian Bank at the current time,** partly because the banking system is not on IAS. A condition of eligibility for the EBRD line was an international audit by a "Big Six" accounting firm. The report of Grado Bank's auditor, is confidential so it is not possible to know what was said and how this audit was interpreted by the responsible EBRD officials in London who qualified Grado Bank for the credit facility.
- **A program which is to concern itself with upgrading the safety and soundness of the banking system must have effective monitoring of bank solvency**. Donors, such as EU Tacis, monitor their twining arrangements with the banks in the EBRD program which they are responsible for. The EBRD monitoring unit at the NBU concerns itself with the logistics of the program and the merits of individual loans. There is also a requirement for annual audits by an international accounting firm. What is missing (and now appears to be essential for any program to upgrade the banks through a foreign credit line) is a group of analysts (preferably bank supervisors) who: a) Are completely arms-length from the banks; b) Develop rigorous criteria for bank eligibility in the program; c) Review the overall financial condition of the banks participating in the facility, on a regular basis. This should be part of the ongoing supervisory process of the

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for screening borrowers." (Fleming, Alex et al, *The Baltics-Banking Crises Observed*, "Policy Research Working Paper", No. 1647, The World Bank, September 1996.

[19] Grado Bank in Ukraine was considered one of the best of the private banks. It was, in fact, the first bank which qualified for the EBRD small business lending facility in 1994. In late 1996 what became apparent was that a German reparation facility to victims of Nazi war crimes, for which Grado Bank acted as Agent, never reached the intended recipients. It is alleged the management of Grado diverted the money to other sources. After forceful complaints by the German government, criminal charges were filed against senior management.

[20] This holds not only for a small business facility as described above, but, also applies to other types of programs. For example, a deposit insurance scheme which carries with it social safety net concerns about safeguarding household savings. A structure such as this could dampen the incentive to take forceful actions against errant bank members.

There are alternative ways to structure a foreign credit facility which U.S. AID has tried throughout the world with some notable successes. One approach is to stage the program so that a lengthy period of technical assistance precedes bank assumption of credit risk. In the first stage the program would be a donor funnel. A local bank would earn fee income by suggesting clients for the facility. The local bank would assume credit risk, gradually, as it gains experience from day-to-day work with foreign bankers. Another approach is through usage of partial guaranties to encourage banks to lengthen the term of a loan. A guaranty could be put on the second half of the loan. A guaranty need not even be on loans, but could be placed on spikes in funding costs which would be a hedge for the bank on term mismatch.

National Bank, which is extending a loan guaranty; and concretized by setting up a unit with specific responsibility for these proliferating foreign credit lines as part of the NBU's bank supervision function.

- **The National Bank of Ukraine has given a sovereign guaranty to the EBRD credit. This is usually not a good idea.** This raises the question of whether the program was premature. A problem with a sovereign guaranty is that it runs the risk of lessening the foreign donor's preexamination as well as ongoing monitoring. It is interesting to note that the EBRD's Russian small and micro business lending facility does not have a sovereign guaranty.

4. Going Forward

What does all the above add up to — how much progress has been made to date and what still needs to be addressed?

First, basic financial infrastructure functions housed in the National Bank have come a long way in the last few years, starting as they had from literally nothing. Payments today are quickly processed by an efficient electronic funds payment system. Both the commercial banks and the central bank should be switched to international accounting standards by 1998. The Bank Supervision Department at the NBU has been reorganized and upgraded. The efficacy of this new structure will be tested in the coming months. At the rank and file level, basic skills of bank supervision are being developed. One can see the contours of a professional department in the making. Progress on the legal infrastructure is more problematic. The Verkhovna Rada has still not passed new banking laws. This implies that NBU regulations will have to be used more extensively, based on the enabling legislation in the old law.

On broader questions affecting banking sector structure, however, progress has been slow. There is not a coherent strategy for banking sector restructuring. The questions still to be elaborated include:

i) fragmentation: About 90 per cent of the roughly 200 banks account for less than 15 per cent of the banking sector's total assets; while more than 85 per cent of the assets are concentrated in the largest 20 banks. While higher capital requirements, which are being introduced gradually this year, will help, it is not altogether clear that this will have enough bite to effectively rationalize the system.

Table 4
Distribution of Banks by Total Assets*, March 1997

Range ($ million)	Number of Banks	Total ($ billion)	Percentage
Total	191	7.30	100
550 - 815	Top 5	3.82	52
150 - 550	Next 5	1.37	19
40 - 150	11 - 20	0.85	16
30 - 40	21 - 30	0.32	4
.06 - 30	31 - 191	0.94	9

Source: National Bank of Ukraine.
* Statitics are adjusted to exclude doublecounting because branch report is not consolidated. This adjustement represent rougly a 30 per cent downward adjustement in total assets.

ii) fragility: Without full-scale supervisory inspections and international accounting standards in place, only guesstimates can be made about the condition of individual banks. The consensus, however, among knowledgeable observers is that many banks are on the path to insolvency (and indeed some have already arrived). This could accelerate as balance sheets quickly expand. The World Bank's FSAL begins to think about this problem but understandably, in its early stage, is most concerned with the fundamentals of the financial infrastructure.

iii) Upgrading: There is still no pervasive culture within the banking sector which impels these banks to develop their practice in a manner consistent with market-based principles.

Each of these three factors will be considered in turn.

4.1. Fragmentation — Rationalization of the Fragmented Banking Structure

At the end of 1996 there were approximately 230 entities with banking licenses, of which roughly 50 were awaiting either liquidation, rehabilitation, or reorganization. It is difficult to make a determination of the optimal number of banks because this judgment basically flows from the scope of financial services envisioned for the Ukrainian banking sector. Fundamental research on how other transitional economies have approached this question would be welcome. There probably is no “right answer,” however. In the industrial countries, for example, there is a wide range of solutions.

In the United States, there are thousands of commercial banks, not to mention savings banks, cooperative banks and investment banks. For most of this century U. S. banks were not allowed to expand beyond state lines nor to engage in investment banking. Only in the last decade has this changed. The 1980s was a difficult period for the US commercial banking system. Many of the nation's largest banks were in great difficulty as a result of lending to developing countries (the LDC debt crisis). Arguably, aggressive, orchestrated action by the Federal Reserve helped ensure an orderly market restructuring of the banking system and resulted in a more concentrated banking system structure.[21]

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[21] In the early 1980s the Federal Reserve articulated a “too big to fail” policy. The Federal Reserve named the banks which would not be allowed to fail because of their prominent role in the financial system and the systemic problems which could ensue. The Federal Reserve also allowed

Just north, in Canada, a completely different banking structure evolved. Like the British system, there are a small number of banks with coast-to-coast branching networks. In this system too, there had been traditionally a China Wall built between commercial banking and investment banking activities, in contrast to many European countries.

Although there is no "correct" answer, there are several considerations which suggest the banking system in Ukraine is operating at less than optimal efficiency because of fragmentation and the current small scale of even the larger banks. To begin with, in a big country, like Ukraine, one factor to consider is that opting for a model with many small banks could be very difficult to supervise — it is costly and inefficient. Even if the small size of most of these banks does not warrant an on-site bank inspection, and their simultaneous demise would cause the banking system no more than a ripple, they would still require substantial supervisory facilities and time in terms of basic off-site monitoring and eventual liquidation. This is one factor to consider in view of the current (and for the foreseeable future) limited capacity of NBU's Bank Supervision.

The second point is that the banking system contains an inordinate number of entities which are not true financial intermediaries but more properly seen as extensions of enterprise treasuries — their primary function is to channel funding to their corporate owners. While many may appear to be well-capitalized for the moment, and thus, not a systemic threat, this situation could change quickly. These so-called "pocket banks," with concentrated portfolios and large participation in the interbank market, (as well as in some cases soliciting deposits from the public) require constant supervisory oversight.

There is, however, a second problem with these "pocket banks." Such entities, if allowed to operate on the same basis as other commercial banks, perpetuate a banking culture of directed lending (in this case to owners rather than to favored government industries). This is the antithesis of a market based banking sector, in which lending is to the most efficient borrowers on the basis of price competition. (The price too reflects the bank's assessment of risk).

Finally, as noted earlier, banking is one industry where scale is important because of the need to diversify risk. Judging from the experience of the more advanced Eastern European countries, western banking practice, with its myriad of instruments, can come very quickly once banking system development accelerates. Part of this development will be brought by western financial institutions, and then emulated by Ukrainian entities. As Ukrainians gain experience in western financial institutions too (which is beginning to happen), they will bring back to the Ukrainian banking system sophisticated methodology (for example in risk management). However, these more advanced methods often mean high fixed costs in the form of sophisticated, high powered computer systems which are only financially viable with a large enough scale of operations.

Thus, in summary, there are good reasons to think that the current banking system in Ukraine should be rationalized and the number of banks reduced:

- Supervisory oversight is currently difficult with so many small entities;
- More sophisticated banking implies a certain scale to be efficient because of higher fixed costs;
- Scale is also important to hedge risk by portfolio diversification;

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banks to deal with impaired lending portfolios to developing countries in a "liberal" manner, having to do with rescheduling agreements and provisioning. This respite defused a highly explosive situation. It gave these banks, and others, time to increase capital, and to adequately provision and otherwise deal with impaired loan portfolios. Ultimately some of these banks merged and downsized. What emerged was a more concentrated, but arguably sounder banking system.

– The banking system cannot be said to be truly market-based until lending to owners becomes less pervasive.

As noted earlier, the inclination is to keep government intervention at a minimum. Thus, certainly, when speaking of rationalization, this is not meant to imply that the government should develop a bank specific policy. Rather, the role of the government is to establish the infrastructure which specifies the regulatory framework. Ideally, once this infrastructure is established, it should be applied in an evenhanded way, so that all banks which meet the set conditions (such as those currently being developed as part of the World Bank FSAL) will have the right to perform banking services. At the same time, the government has to ensure that its regulations are stringent enough to carry out its fiduciary role to ensure a safe and sound banking system. This is not so straightforward an exercise, however, and will need careful thought. There will be countervailing pressures, such as, for example, situations in small towns, in which a tiny bank may be the only financial intermediary.

On January 1, 1998 the minimal statutory capital requirement for a bank to operate will be raised to ECU 1 million. As a result, a certain number of banks, which are doing poorly, may simply decide to close up shop. The system will rationalize through attrition or merger. As noted, a certain number of banks are in the NBU Bank Resolution Department waiting for the necessary paperwork to close operations. Certainly, more research would be welcome, outlining for the government how effective the current minimal capital requirements will be in helping to prune the system of inefficient entities. As can be seen, however, in the accompanying table, during the last few years there has been a decided redistribution in banking size. Just two years ago, 96 per cent of the banks had less than $1 million in statutory capital. By early 1997 that number was only 29 per cent.

Table 5

Distribution of Banks by Statutory Capital

	1994	%	1995	%	1996	%	April 1997	%
Number of Reporting Banks	220	100	210	100	188	100	188	100
US$ Million								
Under 1	210	96	156	74	71	38	54	29
1.0 - 1.5	3	1	27	13	49	26	48	26
1.5 - 5.0	5	2	19	9	52	28	62	33
5.0 - 20.0	2	1	4	2	11	6	19	10
20.0 - 40.0	0	0	3	1	2	1	2	1
Above 40.0	0	0	1	1	3	2	3	2
Total Statutory Capital	$84 mln		$ 300 mln		$ 560 mln		$ 650 mln	

Source: “Monthly Bulletin”, National Bank of Ukraine.

The NBU has a very important tool in its licensing power. There are 32 different functions which banks receive permission to engage in, such as specific approval to handle foreign exchange transactions. Thus, the banking system has many tiers. In the absence of supportive legislation, this licensing tool gives the NBU an effective way to make the banking system safer during the early stages of the transition. At the current time the spread of banks access to the different functions is as follows;

32 operations	8 banks
28-31 operations	57 banks
8-27 operations	71 banks
5-12 operations	42 banks

In 1996 the NBU used its licensing authority to enforce the requirement of its regulations that only banks with an authorized capital fund of ECU 500,000 would be eligible for full foreign exchange licenses (the ability to receive deposits and grant credits in foreign currencies and enter into direct correspondent relationships). This action resulted in the removal of foreign exchange licenses from 26 banks. A logical follow-on action now would be to use the minimal capital requirement to restrict domestic currency operations (e.g., deposit taking) of technically insolvent banks. These banks should not be able to accept deposits from the public nor participate in the interbank market.

Another potentially powerful tool for dealing with the “pocket banks” described earlier is the tightening and aggressive implementation of NBU regulations on concentrations of loans to one borrower and on loans to insiders. Banks, which basically service owners, under a strict “lending to one borrower” NBU regulation, would no longer be able to fulfill their original function. They would either cease functioning or develop into genuine financial intermediaries. The problem with the law, however, is that in its current form it can be easily circumvented because the lending to one borrower is not on a consolidated basis. This should be a priority for change.

4.2. Dealing Systematically with Problem Banks

Impaired loan portfolios have been the Achilles heel of virtually every banking system in the new, transitional economies. For the state banks, and former state banks, the reason, more often than not, is continuation of directed lending to favored sectors. And for the private banks, although there is some jawboning from the state, the problem stems more from lax licensing in the early days which spawned poorly capitalized banks with no experience in lending, a fascination with sophisticated western financial instruments, and a proclivity to lend to owners and associates.

There have been banking crises in many countries, be they traumatic as in Bulgaria, or merely scares, as in Russia and Ukraine (in August 1995 and March/April 1995, respectively, when the interbank market seized up and the central banks quickly pumped in liquidity to defuse the situation). Too often, strategy comes after the crisis and is costly to an ill-prepared government.

There is good reason why the question of impaired loan portfolios of the state and former state banks is of some concern to the government. To begin with, these entities account for the overwhelming share of banking sector assets. Thus, liquidity problems of these largest Ukrainian entities pose could spillover into problems for the entire banking system, and the economy.

A need too, for an increase in capitalization of these entities, or other public support, could result in a call on the budget. The fiscal effects, and in turn the impact on macro stabilization policies and the real economy would not be limited, however, to the direct impact on the budget (through recapitalization of the banks). The reduction of liquidity to enterprises could hamper their ability to pay taxes, while the reduction of the deposit base could reduce demand for treasury securities, and thus raise government funding costs. Finally, because a significant share of the problem loan portfolio results from directed credit at the

behest of the government, these loans are basically the government's responsibility even if not covered by official guaranties.

To reiterate, however, a point made earlier, this is not exactly the same problem that, for example, faced several of the Central European countries. For these countries, the size of the impaired loan portfolios, relative to GDP was a burden, among other things, for its sheer magnitude. For Ukraine, the problem is more subtle and understood best as a function of a relatively much less propitious starting point — the current troubled state of government finances, the economic decline still taking place in at least the official sector, and the substantial public mistrust of the banking sector.

In the transitional economies there has been a wide range of programs for dealing with impaired loan portfolios of the state banks. One could think of a spectrum of centralized to decentralized approaches. Slovenia and Macedonia could be considered examples of the former, in which a separate bank rehabilitation agency was established and impaired loans of the banks were transferred to this new government agency. However, in both countries there were serious problems with this approach. First, it was difficult to find good professional staffing. Second, the National Bank felt its prerogatives impinged upon and was not fully collaborative. Third, the banks themselves were not willing to hand over credit portfolios and otherwise cooperate.

Poland is an example of a decentralized approach. In exchange for recapitalization, Polish State Banks had to aggressively work out their portfolios. By a specified deadline, banks were required to sign reconciliation agreements with enterprises holding overdue loans. This program is considered a qualified success because it catalyzed a change in the banks from passive to active creditors; trained staff in workout and related credit procedures; and performed a triage on the impaired loan portfolio — separating out potential future clients who needed temporary liquidity from the unviable entities which were forced into liquidation. However, bank-led restructuring seemingly did not, by and large, greatly improve corporate governance and restructuring of client enterprises. Nor, was there always even handed treatment for holders of suppliers' credits[22].

Moreover, the Polish experience had unique characteristics which would probably make it of limited applicability to Ukraine. These factors include; clear government ownership of state banks; a talented and activist nucleus at the Ministry of Finance; a large government recapitalization fund which had been initially given by Western governments for exchange rate stabilization; and an already skilled group of bankers with substantial experience with western financial markets.

Nonetheless, there is much to be said for a decentralized approach — for not setting up a separate government entity to deal with problem loans separate from the banks. Particularly, in Ukraine, with already badly fragmented government authority, it probably is wiser not to proliferate more government institutions, particularly given the scarcity of skilled professionals

As noted earlier, the question of the three former state banks is being addressed in the World Bank FSAL. However, the basic thesis of the World Bank is that the problem is not large and the former state banks (and their directed lending) will wither away. Based on this view, there is not yet an aggressive attempt in the FSAL to develop a comprehensive restructuring program for these entities. Once the NBU bank supervision has completed full-scale on-site examinations, there will be a more informed view of the weaknesses of these banks; and a better handle on both the stock and the flow of the impaired loan portfolio.

[22] Grey, Cheryl and Arnold Holle, *Bank-Led Restructuring in Poland*, “Policy Research Working Paper”, No. 1650, September 1996.

In the case of the private banks the problem is somewhat different as no argument can be made for government financial underwriting of any troubled private, profit making entities whose problems basically reflect poor management and inexperience. (There are some instances where private banks have underwritten projects at the government's urging and guaranty, but these are the exceptions.) For private banks, the question is how to strengthen the NBU Bank Supervision's bank resolution work which has picked up some momentum lately, but is still inadequate. The other part of the equation is the absence of legislation giving the NBU clear enforcement authority, as noted before.

4.3. Bank Upgrading — Developing a Core of International Standards Banks

Another absolutely critical element is development of a program which encourages the improvement of corporate governance in the new private banks. While not reaching the proportions of similar Russian entities (where several have now grown larger than the former state banks), the private banks in Ukraine are increasing market share. As noted earlier, however, currently, there is no strong incentive for these entities to develop their banking practice in accord with generally accepted market-based banking principles.

For example, one commonly accepted practice in western banking is to ensure objectivity in a loan workout, there is a China Wall between individuals who originally made the loan and/or have a relationship with the borrower. This is not always the practice of Ukrainian banks. Even larger banks, do not always have well-established procedures for separating these functions through workout departments. In fact, the banking culture emphasizes more that the person(s) who made the loan has the responsibility to collect it. There is also in western banking strict regulation of the concentration of loans to one borrower and particularly to insiders (owners and management). Moreover, these loans must be made on the same, unsubsidized basis as other assets. These norms are still not at all part and parcel of accepted banking practice in Ukraine.

How then indeed, can the banking culture and practice in Ukraine change? Basically, it is an organic process which comes from the banks themselves and is just beginning. There are two components: First, foreign banks come to Ukraine; and second, domestic banks develop an outward orientation and try to increase their ties to international financial markets. Each of these factors will be discussed below.

4.3.1. Foreign Banks Entry

The Ukrainian banking system, is characterized not only by fragmentation with many small entities (as discussed earlier), but also concentration with a group of 10 banks accounting for roughly 70 per cent of total assets. An infusion of competition by world standard foreign banks will be a healthy development. What has occurred in other transitional economies is that entry of foreign banks entry has increased competition, and introduced new products and services. Foreign banks also provide a training ground for banking professionals. These individuals will, in turn, spread out to indigenous Ukrainian banks, bringing new ways of doing business, and equally important, a market-oriented banking culture. But, this, osmosis takes time.

Ukraine, however, is a large, potentially rich country, with clever, skilled people. If the environment is hospitable for the international banks, and their corporate clients, and it makes business sense, these entities will come. The broad range of technical assistance foreign donors are currently supporting, from tax reform to support for the adoption of international

accounting standards, will provide an infrastructure over time as sound stabilization policies gain credence and growth resumes. However, a supportive infrastructure is a necessary but not a sufficient condition.

Although policy is relatively liberal, foreign banks still do not always receive clear signals from the government on how favorably a license application will be received and what activities they will be allowed to engage in. The Ukrainian government has still not worked out a fully delineated policy. For example, there is some discussion at official levels of an entry tax in the form of a purchase of an insolvent Ukrainian bank (as was defacto required in Poland, for a certain period). In the current, less propitious Ukrainian environment, this could be a significant deterrent. Moreover, the logistics necessary before a license is granted can be difficult and protracted, in Societe Generale's case about nine months. Responsibility at the NBU is divided. Foreign bankers can spend an inordinate amount of time, ascertaining who has the authority to answer different questions.

The government should more clearly articulate how welcoming it wishes to be of foreign banks and which banking activities they will have access to; and issue a clear policy on its decisions; as well as developing well-delineated procedures; and ensuring a level playing field for all potential investors. The best policy would be for the government to have an open door for any reputable bank which can meet NBU prudential requirements. This specifically means eliminating the current regulation in the law which puts a 15 per cent limit on foreign holdings of the system's statutory capital.[23]

4.3.2. Orienting Toward Western Financial Markets

While the differences between Ukraine and Russian financial markets are enormous, in this area the experience of Russia is useful. What is seemingly developing in Russia is a very effective mechanism for inducing banks, on a voluntary basis, to undertake a program of upgrading. The program is called the Financial Institutions Development Program (FIDP). The FIDP is a joint effort of the EBRD and the World Bank, under control of an Inter-ministerial Committee, but with significant participation by the Central Bank of Russia.

The most important point about the FIDP is that from September 1996 there was a separate unit established, monitoring solvency and condition of the participating banks (as well as developing tough criteria for entry). The unit is staffed both by Russians with regulatory experience, and by foreign bank supervisors (two of whom previously participated in US AID bank supervision projects in Russia and Macedonia). The unit reports to the Inter-ministerial Committee.

There are currently 32 banks, which have qualified for the FIDP program, selected from about 80 applicants. Over the last year, the program has changed considerably, learning from early design mistakes. As initially designed, the incentives were a) twinning with a foreign bank; b) computer equipment for information technology development. What has turned out to be the real basis for the program's popularity, however, is that it is now seen as important for a Russian Bank which wants to have an international presence.

By and large, foreign investors and foreign financial institutions will look at the banks which have qualified for the FIDP. The foreign investors are using membership in the FIDP as a culling mechanism. The top Russian banks have become active borrowers in the Eurodollar market. They also actively engage in correspondent relations, foreign exchange

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[23] According to NBU statistics, in April 1997 the statutory capital of the banking system was $650 million. This means that foreign bank investment could only amount to about $100 million.

dealings and custodian arrangements for foreign entities in the Russian government paper market[24]. Thus, membership in the FIDP is highly desirable for them.

Would this same incentive apply to Ukraine? Undoubtedly, although the timing is uncertain. What we have seen in recent months is that once a country is discovered, there is considerable portfolio investment which will come in very fast. For example, in the first two months of 1997, offshore investors purchased almost 50 per cent of Ukraine's primary market government securities. (As a consequence the hryvna strengthened, and reportedly, NBU intervention was even needed at points to stem the currency's appreciation.)

Investment in the Ukrainian government securities market usually requires a custody agreement with a Ukrainian Bank. First Ukrainian International Bank (which is partially owned by foreign investors) has been the bank of choice to date. Going forward, however, one entity will not be able to handle, by itself, a greatly increased volume of foreign portfolio investment which will most assuredly come into the market if macroeconomic stability continues. Several large mutual funds, such as Regent and Caspian have formed multimillion dollar Ukrainian funds and will be looking for the services of Ukrainian banks.

There is also interest by several of the larger Ukrainian private banks in finding foreign strategic investors, not to mention the more pedestrian business in terms of correspondent relationships and letter of credit guarantees. Then too, when Ukraine finally does access international euromarkets, domestic banks will be interested in establishing business ties with foreign investment banks which hold mandates from the Ukrainian government for the issues.

What this implies is that, as in Russia, an institutional mechanism will be needed to determine "international standard banks" which meet certain stringent criteria. This could develop in several ways, including a private bank rating agency which advises banks about potential lending in the interbank market. As the NBU Bank Supervision gains professional expertise (and increases staffing), it too can play a pivotal signaling role through such things as more aggressively using its licensing authority to tier banks, as well as formally approving bank participation in foreign credit lines for which the NBU is extending guaranties. The objective is that a cadre of banks emerges which is interested in integrating into the international financial community and emulating acceptable international practice.

5. Summary

To summarize, going forward the difficulties for Ukrainian banks could increase, as relatively low-risk (high-return) income sources for banks diminish. Moreover, although the banking system is currently relatively small, and the impact on government finances from even a large banking sector problem would be relatively contained, the instability of the banking sector is still a situation which should elicit concern. This flows from the current problematic government fiscal situation, still falling growth in at least the official economy, and the public skepticism about the usage of the banks as a safe storehouse for savings — even though inflation is at respectable levels.

There are three elements which should be the foundation of a strategy to develop a safe and sound banking system in Ukraine:

[24] Most recently, Alliance, a leading U.S. money manager, formed a joint-venture with one of Russia's largest private banks, SBS-Agro Bank to manage ruble-denominated mutual funds for Russians. "Wall Street Journal", July 3, 1997.

– **The banking system is fragmented**. There needs to be rationalization so that remaining entities which have deposit-taking authority; first, compose a system which is not unwieldy for the NBU to supervise; second are true financial intermediaries, rather than arms of corporate treasuries; and third, have a large enough scale to allow portfolio diversification and to spread startup costs.
– **The banking system is fragile**. There needs to be a culling in which banks not meeting NBU capital requirements and insolvent banks are purged from the system. There also needs to be a plan developed for former state banks which addresses, among other things, corporate governance and lack of transparency in the ownership structure. (Depending upon conclusions reached by on-site inspections, conducted by the NBU's bank supervision function there may be a need for some form of recapitalization).
– **The banking system lacks incentives for upgrading**. There needs to be a mechanism to separate out a core group of international standard banks. These banks will set the pace for the rest of the banking system to develop banking practice in a manner consistent with market-based norms — to put in place, more rigorous internal controls, risk evaluation procedures, and to take a more aggressive stance with recalcitrant borrowers.

Appendix: Separating the Wheat from the Chaff: Developing a Sound Banking System in Ukraine

The development of a financial sector strategy for Ukraine, happily, is not virgin territory. By now it is a well-traveled path for the transitional economies of this region. Eastern Europe has spawned as many models as there are countries. As noted earlier, there are a great many similar characteristics between the banking systems of these former centrally-planned economies. What is unique for each of these countries, is the way these characteristics are combined.

General factors to consider include:

- **Macroeconomic dislocation:** There has been severe macroeconomic adjustment. This reflects the fundamental need to move to market based pricing, to cut subsidies, to relocate production factors in viable industries and to end the "soft budget constraint". In the wake of these large gyrations, many countries went through a period of accelerating inflation (and even hyperinflation for some), which, in turn, resulted in substantial financial disintermediation. Moreover, the disintegration of the Soviet bloc resulted in serious problems for trade. For some countries this meant that critical commodities, such as energy products, were no longer available at subsidized prices. For others it meant that substandard exports to, essentially, a captive market, now had to compete in international markets.
- **Structural reform:** In the centrally-planned system, banks passively accommodated the central production plan and had no independent role in credit allocation. (While declining, governments still use the banks for directed lending, as they did during the communist regimes.) For these banking systems, there was no need for risk-based government bank supervision, nor for legislation delineating property rules and collateral standards, nor for bankruptcy procedures. Thus, developing a market economy entails not only dismantling old institutions but, in some instances, the development of institutions and practices unknown in the former communist system — such as risk-based bank supervision. Moreover a new legal infrastructure has to be developed which reflects the emerging economic relations, and in particular the respect for contracts.
- **Financial Intermediation:** The public has little confidence in the banking system as a depository for savings, as evidenced by the falling level of financial intermediation (M2/GDP). Hyperinflation, confiscation of bank deposits, chain reaction bank failures have all played a contributing role to public cynicism toward the banks.
- **Human Capital Development:** This is a priority. The corollary of dismantling old institutions and developing new ones is that significant retraining is needed, not only in technical skills, hitherto unknown, such as risk analysis and asset-liability management, but cultural attitudes as well. An internal culture has to be developed within banks that puts a premium on "good banking practice."
- **Political Consensus:** The termination of authoritarian control and the development of effective democratic governance is an evolving process. In some countries political power is too fragmented to allow decisive movement forward on reform, while in others the political power of those interests, which benefited from the former system, still holds sway. In this environment it takes a long time for effective legislation to be implemented. In the interim, patching is often needed. This may mean using the central bank's regulatory power in a more creative way.

– **Definition of the central bank:** The central bank has often borne the brunt of the struggle in transitional economies to end the “soft budget constraint” — using banks to fund state enterprises and favored, if inefficient sectors; and its corollary, to limit government budget deficit financing through central bank financing. Thus, in many countries, the central bank, never popular, is engaged in a constant struggle with less progressive government elements to limit its independence and power.
– **Bank Licensing:** In many transitional economies the early stages, before bank supervision was well organized, were characterized by liberal licensing policies. Spawned was a fragmented, inefficient, and weak banking industry.
– **Prudential Regulations:** There is a wide spectrum in the commitment of governments of this region to rigorously regulate the banks and empower a bank supervision function to oversee the safety of the banking system.

Applying these general considerations for transitional economies to Ukraine brings some of the elements which must be addressed into sharper focus:

– **“Rules of the Game” are not well established for the banking industry.** The culture is still very much a hybrid, partially reflecting the confiscatory, authoritarian modus of the Communist system under which banks were little more than financing arms of the Ministry of Finance (and although less pervasive, directed lending continues to favored industries). It also, increasingly, reflects what could only be termed Dickensonian or cowboy capitalism — a capitalism in which anything goes. Thus, for observers reared in western business ethics and rules, some aspects of banking practice, such as the magnitude of the concentration of bank loans to insiders is quite startling. Codifying business ethics and practice for the banking industry is a priority.
– **Technical capacity at both the NBU and the commercial banks is thin.** Unlike many other countries in the region, Ukraine (which had not been a sovereign country for literally ages), by and large does not currently have a stratum of banking professionals who interacted with western bankers during the Communist years (if only through London Club debt negotiations as did Romania, Yugoslavia, Russia and Poland) and assimilated western banking techniques. While skills are being implanted through such programs as the Muskie Fellowship (which gives fellowships for US study, often followed by jobs in western commercial and investment banks), it will be some time before a critical mass is reached. Training courses through the NBU-National Bankers Association sponsored National Center for the Training of Bank Personnel, which bring foreign bankers supported by US AID for one-week courses, are useful as an introduction for large numbers of junior and mid-level bankers. However, this mechanism can only provide the depth needed over an extended period.
– **Ukraine, as a country, is in a precarious financial position**. External current account deficit financing and foreign amortization payments are primarily financed by loans and grants from international agencies (IMF, World Bank, etc.) and by foreign governments' loans and grants. Financing of the government's domestic budget over the last year has been paid for, in part, by the accumulation of substantial arrears in wages and payments. Thus, there is seemingly, no room in the budget for bank recapitalization.
– **Financial disintermediation is taking a long time to reverse**, even with inflation decelerating for over a year and the exchange rate stable. Recent bank failures, like Grado Bank, have not helped to calm the nerves of a skeptical and cynical public. There is also the point that a substantial share of income is earned in the informal sector. A bank account exposes that income to taxes. Finally, rules such as the “kartoteka” (which

prohibited businesses from having more than one bank account) had limited deposit growth.

- **Licensing was very lax in the early days and the banking sector is highly fragmented** (as discussed earlier).
- **Concern with the fragility structure of the banking system currently does not extend beyond the National Bank of Ukraine** and even there, the pure magnitude of day-to-day brush fires precludes work on developing a more strategic approach to systemic problems. This is interrupted only in a significant way when the World Bank FSAL Mission visits. However, because of both the fiscal implications of a banking sector restructuring and the potentially damaging effect on the real economy, the reach of involvement should be much broader. All too often the executive and legislative branches get involved too late, only after a damaging banking crisis is in progress[25].
- **Unlike many other transitional countries, it is not the case that reform elements unequivocally asserted their ascendancy.** The left-dominated Verkhovna Rada wields considerable power and actively impedes reform. A large section of the Verkhovna Rada still clings to the belief that banks should continue to serve the "public interest" which is part and parcel of a more profound opposition in the parliament to all emerging capitalist structures. Thus, the NBU and its reform-minded Governor, are constantly under attack. There is an ongoing struggle to limit the NBU's authority. The pending National Bank Law, for example, provides for a supervisory council over the National Bank, although its mandate is not well delineated.

[25] In the United States the savings and loan crisis was allowed to fester for years. Only after the costs to the U.S. taxpayers mounted to billions of dollars did the U.S. Congress and the U.S. Treasury (the Ministry of Finance) become involved in setting up a new government agency, the Resolution Trust Company, to liquidate and rehabilitate insolvent and troubled savings institutions.

Table 6

Principal Central Bank Regulatory Guidelines

Capital Requirements:	I	Statuatory fund: ECU 1 million by January 1998	
	II	Banks with 100 percent foreign ownership: ECU 5.0 million by January 1998	
Capital Adequacy Requirements:	I	Capital equal to 8 percent of risk-weighted assets.	
	II	Not mandatory but part of evaluation: capital equal to 5 per cent total liabilities	
Classification of Loans and Loan-Loss Provisioning*		Category	Reserve
		Standard	2 per cent
		Nonstandard	5 per cent
		Substandard	20 per cent
		Doubtful	50 per cent
		Loss	100 per cent
Insider Lending and Limits on Large Exposures**		Loans to insiders not more than 100 per cent of bank's capital; decreasing to 25 per cent by July 1, 1998.	
Limits on Equity Investment	I	Total equity investment not more than 25 percent of total capital.	
	II	Equity investments will be deducted in estimation of total capital.	

* Requirements of new Regulation No. 20 will be phased over two years beginning July 1, 1997. Only "standard" provisioning, which is a general provision (and part of Tier 2 capital) is tax deductable. The other categories are not tax deductable.

** Will not be mandatory until Law on NBU is passed.