An Assessment and Rating of The Ukrainian Banking System

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I Introduction

The following assessment of the Ukrainian banking system has been produced under contract to the United States Agency for International Development/ENI/PER by Michael Borish and Company, Inc with support from Triumph Technologies, Incorporated Michael Borish and Company, Inc would like to thank Jean Lange of USAID/ENI/PER, and Laurie Landy of USAID in Ukraine for their kind support and guidance Michael Borish visited Ukraine from April 25-May 1, 1998 in conjunction with this project

II Methodology of the Rating System

The rating system utilized to assess the banking sector of Ukraine is based on a review of more than 200 issues and topics that have been used to construct a diagnostic methodology for the review of banking systems This tool will be utilized by USAID in other parts of "transition Europe," and is applicable to virtually all banking sectors in the world

In its simplest form, the rating system is focused on four general areas of activity—based on 28 "sub-categories," and subject to five general classifications The activities and sub-categories are included below

USAID/ENI/PER Banking Sector Rating System Activities	
General Areas of Activity	***Sub-Categories***
• ***Financial Sector Infrastructure***	• General policy and system • Legal framework • Regulatory and supervisory capacity • Payments systems • Accounting framework • Rating agencies • Financial media • Professional associations • Academic institutions • Miscellaneous areas relevant to financial sector infrastructure—telecommunications, postal, safekeeping
• ***Economic Factors and Indicators***	• General trends • Private sector development issues • Monetary and related savings and credit matters • Fiscal considerations • Exchange rates • Balance of payments issues
• ***Banking Structure and System Profile***	• Overview of the system and financial measures • Profile of ownership structures • Governance and management issues • Non-bank competition
• ***Banking Sector Development Based on Prudential Norms***	• Capital adequacy • Asset quality • Management capacity • Earnings • Liquidity • Operating environment • Transparency and disclosure • Sensitivity to market risks

The following classifications are utilized to provide a scoring for the individual issues assessed, as well as in developing a composite rating for the banking sector as a whole Annex 1 provides greater descriptive detail about how the ratings apply by sub-category

USAID/ENI/PER Banking Sector Rating System Scoring Description	
5	Outstanding world class state-of-the-art best practices virtually no serious systemic risks
4	Solid strong satisfactory competitive few systemic risks or problems and those are manageable
3	Adequate favorable trend improvement needed potential for major systemic risks
2	Inadequate weak significant improvements needed major potential for destabilization via systemic risks
1	Dismal monopolist resistant to competition and change no confidence widespread corruption weak institutions

No effort has been made to weight individual variables, or to quantify ratings along mathematical lines Rather, 28 major sub-categories of the four main groupings were all rated within the five-point rating system, with allowances for pluses and minuses in the event that the direct numerical classification did not fully match with performance The evaluation is both qualitative based on trends and assessments, and quantitative to the extent the figures are useful and meaningful In general, the information available in Ukraine is sufficient to form a judgment at the macroeconomic level However, Ukraine has not yet converted to international accounting standards, so firm-specific financial data—including financial statements for banks and the banking system as well as bank data presented to the National Bank of Ukraine—are improving in quality, but still incomplete or inaccurate Likewise, because approximately one-third of the economy operates as a "shadow economy," there are weaknesses in the data with regard to private sector trends and these links to macroeconomic data

III The Ukraine Rating

The composite score awarded Ukraine was **2-**, which generally reflects Ukraine's weak financial infrastructure, poor macroeconomic performance and outlook, distorted environment for private sector development, limited progress in developing a well-governed and -managed banking system, generally poor financial indicators, weak risk management capacity, and high sensitivity to market risk Ukraine has begun to make progress in some of these areas At the macroeconomic level, monetary policy has succeeded in bringing the inflation rate down to near single-digit levels from hyperinflation a few years earlier, while maintaining reasonable levels of exchange rate stability in recent years At the structural level, payments systems work well Ukraine is also making good progress towards improving the legal and regulatory framework in the banking sector based on better information and oversight However, overall, the economy is weak at the macroeconomic as well as the structural level In particular, the country's weak fiscal position is unsustainable Ukraine has depended almost entirely on monetary policy for stabilization in recent years Such fiscal weakness and imbalance between monetary and fiscal policy raises the possibility that Ukraine could experience a balance of payments crisis, with the banking sector among those segments of the economy that could be adversely affected Ukraine is generally at the beginning of a long structural adjustment process which will take many years before institutions and markets function properly in support of sustainable economic growth Thus, as of summer 1998, the assessment of the Ukrainian banking system is as follows

The Ukrainian Banking System—Summer, 1998	Composite Score 2-

Ukraine is only beginning to establish a satisfactory legal and regulatory framework for banking Progress in the area is ahead of reforms in the real sector, where the formal economy continues to deteriorate Ukraine has been slow to move towards a suitable incentive structure for strategic investment, as shown in the sluggish pace of privatization in many key sectors and weak direct investment statistics Where ' privatization has occurred this has generally been through ownership transformation" without incremental capital injections, strategic investment, or necessary changes in governance and management This has likewise been true in the banking sector, where banks have generally functioned as during the Gosbank period apart from the hard budget constraints and new prudential regulations that have only recently been in effect Corruption is rampant, and at least one third of 1997 GDP was estimated to be in the informal economy Ukraine continues to face significant macroeconomic weaknesses in the form of high interest rates fiscal deficits, and mounting debt Arrears are pervasive throughout the economy and confidence in public institutions is low This is both cause and consequence of Ukraine's flawed public administration and unsustainably weak fiscal position that could lead the country to a balance of payments crisis Officially registered unemployment of 2 3 percent reflects the absence of operational restructuring in the enterprise sector as Ukraine enters what is potentially its ninth consecutive year of declining GDP Purchasing power is nearly half levels from five years earlier The Ukrainian banking system faces numerous weaknesses, including uncertainty about the solvency of its major institutions, strained liquidity, and limited potential for growth in the absence of a major restructuring of the system and incentives Banks generally operate as "pocket" banks or commercial credit companies based on traditions of insider and connected lending that are only now being challenged The larger state and ex-state banks may be insolvent or, at a minimum capital-impaired Asset quality is weak, with needed provisions estimated to be at least $1 billion, equivalent to nearly two thirds of estimated total capital at year end 1997 Management is sometimes prudent and cautious but risk management systems are considered elemental at best Earnings and cash flow are coming under pressure due to shrinking spreads, high cost structures, needed expenditure for investment in modern information systems and training, and the impact provisioning will have on earnings Liquidity is strained due to the weak state of public finances the high levels of money kept outside the banking system the shallowness of the capital markets, and limited direct investment in the financial and real sectors The operating environment is improving and there are favorable trends with regard to management information, public disclosure, standards of accountability, and general transparency However, Ukraine remains susceptible to market risk due to its macroeconomic and structural weaknesses, most notably fiscal weaknesses rising debt, and the potential that such methods of deficit financing will have an adverse impact on Ukraine's overall balance of payments In addition to the potential impact a balance of payments crisis could have on the banking sector, there are several major risks in the foreseeable future for the banking sector These include fundamental credit risk management and the management of off-balance sheet risk as banks seek to increase earnings from a limited earning asset base general maturity and pricing risk, governance and management capacity to set and achieve reasonable strategic goals within prudent risk tolerance levels, and the ability of the regulatory authorities to provide adequate supervisory oversight as needed in support of safety and soundness

- Seven of 227 banks control about half of banking system assets
- The top 20 banks account for about 80 percent of assets
- Only 23 foreign banks are operating, of which only seven are wholly foreign-owned
- Total assets prior to provisions and writeoffs are less than $12 billion—about $64 million on average per active bank—but most banks had trouble meeting the ECU 1 million minimum capital requirement by end 1997
- Nearly 50 banks are to be liquidated, and more than 20 others are in rehabilitation
- Provisioning requirements are estimated to be a minimum $1 billion or nearly two thirds of total estimated capital
- Net credit to the government accounts for about one third of total banking assets
- Tier I and II capital are nearly 15 percent of assets (unaudited) but needed provisions/charge-offs could bring this down to 4 percent or less
- 1997 ROA (rough estimate) 1 5 percent
- 1997 ROE (rough estimate) 10 2 percent

The basis for the composite is described by each of the four general activities and the 28 sub-categories below A more detailed summary is attached as Annex 2

Section 1 Assessment of Financial Sector Infrastructure

1 Financial Sector Infrastructure Score 2-

Ukraine's financial sector infrastructure is generally weak with regard to institutional capacity, although trends are improving on a number of fronts Laws, regulations and accounting standards in the financial sector are slowly evolving in the direction of international standards Electronic payments systems and transaction-related information flows in the banking sector are considered safe and adequate relative to current levels of transactions Academic capacity is satisfactory for a wide range of training activities News media appear reasonably objective There is slow movement towards improved telecommunications capacity However, Ukraine still suffers from old and fragmented organizational structures which weaken the ability of public institutions to play an effective role in the delivery of public services There is an absence of agreed policy and coordination, information is often inconsistent and frequently undisclosed, and decision-making can often be discretionary and subject to fraud While the National Bank has become effective at implementing monetary policy and is beginning to develop effective supervisory capacity for the banking system, much of the rest of the public sector appears to serve as a constraint to formal private sector growth This, in turn, undermines public confidence, and adds to the downward spiral which is partly reflected in and caused by the debilitating fiscal deficits faced by Ukraine's government

1 1 Policy and System. Score 2-

Ukraine s financial sector infrastructure and overall economy are burdened by weak institutions While there is clear respect for the rule of law and compliance with regulations in many areas there is also pervasive fraud and corruption that are simultaneously responsible for and reactions to the downward spiral Ukraine is facing While there is an orderly electoral process and democratic institutions are in place, their effectiveness is undermined by division and economic decline Much of the legal and regulatory environment is still insufficiently reformed for conversion to a market-based economy The economy is at the beginning of its transformation to a market orientation but much of this development is in the shadow economy with corollary distortions than in the formal sector Much of the formal sector remains state-owned or ' privatized via ownership transformation rather than from strategic investment There is some capital markets activity—approximately 150 shares are traded on the over-the-counter market of the Ukrainian Stock Exchange, where about 80 percent of trading activity occurs—but capitalization is low and strategic investment is minimal Banking is likewise relatively weak as a sector having become two-tier but still in the process of adapting to a more commercial orientation There are a few banks that are perceived to have elements of modern management and governance that may lead to effective banking in the future But for the moment, most large banks appear to be in poor or uncertain financial condition, and most other banks are "pocket banks that have served as captive finance or administrative vehicles for state enterprises New regulations seek to change these structures but it will take time before such changes show their beneficial effects The wild card in the equation is Ukraine s ability to attract direct investment from foreign sources To date, performance has been weak It is expected that over time, membership in the IMF and other multilateral organizations will help along with EU Partnership and Cooperation Agreements However in the near term Ukraine may also be facing a scenario of such economic decline as to usher in a balance of payments crisis prior to a period of ambitious and meaningful economic and structural reform

1 2 Legal Score 2-

Ukraine s laws have effectively moved the country away from the monobank system that existed during the Soviet period and laid the preliminary groundwork for slow movement to a market economy However, while basic laws are either in place or being drafted to accelerate reform, institutional capacity to effectively implement such laws has been weak to date Above all while many Ukrainian institutions have a reputation for being legalistic and compliant, Ukraine s government also has a reputation for corruption and fraud This is partly evidenced by the shadow economy approximating half of the official economy Much of that shadow economy is the result of corrupt and cumbersome procedures frequently in the form of inspections, permits tax payments fines and other enabling environment issues that have undermined satisfactory development of a formal private economy While laws and their application in the financial sector are not considered quite as egregious—the National Bank appears to enjoy an independent reputation with a mandate to enforce—the weakness of judicial institutions and other public offices undermines the rule of law and makes it more difficult for the banking sector to function in a sound and efficient manner

1 3 Regulatory and Supervisory Score 2

Ukraine is at the beginning of a long process dedicated to building effective regulatory and supervisory capacity for the banking system There are several strong points to efforts achieved to date, largely with targeted donor assistance These include development of an ambitious strategic plan for the NBU s banking supervision department, an increasingly clear mandate for supervision to enforce regulations, the introduction of new regulations which get prudential norms closer to international standards, movement towards adoption of IAS for the generation of more meaningful information, investment in information technologies to assist with the timely flow of information, improvements in the organizational structure of banking supervision to encourage better coordination of information and policy, and an integrated supervision approach which leverages off of a combination of on-site inspections and off-site surveillance These are all positive steps forward which, in due time, should strengthen the institutional capacity of the NBU to monitor for risks in the banking system as banks themselves engage in riskier activities It is particularly important that donor support be sustained in these areas to help NBU address existing risks, to plan for contingencies, to contain future risks, and to generally build capacity It is likely that the emergence of a banking crisis would be exacerbated by the curtailment of such needed support There are still many weaknesses with regard to regulations and supervision New regulations have recently been introduced, and it will take some time for banks to effectively adapt In some cases, such as minimum capital, regulations support the existence of very small banks which may add to the cost of supervision Additionally, it will take time before sufficient human capital is developed to ensure supervision is able to identify, evaluate, monitor and contain risks in a timely fashion However significant progress is being made with the provision of technical assistance for on-site inspections, off-site surveillance and general policy coordination These are all necessary building blocks for effective supervision If the supervisory function is indeed weak, the trend is favorable as long as support is sustained

1 4 Payments System. Score 4

The payments system functions well in Ukraine and is reputed to be the best among FSU countries The system is based on electronic funds transfers—checks are not used Real time gross settlement is reported to take place within 20-30 minutes Ukraine currently processes about 500,000 transactions per day, and capacity exists for significantly greater volume Notwithstanding other problems in the economy, the payments system is considered highly effective and efficient, and reasonably well protected from credit, liquidity and systemic risk Credit risk is essentially non-existent as the recipient receives funds only after the payer has written such payments off his account and transferred them to the payee account. Liquidity risk is substantially reduced due to the prevalence of real time settlement Systemic risk is reduced due to the exclusion of overdrafts Thus, despite risk management weaknesses at the banks, the payments system applies controls that substantially mitigate a crisis through the payments system This helps to provide some underlying stability to the interbank market Assuming the NBU focuses on the largest banks activities—the interbank market is currently dominated by two banks (e g , Bank Ukraina and Privat Bank)—and requires banks to maintain sufficient reserves, these risks should be identifiable and mitigated The electronic payments system provides additional defense for these efforts The payments system has also helped reduce the incidence of fraudulent interbank payment documents

1 5 Accounting Score 2

Ukraine s accounting standards are slowly evolving towards international standards Banks are required as of January 1 1998 to report according to IAS To accommodate this conversion as well as regulatory reporting requirements recently introduced by NBU NBU has introduced a new chart of accounts While Ukrainian accounting standards—principles and procedures—have not yet been officially introduced that are IAS the new chart of accounts for bank reporting is broadly consistent with the IAS framework Key weaknesses that currently exist in the banking sector with regard to the production of accounting information include fragmented branch reporting, the need for improved verification of journal entries (e g , for the detection of possible fraud regarding credit and securities transactions, registration of collateral and guarantees), and the general need for stronger internal controls Key banking sector weaknesses with regard to the use of accounting information include the general notion that the information produced is primarily for regulators, and that it is of marginal usefulness for management purposes Notwithstanding these weaknesses it is expected that banks will learn to utilize accounting information increasingly for management purposes and not solely for regulatory reporting purposes It is also expected that as banks adapt to new standards that companies in the real sector will likewise begin to report accordingly This will be particularly true if Ukraine is to attract needed foreign direct investment as well as to move forward and more fully develop its capital markets In both cases, IAS will be a fundamental element of valuations due diligence and investment decision-making (both for direct investment and portfolio investment) New standards will among other things bring ' market-based values of companies closer to reality due to new standards for provisioning and allowable deductions Ukrainian accounting standards currently distort income statement and balance sheet measures in the enterprise sector thereby distorting the quality of banking portfolios and contributing to a misrepresentation of banks earnings and balance sheets As Ukraine experienced significant portfolio outflows in late 1997—symbolizing the limited depth of its markets and its vulnerability to 'hot money —it will be in the interests of Ukraine from a macroeconomic as well as a structural point of view to accelerate the conversion of systems to IAS This will have to be comprehensive, from charts of accounts that are useful in generating meaningful information all the way through to transparent methods of disclosure for both public and private consumption All the major international accounting firms are active in the Ukraine, and this should help with the process

1 6 Rating Agencies Score 2-

The major international rating agencies became active in the Ukrainian market in 1997 Ukraine s ratings in February 1998 were generally unfavorable in terms of the long-term outlook There are no domestic rating agencies, although one firm ranks' banks based on financial measures In general there appears to be only limited information on banks and companies Part of this may have to do with traditional reluctance to disclose information, as well as the quality of information that has been provided to date Conversion to IAS and introduction of stricter standards of governance and scrutiny might improve the situation but this will take time More information is available on government securities and debt, largely due to financing needs and market requirements The potential exists for domestic rating agencies to play a useful role in market development, but a weak economy and traditional non-disclosure have undermined such potential to date

1 7 Financial Media Insufficient Basis for a Score

No particular effort was made to assess the financial media. However there are several newspapers that report financial information Press coverage of tax legal and accounting issues is considered satisfactory There is an effort to utilize the media to instill financial discipline in banks There is one English-language journal which provides broad and seemingly responsible coverage of government and economic issues Media coverage is generally considered responsible

1 8 Professional Associations Score Insufficient Basis for a Score

No particular effort was made to assess associations in Ukraine However there are a few professional associations in Ukraine for financial sector individuals and groups The major association in banking is the Association of Ukrainian Bankers which has been a useful institutional vehicle for coordinating donor-financed training activities in accounting, financial management, and other areas of relevance for banking The Association has also been active in lobbying for input into the drafting process although not always in a manner that reflects an adequate understanding of market-based banking and international norms Some programs offering financial training that is administered by associations lead to certification Standards are generally considered to be highly professional

1 9 Academic Insufficient Basis For a Score

No particular effort was made to assess the number or quality of academic institutions in Ukraine Nor was there a systematic effort to speak with business/management school officials However, there are prominent schools and institutes in Kiev, Lvov, Odessa and other major urban centers There are also some think tanks that make a significant contribution to economic and financial sector development

1 10 Miscellaneous Score Insufficient Basis For a Score

There has been slow movement towards privatization and modernization of the telecommunications market While Ukraine earlier allowed cellular operations, the major telecommunications monopoly Ukrtelekom is still wholly state-owned Privatization may begin in 1998 The telecommunications sector has improved in major metropolitan areas in recent years but still is considered inefficient unreliable and costly by global standards Further companies have reported the need to pay a nearly $900 unofficial payment for installation per line up from

$550 per line in 1994 Ukrtelekom's reputation is respected with regard to capacity provided for critical financial sector institutions such as the electronic payments system However branches have trouble connecting by phone with head offices Hence, basic services for most companies and households is weak to non-existent Postal services appear adequate and largely irrelevant to the banking sector due to the efficiency of the electronic payments system Safekeeping from a physical and logistical standpoint also appears adequate although the reliance on cash adds to security risks between the NBU banks' home offices, and bank branches No systematic effort was made to review this

Section 2 Assessment of Economic Factors and Private Sector Indicators

II Economic Factors and Indicators
Score 2-

Ukraine's economy is generally weak from a structural standpoint, with mixed reviews from a macroeconomic standpoint that are bound to worsen over time unless direct investment increases and structural reforms accelerate The good news from a macroeconomic standpoint is that monetary policy has been effective over the last two years in bringing down the inflation rate Year on year, the inflation rate (CPI) was only 10 percent at end 1997, compared with 40 percent at end 1996 and hyperinflation just a few years earlier Ukraine also does not appear to have a significant current account problem, with a deficit averaging about 3 5 percent since 1995 However, there are warning signs of rising fiscal deficits, increasing debt, and general crowding out of potential private investment Such a trend could ultimately spiral downward, manifesting itself in a balance of payments crisis as a result of depleted foreign exchange reserves, exhausted debt capacity, and unsustainably high interest rates offered on securities Ukraine has shown itself to be vulnerable to portfolio investment Combined with a poor track record in attracting direct investment, Ukraine's balance of payments are likely to depend increasingly on donor financing unless there is a major acceleration of strategic privatization There is potential interest rate and exchange rate risk due to Ukraine's financing needs in the event donor financing gets off track For such a scenario to be avoided, Ukraine will have to accelerate structural reforms This will require better performance in attracting foreign direct investment and accelerating the privatization of large-scale enterprises Even more fundamentally, changes over time will have to include tax reform, administrative reform, and reduced public expenditure The sooner these changes occur, the sooner Ukraine should begin to benefit from economic growth The Ukrainian private sector is primarily in the shadow economy, with growth constrained partly due to a poor enabling environment characterized by corruption, fraud, and excess bureaucracy This is closely linked to an arbitrary and inefficient tax system which is poorly administered Public expenditure will need to be reduced to bring down fiscal deficits in the absence of a viable fiscal base Meanwhile, structural reforms focused on economic competitiveness should have development of a viable tax base as one of its key medium- and long-term objectives to restore confidence One of the key risks to Ukraine's ability to accomplish needed reforms is political Officially registered unemployment is likely to increase with reforms, and it is questionable if government will have resources for the needed social safety net that has slowly deteriorated in recent years even without reform Overall, current fiscal problems may serve as a mixed blessing Given the government's cash crunch, it may have little choice but to accelerate privatization of key enterprises in the energy, chemicals, airline and telecommunications sectors Short of this, the economy is likely to continue into its ninth year of attrition

2 1 General
Score 2-

The economy is weak in Ukraine While monetary policy has succeeded in bringing down Ukraine s high inflation rates, in most other categories the outlook is negative Fiscal deficits are high The stock of debt is growing as a percent of GDP particularly domestic debt, reinforcing a crowding out syndrome which only adds to public expenditure at a time when fiscal deficits are deepening While current account figures are not worrisome the structure of Ukraine s capital account weighted towards portfolio investment exposes the country to volatility as experienced in late 1997 Meanwhile, the sheer weakness of Ukraine s real sector activity provides little hope for growth, precisely what is needed for a broadening and deepening of Ukraine's financial markets to reduce the country s overall vulnerability to balance of payments swings Official statistics showed average enterprise losses to approximate 5 8 percent of GDP in 1996, a figure that likely worsened in 1997 due to the lack of working and investment capital Ukraine s foreign trade balance was positive in 1997 but based on a $2 5 billion decline in imports rather than growth in exports Meanwhile the current account worsened due to a reduction in the surplus in nonfactor services Thus Ukraine's general economic outlook is negative with the exception of an improving inflation rate scenario Particularly worrisome is the weak fiscal position of Ukraine and the negative implications this is likely to continue to have on Ukraine's debt profile Unless a major reversal of trends occurs, there is a growing possibility that fiscal deficits and mounting interest payments on debt will lead to a balance of payments crisis

2 2 Private Sector Development Score 2-

The 'enabling' environment in Ukraine is one of the weakest in the region While privatized enterprises numbered about 57,000 and total small private businesses numbered as many as 93,000 in 1997, the private sector share of GDP was estimated to be only 50 percent in mid-1997 Most of these enterprises are small-scale and of little consequence to the official economy, although they serve as a bulwark of the shadow economy Most have been privatized largely through ownership transformation' methods—management and/or employee ' buyouts —with little incremental capital, strategic investment, or change in governance and management Meanwhile most of the "larger ' industrial enterprises and farms remain in state hands With registered unemployment at only 2 3 percent at end 1997 and eight consecutive years of negative GDP growth, it is apparent that the real sector has yet to restructure for long-term competitiveness Private businesses are hindered by the critical need for administrative reform in the public sector to free the private sector from needless inspections and taxation Pervasive fraud and corruption, and inconsistent, unclear and cumbersome licensing and permit requirements only serve to undermine the tax base and drive the economy increasingly into the informal sector A 1996 survey indicated that average "unofficial' fees for businesses to obtain services was a high volume business, with payment frequency per visit or service ranging from half the time (e g , "visits" by tax inspectors) to most of the time for most services" (e g , enterprise registration, visits by health and fire inspectors, phone installation, export-import license registration) to all the time for border crossing Rates in 1996 included $894 per telephone line installation, $278 per import license registration, $211 per border crossing, $176 for company registration, and $123 per export license registration Most charges were about the same in 1996 compared to 1994 although rates for phone installation and import license registration had materially increased while rates for export licenses had materially decreased These payments along with smaller payments for each visit by tax fire and health inspectors, have contributed significantly to a "very high increase" in the unofficial economy, with only war-burdened Georgia and Azerbaijan showing higher growth among a large sampling of European and Central Asian transition countries Enterprises in general continue to show increasing losses In 1996, "accounting losses" were nearly 6 percent of GDP exceeding wage and other arrears several times over and making it virtually impossible to operate Net inter-enterprise arrears, mainly in the state sector, approximated UAH 28 4 billion at end 1997, or 31 percent of official GDP Much of this is financed by promissory notes, much of which is quasi-money of dubious quality Wage and pension arrears approximated UAH 6 2 billion at end 1997 or nearly 7 percent of GDP (and nearly identical to the fiscal deficit for 1997) In general, Ukraine's private sector is essentially informal, and operating on a cash basis in the shadow economy The formal sector remains largely state-controlled Until the enabling environment improves and there is a political mandate to move to a market-based economy the Ukrainian economy will remain uncompetitive, inefficient and poverty-stricken

2 3 Money, Savings and Credit Score 2+/3-

Monetary policy has been successful in recent years in taming the inflation rate The GDP deflator from 1990-95 was hyperinflationary at 1,040 5 percent Based on CPI figures at year end the inflation rate had dropped to 40 percent by end 1996 and 10 percent by end 1997 However due to problems throughout the rest of the economy, about half of all money is held outside the banking system This percentage has increased through the 1990s—in 1991, 12 5 percent of currency was held outside banks rising to 20 percent in 1992 27 percent in 1993, 38 percent by 1995 and 49 percent by end 1997 This has been driven by several factors, which include the growth of the shadow economy which reportedly operates strictly on a cash basis lack of confidence in the banking system, and a desire to withhold information from tax authorities These developments have had a broadly negative impact on savings and credit, and have made it difficult for banks to play a significant intermediary role in the economy This is indicated by the percentage of broad money to official GDP—only 11 6 percent in 1996 and 13 6 percent in 1997 Deposits were only 6 6 percent of official GDP in 1996 and 6 9 percent in 1997 Thus low levels of resource mobilization make it virtually impossible for banks to play much of a role in economic growth

2 4 Fiscal Score 1+/2-

Fiscal developments in 1997 showed a deficit of nearly 7 percent of GDP This was largely due to deterioration in the government s ability to collect revenues itself a function of structural weaknesses in the economy Revenue collection declined more than 10 percent Meanwhile expenditure was relatively flat but would have accounted for a 3-4 percent of GDP deficit even if revenues collected had matched 1996 totals Major areas relative to budget where revenue collections came up short were for the Chernobyl plant social funds, VAT and personal income taxes The authorities consequently over-collected ' from the enterprise sector by nearly 50 percent above what was budgeted This likely explains some of the harassment reported bv the enterprise sector at the hands of the tax authorities Meanwhile nearly two-thirds of expenditure was for social funds and social/cultural institutions—presumably health, education and other social infrastructure Unlike other countries where expenditure appears to be the main culprit behind budget deficits and high interest rates Ukraine is faced with the challenge of reviving its economy to expand the fiscal base to ensure it has needed revenues for basic social services This will require political will, and tax and administrative reform Short of major reforms Ukraine runs the risk of its fiscal problems leading to an unsustainable debt load that could ultimately prompt a balance of payments crisis As banks are a major source of financing for the government through purchases of T-bills such fiscal deterioration could have a major adverse effect on the banking sector

2 5 Exchange Rates Score 2

Exchange rate policy has been reasonably steady since the new currency—the *hryvnia*—was introduced in 1996 The macroeconomy has achieved some relief from high inflation rates due to effective monetary policy, while the current account deficit has averaged 3 5 percent over the last three years Questions about future exchange rates pend increasingly on the ability of government to bring down fiscal deficits to restore confidence among portfolio investors, to attract higher levels of direct investment, and to come to agreement with external donors on new debt In a worst case scenario, government finances would collapse there would be a further reduction in confidence portfolio outflows would further increase, Ukraine would attract little to no direct investment, and there would be a breakdown of negotiations with the IMF Under such circumstances the exchange rate would likely not be sustained within the existing or a minimally expanded band This is particularly true given low levels of reserves—net foreign reserves are marginally negative—and increasing debt service against a decline in 1997 export sales levels of nearly $1 billion While this scenario may not be probable, there may be a worsening of circumstances that could prompt a further devaluation of the currency The global market fallout in May 1998 which prompted the Central Bank of Russia to triple ruble interest rates to 150 percent is likely to have spillover effects in Ukraine for the foreseeable future This makes agreement with the IMF all the more necessary to trigger significantly greater investment from direct and portfolio investors

2 6 Balance of Payments Score 2-

Ukraine's balance of payments figures showed some weakening in 1997 The current account deficit increased to 3 4 percent of GDP from 2 7 percent in 1996 This is not an alarming rate but it was combined with an overall decrease in trade volume mainly with FSU countries Trade in goods and services declined 8 4 percent in total, and by 23 4 percent with the FSU region However, the country s capital account showed vulnerability to portfolio investment compounded by growing domestic debt—which generally needs to be serviced in 12 months or less at higher rates—and poor performance in attracting direct investment The general financing weaknesses experienced by Ukraine are rooted in structural weaknesses and the absence of measures and institutions to build a competitive economy Thus, until major structural reforms are introduced and effectively implemented in government (e g tax public administration) and the real sector and more fully advanced in the banking and financial sector, balance of payments problems are likely to persist

Section 3 Assessment of Banking Structure and System Profile

III Banking Structure and System Profile Score 2-

The Ukrainian banking system is now almost wholly private in ownership, but in most cases weak by international standards There were 227 registered banks at year-end 1997, but paid-in capital was only UAH 1 6 billion (about $838 million), or about $3 7 million on average Total capital was estimated at UAH 3 3 billion (about $1 75 billion), but these capital figures are all prior to an estimated $1 billion or more in provisions or writeoffs for nonperforming loans and potentially reduced fixed asset valuations In general, loan classification, collateral and capital are all suspect in terms of accuracy and/or quality Of Ukraine's total number of banks at end 1997, 22 had foreign capital participation—including six which were 100 percent foreign-owned Nearly 50 banks are slated for liquidation, while another 20 or so are in rehabilitation This brings the number of operating banks down to about 180, of which most are considered impaired and/or marginal Most banks represent small captive finance or "pocket" banks that were part of the old Gosbank system During that period, they served as administrators for funds gathering and payment functions rather than as commercial institutions generating profits and losses based on risk assessment and management Their owners tend to be unrestructured state enterprises, and/or recently privatized SOEs that still operate on the basis of old governance and management practices Rather than being considered banks, the vast majority of these should be considered commercial finance companies Some banks are making efforts to better manage resources and risk, and new prudential regulations are putting into place measures that may help protect banks and the system from unwarranted or systemic risk. However, most banks are very small—minimum capital is just ECU 1 million—and most banks did not even have that level of capital until it was required by end 1997 Many of the larger banks, including existing state-owned banks and the larger ex-state banks, could be insolvent. Ukraine is currently in the process of introducing a new chart of accounts and moving accounting standards closer to IAS Once implemented, the magnitude of overvalued assets and nonperforming loans, and consequent needed provisions and write-offs will be known However, many of the larger banks might be insolvent after provisioning for losses and writing off what is unrecoverable Meanwhile, most banks have liquidity problems from a practical funding standpoint (although they are in compliance with regulatory requirements), largely due to the weak deposit base they have and reliance on an interbank market composed of other banks with comparable problems Nearly half of the total money supply is circulating outside the banking system, and the State Savings Bank controls about 33 percent of household deposits (an estimated 20 percent of total held with banks) which are then invested in government securities Non-deposit sources of funding for banks are likewise scarce Only the interbank market provides overnight or very short-term liquidity needs Banks generally do not issue paper or other securities for additional financing on formal markets, although promissory notes are now circulating throughout the economy and may constitute a risky form of quasi-money It is currently unknown how this affects banks from a funding or collateral/investment perspective Equity is limited to small contributions from shareholders which, after IAS is applied, may be negative in value There are draft laws on the National Bank and for commercial banks which would bring existing legislation more in line with international standards There are also signs that Ukraine may be willing to permit more foreign entry into the banking system However, it will take time before a safe and sound banking system emerges in Ukraine Even with progress in the financial sector, lagging progress in the real sector will only limit the market for banks and other financial institutions

3 1 Overview
Score 2-

Ukraine s banking system is only at the beginning of a long process to restore confidence and play a more meaningful intermediary role in support of economic growth and competitiveness Balance sheet indicators are generally weak—funding sources are limited a high proportion of loans are estimated to be nonperforming, and other assets are often overvalued According to NBU 'large banks are among the most troubled from a balance sheet standpoint, and their resolution might well be costly financially and/or politically Until confidence is restored in the banking sector, funding will continue to be a problem Adding to this dilemma are high cost structures based on excess overhead Banks frequently have too many branches too many personnel inefficient procedures and outmoded information systems Ukrainian banks will likely have to undergo major operational and financial restructuring simultaneously This will mean that branch closures the release of employees investment in new information systems and the introduction of modern procedures and controls will have to coincide with the estimated $1 billion or more financial cost of provisioning and charge-offs Margins likewise declined in 1997 making earnings more of a challenge in a weak and uncompetitive economy

3 2 Ownership
Score 1+/2-

The banking system in Ukraine is now primarily private in ownership, with only two banks considered state-owned State Savings Bank and Eximbank However the manner in which most banks became private was in the form of ' spontaneous corporatization or ownership transformation ' Governance and management are generally considered weak particularly as owners are still frequently the state enterprises which the banks served administratively during the Gosbank period This kind of ownership transformation has not led to incremental capital for the banking system which is needed for the development of a modern banking sector and system Only 31 banks—or 14 percent of the total number of banks in Ukraine—had year-end 1997 capital of at least ECU 5 million the EU minimum and still exceedingly small by global standards Until there is meaningful investment in the banking system combined with international standards of governance and management, it is unlikely that Ukraine s banks will be able to provide the range of banking services needed to accommodate growth and development in the Ukrainian economy New regulations represent a start towards breaking the connected patterns of financing that have been a major cause of weakness and insolvency in Ukraine and other banking systems However new ownership based on new investment and management will ultimately be needed for real transformation New laws and regulations alone will be insufficient

3 3 Governance and Management
Score 1+/2-

Governance and management are perceived to be weak in Ukraine, largely due to distorted incentive structures characterized by limited transparency, low levels of capital, the absence of strategic investment, and continued ownership weaknesses in both the banking system and the economy at large Modern standards of corporate governance are rarely practiced due to weaknesses of supervisory board structures the absence of viable internal audit functions and weak, fragmented or non-existent information This undermines the ability of boards to devise suitable strategic plans for banks, and to oversee management performance within these plans The benefits of primarily private ownership in the banking system are offset by many owners still being state-owned enterprises or privatized enterprises that still operate according to old state owned ways Under existing economic circumstances management is by necessity short-term and "survivalist' in focus

3 4 Non-Bank Competition
Score 1+/2-

Weak as Ukraine's banks generally are they face little competition from non-banks The local stock exchanges have only about 150 company listings of which many are non-tradable and illiquid These represent shares in privatized firms There is very limited insurance activity in Ukraine although there are an estimated 231 insurance companies Premium revenues are likely limited by the small scale of operations the absence of reliable actuarial data, and the limited liquidity of insurance firms themselves to cover damage claims Most activity is presumed to be in auto and other non-life insurance sectors Nor is there any major factoring, leasing or pension fund activity in Ukraine Banks are the main players in the government T-bill market, and the interbank markets for currency trading in hryvnia and foreign exchange are growing However the equity markets show limited trading volume and weak market capitalization, undermined by a combination of macroeconomic and structural weaknesses The more active markets in government securities are due to persistent budget deficits and ongoing public finance weaknesses Increasing activity in interbank markets partly reflects frequent liquidity and funding weaknesses Market infrastructure for government securities is considered satisfactory, as reflected by the wide range of investors in the last year or two However in the equities markets significant work is needed to instill confidence in the safety of basic transactions There is virtually no competition of any sort from credit unions or leasing companies There is also limited if any factoring or commercial credit activity, although most banks could be considered commercial credit institutions instead of banks

Section 4 Assessment of Banking Sector Development Based on Prudential Norms

IV Banking Sector Development Based on Prudential Norms Score 1+/2-

The Ukrainian banking system is generally weak based on financial indicators Capital may well be severely impaired, with the exact magnitude currently unspecified due to poor information, the absence as of yet of IAS, and many legal issues unresolved with regard to debtors, obligations and guarantees Asset quality is likewise weak in many banks, particularly in the largest banks where the highest concentration of non-performing assets is found Management is generally weak from a risk management standpoint, although many banks now appear to be demonstrating fundamental prudence in their management of resources during a period of hard budget constraints Earnings are strained as a result of limited asset-based opportunities, reduced net interest margins, low fee income (due to a tradition of providing little more than basic services), what are thought to be generally conservative trading activities, high overhead costs, and general inefficiency Liquidity is likewise tight due to a restrictive monetary policy to keep the inflation rate down, a weak funding base, and limited debt and equity financing aside from interbank markets for overnight or very short-term funding needs The operating environment remains weak on a number of fronts, and transparency and disclosure standards are weak and undermined by the poor quality of information Ukraine's weak position means that much of Ukraine's sensitivity to market risk has already been factored into resource mobilization and other funding patterns This is reflected in high real interest rates, the short-term perspective that most financial institutions have, and the degree of disintermediation that exists in a largely informal, cash-based economy However, there is still a possibility of fundamental collapse if Ukraine's fiscal and balance of payments position does not improve, particularly as banks have significant exposure to the government securities market In the near term, key banking risks are likely to include attempts to generate extraordinary gains from risky positions and trading activities based on maturity and pricing risk (e g , interest rate, exchange rate, commodity), off-balance sheet exposure involving trade finance and guarantees, loans from banks that have been used as equity by banks' borrowers and that are now poor investments, and general problems associated with regulatory compliance and transactional fraud These concerns will be against a backdrop where foreign investors—direct and portfolio—may not (re)enter Ukraine for a sustained period, political stability may be challenged by criminal activities, and markets in general will remain concerned about the steady deterioration of the Ukrainian economy, weak institutional capacity, and sensitivity to worrying trends in Russia, CIS and global markets

4 1 Capital Adequacy Score 2-

Management practices appear to now be conservative and prudent since monetary policy was tightened in 1995, and more recently since new prudential norms have been introduced However, the magnitude of overvalued assets nonperforming loans and future writeoffs is still not precisely identified The largest banks in many cases may have negative net worth Others may be well below the BIS-recommended eight percent for the world's strongest banks and systems on a risk-adjusted basis let alone a much higher figure that would be considered appropriate for the risks found in the Ukrainian marketplace While most banks remain too small to be viable the largest banks still often carry a high level of loans that have been rolled over or capitalized without making proper adjustments for provisions loan loss reserves and overall capital adequacy ratios Portfolios are still heavily weighted towards government securities—which are zero risk-weighted according to BIS This is positive from an earnings and capital adequacy standpoint, assuming a zero risk weight is appropriate for Ukraine This puts additional pressure and focus on the country s underlying reserves, access to international financing, and ability to honor its obligations at a time when it has a very weak fiscal position, limited capital markets activity, and the burden of high interest charges in domestic and international markets Banks themselves also face the task of meeting capital adequacy ratios at a time when they have questionable asset quality possibly well overstated earnings, and high costs relative to current and near-term investment needs for efficiency competitiveness and sustained profitability Extraordinary capital injections can not be expected from privatization activity, as most banks are either too small to generate proceeds of any meaningful sort or too troubled for prime rated banks to want to sort out Given questionable asset and earnings quality the absence of viable capital markets, and the need for investment in information systems, it is highly unlikely that Ukrainian banks will have adequate capital to approximate international standards and to provide competitive service levels in the foreseeable future

4 2 Asset Quality Score 2-

Asset quality appears to be improving on a flow basis as more prudent management practices are reputedly being followed Credit is being managed more carefully, and investments in government securities are providing banks with relatively safe returns However, many of the larger banks still have old nonperforming loans on their books Estimates of nonperforming loans range from 17-40 percent, or up to UAH 2 9 billion Even the smaller figure represents more than UAH 1 2 billion or nearly 40 percent of aggregate capital in the banking system at year end 1997—and a higher percentage of the capital of the 'largest banks Thus, asset quality is generally poor in Ukraine Further, because most banks are small, even high quality assets are not of sufficient volume to generate the earnings required for these banks to become sufficiently competitive There are also concerns about bank lending to affiliates and other parties which have then used resources for poor investments In some cases, these loans may have been collateralized by promissory notes that have no effective market value Additional concerns exist with regard to sector concentration due to the traditional lending practices of the larger banks and the limited clients of the smaller banks Finally, non-earning and low-earning asset levels represent a major proportion banks' balance sheets due to speculative or costly investment in real estate and the maintenance of high reserve requirements

4 3 Management Score 2-

Ukraine s banks are generally viewed to have weak management Governance is weak, experience is limited, and incentives have largely remained distorted in the post-Gosbank period Likewise, the underlying infrastructure and information base needed for prudent management is lacking in Ukraine The overriding challenge in the coming years is financial and operational stabilization in conjunction with efforts to build institutional capacity for market expansion and sustainable growth As part of that ambitious effort, bank managers will need to learn how to utilize new kinds of information and systems for portfolio management purposes across sectors—banking, capital markets, real estate, insurance—and to operate within prudent risk tolerance levels In banking alone this will include a vast array of changes to monitor for and manage the varied portfolio, maturity exchange rate and pricing risks associated with credit, securities, fixed asset investment, asset-liability management, off-balance sheet items, and general operations Likewise, boards will have to introduce effective internal audit functions and adapt to new standards of internal oversight based on proper utilization of information to determine suitable strategic plans that meet the return requirements of shareholders while being compliant with laws and regulations In the interim Ukraine would best be served by building on incentives, systems and institutions that focus on the reinforcement of safety and soundness for a long-term restoration of confidence in the banking system Ukraine would also be far better served by accelerating prime-rated investment into the local market, particularly from those institutions that could serve as a spur to core intermediation functions—deposit mobilization and lending—as a means of restoring confidence and instilling discipline If such an approach is adopted that would require a bold willingness to allow banks to fail to make it more attractive for competitive prime-rated banks to enter retail markets

4 4 Earnings Score 1+

Ukraine s banks have not traditionally presented income statements consistent with IAS although this is now beginning to change with recently introduced reporting requirements Through 1996 earnings have been overstated due to interest income on loans that, by Western standards would be classified as loss Likewise the failure to provision for loss loans has overstated earnings By end 1997, loan loss provisions were only 2 3 percent of total loans By March 31, 1998, it is expected that provisions will increase by UAH 440 million thereby tripling the year end 1997 figure This quarterly figure alone represents nearly half of estimated 1997 pre-tax (and pre-provisioning) earnings on an unaudited basis Based on application of the UAH 440 million provisioning charge to 1997 estimated earnings and a 30 percent corporate tax rate "net income' for the banks could approximate UAH 337 million for 1997—about $1 million per operating bank

However other estimates assume a needed $1 billion or more in provisions or nearly five times the provisions expected by March 31 1998 In any event such provisions will reduce the flow of posted earnings from 1998 on Meanwhile banks will also have to contend with weak client markets shrinking net interest margins excess overhead, and the need for investment in new technologies, systems and processes These will all put pressure on earnings in the near term

4 5 Liquidity Score 1+

Ukrainian banks face a difficult liquidity situation due to the lack of confidence in the banking system limited non-deposit resources available for financing weak or negative earnings and a tight monetary policy In terms of regulatory reporting to NBU banks appear to have adequate liquidity positions Some of the larger banks—Ukraina, Prominvest, Privat, Exim—have also managed to obtain about $50 million in the syndicated loan market from about seven or eight European banks However, in terms of actual cash funding, most banks are in a weak position and hardly able to grow Liquidity constraints are both macroeconomic and structural in nature This weakness is likely to persist until confidence is restored in the banking system and this will be tied to larger efforts to restore confidence in Ukraine s institutions, its macroeconomic policy, and general real sector development

4 6 Operating Environment Score 2-

Ukraine s banking system suffers from a low level of public confidence Hyperinflation and the effect this had on savings and pensions contributed to a significant loss of confidence in the early 1990s The ongoing malaise of Ukraine s economy, the weakness of its institutions the magnitude of corruption and the perception that banks are among the profiteers during a difficult transition from socialism account for much of this sentiment While the State Savings Bank is presumed to carry a government guarantee for household deposits, many of its traditional clients have already lost significant savings from the earlier bout of hyperinflation Tax inspectors are not trusted, and this serves as a catalyst for the informal sector and the high level of national savings kept in the shadow economy Meanwhile, because banks have not been privatized in a manner that has significantly shifted governance and management structures the banking sector has done little to instill confidence in the household sector Banks' traditional corporate clients are largely the same as they were before their enterprise owners As a result, banks have been (at least until recently) administrative or captive finance units of enterprises Ukraine has done a poor job to date of attracting foreign investment which could have gone a long way in compensating for structural weaknesses in the Ukrainian economy and banking sector In terms of financial sector infrastructure, NBU is just beginning to demonstrate regulatory and supervisory effectiveness NBU needs significant strengthening to identify risks early on and to enforce its mandate in support of crisis prevention The emerging regulatory framework generally conforms to prudential guidelines rendered by the BIS and the EU but it will take several years to become effective This will also hinge on conversion to IAS investments in information systems by banks and the ability of a new wave of modern managers to both utilize information for management purposes and to recognize the need for a prudential regulatory framework in support of underlying stability in the banking sector

4 7 Transparency and Disclosure Score 1+/2-

There are major concerns about the poor level of transparency and disclosure in Ukraine Much of this dates back to the Soviet period when people held on to information as a form of protection Today in Ukraine, many organizational structures are fragmented and ineffective due to the lack of disclosure of meaningful information This applies to the disclosure of timely and accurate financial information provided by companies to banks, as well as by banks to the public The persistence of problem loans in bank portfolios slow introduction of IAS and rather late application of prudential norms consistent with BIS guidelines all point to comparatively weak standards of transparency and disclosure The poor quality of information reinforces this notion Nevertheless NBU is taking the lead in promoting better standards for a more accurate representation of the financial condition of banks It is expected that as tighter requirements are applied to banks that banks will likewise begin to apply comparable standards to their existing or potential customers Some banks are even targeting "financial consulting to enterprises to assist them with conversion to IAS as a source of fee income for the future

4 8 Sensitivity to Market Risks Score 1+

Events in 1997—namely the outflow of portfolio investment from Ukraine to Russia and other FSU countries as well as outflows back to Western capital markets—provide an indication of the fragility of the Ukrainian economy and its sensitivity to market risk Events in late May 1998 reflect the potential for contagion with stock exchanges in emerging markets around the globe being hit by a loss of confidence from portfolio investors This represents an extended link in the chain of many emerging markets that are among the hardest hit when investors lose confidence and return to safer havens In the case of the Ukraine concerns about the Russian economy in the aftermath of the Asia crisis in late 1997 led to portfolio flight due to apparent cash needs back in Russia to maintain confidence in the ruble This set off a run from Ukraine which forced the NBU to significantly raise interest rates to try to stabilize the hryvnia and restore confidence While exchange rates remained reasonably stable against the dollar and ruble, interest rates rocketed up to 35 percent in November 1997, and then again to 44-48 percent in February 1998 while the inflation rate continued to decline Developments in Russia in May 1998, which included a tripling of interest rates to 150 percent to maintain confidence in the ruble represent a recurrence of similar trends and can only hurt the Ukrainian economy Ukraine's sensitivity to market risk is high, largely due to the fundamental weakness of its economy at the structural level combined with a high level of dependence on outside financing to avoid total collapse The former will take years to correct, while the latter raises the risk of an emerging debt trap that will only make it more difficult for structural weaknesses to be reversed It appears that until Ukraine is able to both broaden and deepen financial markets, it will remain highly sensitive to regional and global risks Broadening and deepening will require measures that build confidence in the future Apart from monetary policy and an adequate payments system through NBU, there is little that provides the kind of confidence investors need to compensate for the perceived risk associated with the Ukrainian marketplace In addition to legal and regulatory reforms, Ukraine will need to reverse the impediments its bureaucracy imposes on formal private sector start-ups and emerging companies This is true from a tax perspective—both rates and methods of collection—as well as from an administrative standpoint—frequency and cost of inspections, wasted time—if Ukraine wishes to bring the shadow economy into the mainstream Likewise, Ukraine will likely have little alternative than to create an enabling environment for strategic foreign direct investment There has been little domestic direct investment to date, and Ukraine will need the management expertise, information systems, and market links to move its economy forward Strategic investment will be required for SOEs that can be privatized, as well as in companies that have already had their ownership structures transformed and are now officially classified as private companies Such an environment would then provide the banking and financial sector with a greater number of targets for intermediation and services Absent such developments, Ukraine will continue to struggle through an imploding scenario characterized by a shadow economy a steadily weakening fiscal position and continued inability to provide needed public services in a transparent fashion that promotes confidence in public institutions

ANNEX 1. A DESCRIPTION OF THE USAID BANK RATING SYSTEM

Ratings Summary for USAID					
Topics/Categories and Description of Coverage	**Description of Ratings**				
	1	**2**	**3**	**4**	**5**
General Description of Ratings • Financial infrastructure • Economic factors and indicators • Banking sector structure and profile • CAMELOTS indicators	Dismal monopolist resistant to competition and change no confidence widespread corruption weak institutions	Inadequate weak significant improvements needed major potential for destabilization via systemic risks	Adequate favorable trend improvement needed potential for major systemic risks	Solid strong satisfactory competitive few systemic risks or problems and those are manageable privately owned and managed	Outstanding world class state-of the art best practices virtually no serious systemic risks privately owned and managed

I FINANCIAL INFRASTRUCTURE					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
1 1 Policy/System	Wholly unsupportive of stable safe and sound banking	Generally unsupportive of stable safe and sound banking significant improvements needed	Partly supportive of stable safe and sound banking but improvements needed	Supportive of stable safe and sound banking	Wholly supportive of stable safe and sound banking
1 2 Legal	Wholly unsupportive of stable safe and sound banking and meaningful levels of risk taking	Generally unsupportive of stable safe and sound banking virtually no meaningful levels of risk taking	Fairly supportive of stable safe and sound banking but implementation deters meaningful levels of risk taking	Supportive of stable safe and sound banking and meaningful levels of risk taking	Wholly supportive of stable safe and sound banking and meaningful levels of risk taking
1 3 Regulatory and Supervision	Wholly inadequate for prudently managed and supervised banking	Inadequate regulatory framework for prudently managed and supervised banking significant strengthening needed	Adequate regulatory framework for prudently managed and supervised banking but strengthening needed	Solid regulatory framework for prudently managed and supervised banking	Outstanding regulatory framework for prudently managed and supervised banking
1 4 Payments System	Wholly inadequate and undermines integrity of banking system	Inadequate and inefficient systems weaken limited efforts to build up integrity of banking system	Adequate but less than efficient systems support increasing integrity of banking system	Solid systems reinforce integrity of banking system	World class systems reinforce integrity of banking system
1 5 Accounting	Wholly inadequate framework for banking	Unacceptable framework for banking significant improvement needed	Acceptable framework for banking but sophistication needed	Satisfactory framework for banking	Outstanding framework for banking
1 6 Rating Agencies and Systems	Wholly unsupportive of banking sector development	Generally unsupportive of banking sector development	Marginally supportive of banking sector development	Supportive of banking sector development	Wholly supportive of banking sector development

1 7 Financial Media	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth professionalization and code of ethics needed	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 8 Professional Associations	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 9 Academic	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 10 Miscellaneous	Wholly inadequate and undermines integrity of banking system	Generally unsupportive of banking system, significant improvement needed	Only partly supportive of banking system but improving	Supportive and reinforces integrity of banking system	Wholly supportive and reinforces integrity of banking system

II ECONOMIC FACTORS/INDICATORS					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
2 1 General	Dismal macroeconomic fundamentals undermine banking sector development	Inadequate macroeconomic fundamentals deter risk-taking by banks	Adequate macroeconomic fundamentals assist with banking sector stability	Solid macroeconomic fundamentals provide banking opportunities	Outstanding macroeconomic fundamentals reinforce and enhance banking sector
2 2 Private Sector Development	Poor levels of private sector development in formal economy undermine banking development	Growing but inadequate levels of private sector development for sustainable meaningful growth undercut banking sector development	Adequate private sector development supported by favorable trends but improvements needed	Strong economy based on competitive private sector	World class state-of the art economy predicated on innovative resourceful private sector
2 3 Money Savings and Credit	Dismal monetary fundamentals wholly undermine banking sector development	Weak monetary fundamentals deter banking sector development	Adequate monetary fundamentals boost confidence but improvement needed	Solid monetary fundamentals contribute to strong banking system	Solid monetary fundamentals shaped by world renowned risk management practices contribute to global standards of banking system competitiveness
2 4 Fiscal	Dismal fiscal fundamentals wholly undermine banking sector development	Weak fiscal fundamentals deter banking sector development	Adequate fiscal fundamentals boost confidence but improvement needed	Solid fiscal fundamentals contribute to strong banking system	Solid fiscal fundamentals contribute to stability in support of banking system competitiveness
2 5 Exchange Rates	Dismal exchange rate fundamentals wholly undermine banking sector development	Weak exchange rate fundamentals deter banking sector development	Adequate exchange rate fundamentals boost confidence but improvement needed	Solid exchange rate fundamentals contribute to strong banking system	Solid and stable exchange rate fundamentals shaped by world renowned risk management practices contribute to global standards of banking system competitiveness
2 6 Balance of Payments	Dismal balance of payments position reflects competitive weaknesses of economy	Poor balance of payments position reflects competitive weaknesses of economy	Adequate balance of payments position reflects growing competitiveness of economy despite weaknesses	Reasonably strong balance of payments position reflects competitive strengths of economy	Enviably strong balance of payments position reflects competitive strengths of economy

III BANKING STRUCTURE AND SYSTEM PROFILE					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
3 1 Overview	Wholly uncompetitive banking system	Poor reputation re competitiveness in the banking system	Adequate reputation for competitiveness in banking but strengthening is needed	Solid reputation for competitiveness in banking	World class status re competitiveness in banking
3 2 Ownership	Monopolist protectionist banking system resistant to foreign competition and change	Traditionally closed banking system only beginning to open up to foreign competition and change	Adequate levels of competitiveness and performance due to recent trend towards private ownership and management	Reasonably open and generally privately owned and managed banking system respected for competitive position	Open privately owned and managed banking system globally respected for competitive prowess
3 3 Governance and Management	Dismal governance and management undermine banking and economic development	Weak governance and management undermine banking development despite recent but very marginal improvements	Adequate governance and management for banking but improvements needed to achieve global competitiveness in banking	Strong governance and management sustain competitiveness in banking	World class governance and management reinforce and sustain competitiveness in banking
3 4 Non Bank Competition	No serious competition from non banks further undermines the need for financial discipline	Very limited competition from non banks provide little pressure on banks to exercise financial discipline	Adequate levels of competition from non banks but lack of market breadth and depth limit impact on competitiveness and financial discipline of banks	Satisfactory levels of competition from non banks enhance competitiveness and financial discipline of banks	Significant competition from non banks further strengthens levels of competitiveness and financial discipline of banks

IV BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
4 1 Capital Adequacy	Wholly inadequate capital	Inadequate capital	Adequate capital	Reasonably strong capital	Enviably strong capital
4 2 Asset Quality	Dismal asset quality	Poor asset quality	Adequate asset quality although significant room for improvement	Reasonably strong asset quality	Enviably strong asset quality
4 3 Management	Wholesale disregard for fundamentals of risk management	General lack of awareness of risk management fundamentals	Fairly weak but improving reputation based on emerging risk management capacity in a market showing increasing levels of competition	Reasonably strong reputation based on satisfactory risk management capacity in a fairly competitive market	Enviably strong reputation based on world class risk management capacity in fiercely competitive market
4 4 Earnings	Sustained losses that have decapitalized the banks by IAS	Weak or unstable earnings	Adequate earnings but room for added stability and diversification	Reasonably strong and diversified earnings	Enviably strong and diversified earnings
4 5 Liquidity	Severe liquidity problems	Liquidity problems	Adequate liquidity position but room for strengthening	Reasonably strong liquidity position on an ongoing basis	Enviably strong liquidity position on an ongoing basis
4 6 Operating and Regulatory Environment	Dismal operating and regulatory environment	Poor operating and regulatory environment	Adequate and improving operating and regulatory environment	Reasonably strong operating and regulatory environment	Enviably strong operating and regulatory environment
4 7 Transparency and Disclosure	Dismal standards for transparency and disclosure	Weak standards for transparency and disclosure	Adequate standards for transparency and disclosure	Reasonably strong standards for transparency and disclosure	World class standards for transparency and disclosure
4 8 Sensitivity to Market Risk	Dismal reputation for sensitivity to market risk under market conditions	Poor reputation for sensitivity to market risk under market conditions	Adequate and improving reputation to manage sensitivity to market risk as market conditions increasingly prevail	Strong reputation to manage sensitivity to market risk under market conditions	World class reputation to manage sensitivity to market risk and continuously prosper under market conditions

ANNEX 2 A DETAILED ASSESSMENT OF THE UKRAINIAN BANKING SECTOR

I FINANCIAL SECTOR INFRASTRUCTURE Ukraine's financial sector infrastructure is generally weak with regard to institutional capacity, although trends are improving on a number of fronts Laws, regulations and accounting standards in the financial sector are slowly evolving in the direction of international standards Electronic payments systems and transaction-related information flows in the banking sector are considered safe and adequate relative to current levels of transactions Academic capacity is satisfactory for a wide range of training activities News media appear reasonably objective There is slow movement towards improved telecommunications capacity However, Ukraine still suffers from old and fragmented organizational structures which weaken the ability of public institutions to play an effective role in the delivery of public services There is an absence of agreed policy and coordination, information is often inconsistent and frequently undisclosed, and decision-making can often be discretionary and subject to fraud While the National Bank has become effective at implementing monetary policy and is beginning to develop effective supervisory capacity for the banking system, much of the rest of the public sector appears to serve as a constraint to formal private sector growth This, in turn, undermines public confidence, and adds to the downward spiral which is partly reflected in and caused by the debilitating fiscal deficits faced by Ukraine's government **Score 2-**

1 1 Policy/System Ukraine's financial sector infrastructure and overall economy are burdened by weak institutions While there is clear respect for the rule of law and compliance with regulations in many areas, there is also pervasive fraud and corruption that are simultaneously responsible for and reactions to the downward spiral Ukraine is facing While there is an orderly electoral process and democratic institutions are in place, their effectiveness is undermined by division and economic decline Much of the legal and regulatory environment is still insufficiently reformed for conversion to a market-based economy The economy is at the beginning of its transformation to a market orientation, but much of this development is in the shadow economy with corollary distortions than in the formal sector Much of the formal sector remains state-owned or "privatized" via ownership transformation rather than from strategic investment There is some capital markets activity—approximately 150 shares are traded on the over-the-counter market of the Ukrainian Stock Exchange, where about 80 percent of trading activity occurs—but capitalization is low and strategic investment is minimal Banking is likewise relatively weak as a sector, having become two-tier but still in the process of adapting to a more commercial orientation There are a few banks that are perceived to have elements of modern management and governance that may lead to effective banking in the future But for the moment, most "large" banks appear to be in poor or uncertain financial condition, and most other banks are "pocket" banks that have served as captive finance or administrative vehicles for state enterprises New regulations seek to change these structures, but it will take time before such changes show their beneficial effects The wild card in the equation is Ukraine's ability to attract direct investment from foreign sources To date, performance has been weak It is expected that over time, membership in the IMF[1] and other multilateral organizations will help along with EU Partnership and Cooperation Agreements However, in the near term, Ukraine may also be facing a scenario of such economic decline as to usher in a balance of payments

[1] Ukraine joined the IMF and the World Bank in 1992, and achieved Article VIII status in the IMF in May, 1997

crisis prior to a period of ambitious and meaningful economic and structural reform **Score 2-**

- The *political environment* in Ukraine is less than stable Ukraine's financial sector infrastructure is undermined by political divisions, pervasive corruption and fraud, and a deep need for administrative reform Political division is exemplified by the distribution of seats in the new Parliament, in which Communists are the most important party but are offset by "entrepreneurs" with differing interests The executive branch is somewhat weakened by the predominance of Communists in the Parliament Thus, stalemate could characterize the political process in the coming months despite the need for drastic action to reverse fiscal deterioration This weakness points to the level of corruption and fraud some of which explains the non-payment of tax revenues into government coffers Political favors appear to be frequently purchased, partly a response to high tax rates which are high partly due to non-payment from a significant portion of the potential tax base With fully one-third of the economy outside of official figures, such a trend is not likely to improve any time soon even with some credible measure of expenditure control—some of which is already occurring by default in the form of arrears and non-payment of taxes These fiscal weaknesses point to more serious structural problems, and the essential need for administrative reform In addition to tax reform to broaden the fiscal base and lower rates, Ukraine also needs to reduce the cumbersome, inconsistent and discretionary costs of licensing and inspections These characteristics undermine public confidence in institutions, and induce continued growth of the shadow economy when Ukraine is in dire need of developing institutional capacity for long-term stability and growth While Ukraine is to be congratulated for having become democratic through the electoral process in a short time—independence was only granted in 1991—even here, the cost of getting elected has been estimated to be $1 million per seat in Parliament in a country where individuals are frequently responsible for most of their campaign expenditure [2]

- With regard to *legal and regulatory reform*, judicial institutions need strengthening to be effective Many of the laws and regulations are carried over from the earlier Soviet period As for banking, weaknesses abound as a result of organizational structure, reluctance to exercise regulatory mandates, poor information, inappropriate laws or regulations, and the absence of commercial experience in the courts Organizational structures frequently are fragmented, with separate units often working from different information and failing to coordinate from a policy standpoint This results in the inconsistent application of laws and regulations, adding to the uncertainty of the environment and thereby undermining both debt and equity financing Because of old structures and operating traditions, many regulators are reluctant to exercise their mandates for enforcement unless specific infractions are noted and identified In some cases, there is little mandate to enforce without specific approvals from senior bureaucrats This may be changing with regard to banking supervision, but there has been insufficient reform in other administrative structures (e g , tax inspectorate, agencies responsible for issuing permits and licenses) that undermines real sector development Poor and inconsistent information likewise represents a challenge to the implementation of laws and regulations In the case of banking, there is progress as Ukraine is moving towards IAS However, this is only a beginning, and accurate information may still not be forthcoming from banks for at least another one to two years while investments are made in information technologies, branches are more closely linked to head offices and other requirements are put in place for accurate information flows The real sector lags the banking sector, thus representing a broader challenge for fiscal authorities and public policy at large As for the suitability of laws and regulations for a market economy, there is still significant reform to be introduced Some progress has been made with a recently amended Law on Pledges, and draft banking legislation for both commercial banks and the National Bank However, commercial experience in the courts is limited, so it will take time for the amended Law on Pledges to take effect There is also no significant development outside the shadow economy of repossession and liquidation Banking legislation has still not passed, and is not expected to pass at least until late 1998 for NBU legislation and mid-1999 for commercial banking legislation In its favor, Ukraine's general legislation is viewed as satisfactory in terms of openness to foreign investment and the removal of

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2 See "Business connections," *Kiev Post*, April 28, 1998

major trade barriers However, both domestic and foreign investors appear to face problems of commercial, tax and land codes which lead to broken contracts, changing terms of agreements, and limited investment opportunities These problems are aggravated by discretionary and inconsistent application of tax laws, customs regulations, licensing procedures, and company registrations To remedy these problems, ineffectual but frequently changing legislation further reduces confidence, thereby undermining aggregate direct investment

- *Economic* developments in 1997 had limited good news—namely that the inflation rate continued to decline, down to 10 percent at year end 1997 The average inflation rate for 1997 was 15 percent, compared with an average 891 percent in 1994 There also was only a 3 4 percent current account deficit—although this was up from 2 7 percent in 1996—and some sectors are viewed to have export potential, namely chemicals, a wide range of metallurgical products (e g , in mining, steel), and energy-related machine-building However, by most measures, the Ukrainian economy is weak, structurally flawed, and in some ways imploding by default from a combination of arrears, fiscal deficits, corruption, and worsening fundamentals Real GDP declined by 3 2 percent, the eighth consecutive year in which growth has been negative The unemployment rate was officially registered at 2 3 percent at year end 1997, but this measure is difficult to trust due to the degree of barter, underemployment, and informality in the economy More than half the people are reported to subsist and/or operate in the shadow economy With steady increases in arrears, officially registered unemployment is likely to increase Perhaps most problematic is the fiscal deficit, which increased to 6 7 percent in 1997 from 3 2 percent in 1996 Ukraine continues to carry social security and wage arrears due to its perilous fiscal position—a Eurobond issue for $750 million with a 16 2 percent yield was floated successfully in late 1997, with the proceeds reported to have been used to pay down a significant proportion of arrears The vulnerability of Ukraine's economy was highlighted in late 1997, when foreign portfolio investors—mainly Russian—withdrew funds from the market There were earlier signs of vulnerability, due to declining T-bill yields and the limited depth of the corporate bond market However, the more dramatic effects were shown later in the year when cash needs in Russia prompted flight from Ukraine This left banks underfunded, and prompted NBU to raise the discount rate from 16 percent in September-October to 35 percent in November, 1997 Rates further increased in February 1998, with the NBU discount rate rising to 44 percent and the Lombard rate rising to 45-48 percent All of this was in response to turmoil in Russian markets, a problem that was further and dramatically exacerbated in late May, 1998, when the Russian Central Bank raised the discount rate from 50 percent to 150 percent As of April 1998, the Ukrainian T-bill market showed an average weighted yield of nearly 50 percent While this is part of implementation of what has been an effective monetary policy in terms of reducing the inflation rate, it also leaves banks with very limited liquidity The exchange rate depreciated with the outflow of portfolio investment—the local currency was about 10 percent lower in value against the U S dollar in April 1998 than in September 1997 There may also be a looming debt crisis if the budget deficit is not reduced, if interest rates remain high, and if/as foreign exchange reserves diminish Given Ukraine's weak fiscal position, the country may well need significant external assistance and foreign investment to avoid default and a damaging balance of payments crisis Such assistance, if it is agreed to, will need to be accompanied by meaningful structural reforms if it is to spark needed levels of inflows

- The *banking* sector has made some slow progress as a result of what appears to be a hardening budget constraint, matched by underlying prudence of some bank management As the fiscal situation deteriorates and monetary policy remains focused on price stabilization, banks are now forced to better manage their resources to generate the liquidity needed to operate in the marketplace The banking sector's largest 20 banks are reputed to account for about 80 percent of assets, with the largest seven banks representing more than half of total assets However, such measures of "large" asset totals are prior to provisions and write-offs according to IAS It is very likely that the "largest" ex-state banks will have considerably smaller balance sheets once provisions are made for loan losses based on new prudential regulations Insolvency is a possibility in some cases In general, most banks in Ukraine face attrition in the event of continuous "prolongation" (e g , rollovers, interest capitalization) of loans Ukrainian banks are very small, as indicated by the difficulties many of them have had in simply reaching a minimum capital of ECU 1 million (about $1 3 million) The main source of cash income in recent years has been investment in government securities However, new lending and fee income-generating activities will be needed for banks to generate profits in the long run Such efforts are hampered by a weak real sector which keeps funds out of the banking system to avoid confrontations with the tax authorities, limited service availability from banks due to weak systems and experience, and comparatively high overhead rates due to excessive head count, inefficient processing and unneeded branches There is a risk of excessive exposures and off-balance sheet items (e g , letters of credit, guarantees), as well as reliance on inflated real estate values Ultimately, as in other banking systems where problems have emerged from low quality assets and high cost structures, pressure on banks will come from liquidity and the absence of available funds Bank assets were only 24 percent of official GDP and only 15 percent of estimated GDP in 1997 prior to write-offs Thus, after adjustments are made to overstated assets, these ratios will reflect an even smaller portion of banking assets On the funding side, notes in circulation are nearly equal to bank deposits Thus, financial intermediation rates are low—little more than eight percent of total estimated GDP in 1997—reflecting the limited role banks play in the economy and the limited funding available to them

- Ukraine has experienced some development in its capital markets, but not much By global standards, the capital markets and non-bank institutions are very small Market capitalization was only $8 billion at end 1997, but much of this was non-tradable and likely overvalued Where Ukraine has shown rapid growth is in the interbank currency and foreign exchange markets Dollar trading has increased fourfold in two years, from a negligible $8 billion in 1995 to more than $32 billion in 1997 However, Ukraine is subject to high levels of volatility, as shown in the outflow of funds in late 1997 in the aftermath of the "Asia crisis " Ukraine is particularly vulnerable to financial shifts in Russia—Russian institutions accounted for about 40 percent of portfolio investment in September 1997, and about half of all recorded Ukrainian trade is with Russia Likewise, because of ongoing Russian vulnerability to "contagion" effects in emerging markets, there is a spillover effect on Ukraine when Russia responds to restore confidence in the ruble and Russian markets Ukraine's approach to privatization combined with administrative problems has also reduced the level of foreign direct investment, thereby limiting the contribution that source can make to capital markets development Corporate debt markets remain very thin, undercutting potential investment Furthermore, the rest of the *non-bank financial* sector is relatively undeveloped Insurance, leasing and factoring activity is limited There are few if any commercial credit companies, although most of the small banks resemble commercial credit institutions rather than banks While there are about 200 credit unions, they are small and make little impact on savings mobilization or lending flows

1 2 Legal Ukraine's laws have effectively moved the country away from the monobank system that existed during the Soviet period, and laid the preliminary groundwork for slow movement to a market economy However, while basic laws are either in place or being drafted to accelerate reform, institutional capacity to effectively implement such laws has been weak to date Above all, while many Ukrainian institutions have a reputation for being legalistic and compliant, Ukraine's government also has a reputation for corruption and fraud This is partly evidenced by the shadow economy approximating half of the official economy Much of that shadow economy is the result of corrupt and cumbersome procedures frequently in the form of inspections, permits, tax payments, fines and other "enabling environment" issues that have undermined satisfactory development of a formal private economy While laws and their application in the financial sector are not considered quite as egregious—the National Bank appears to enjoy an independent reputation with a mandate to enforce—the weakness of judicial institutions and other public offices undermines the rule of law and makes it more difficult for the banking sector to function in a sound and efficient manner **Score 2-**

- *The Law on the National Bank of Ukraine* (NBU) became effective in 1991 and legally transformed Ukraine from the Gosbank system to a two-tier banking system The central bank appears to be reasonably independent, and has a mandate to implement monetary policy as well as to supervise banks In particular, the implementation of a tight monetary policy since 1995 shows NBU has institutional power However, while this mandate appears to be in place, the absence of reform at the structural level also indicates there are limits to its mandate The NBU is weakened by organizational fragmentation, an apparent lack of coordination across departments, and differing policies, procedures and controls It also appears that lobbying by various vested interests for tax exemptions and related benefits from other government offices and ministries adds to the imbalance of monetary and fiscal policy, putting political pressure on NBU A draft law is now with Parliament to strengthen the role of NBU in its oversight of the banking system A tentative timetable for passage of the law is year-end 1998 In the meantime, NBU Banking Supervision has an array of regulatory measures it can use to enforce compliance with prudential norms that have recently been introduced However, passage of the law is important in giving the NBU a stronger mandate to take enforcement actions when non-compliance is uncovered

- Ukraine's first *Law on Banks and Banking Activity* became effective in March, 1991 This Law was not successful in providing needed guidelines for commercial banking practices that are "safe and sound " The Law failed to prevent high levels of exposure to shareholders and insiders, did not require meaningful consolidation, and did not provide incentives for governance and management consistent with those found in a market economy In response, NBU has drafted more than 18 prudential guidelines to bring banking practices closer to recommended international norms These include regulations on capital, risk management, open foreign exchange positions, and weighted foreign exchange positions These are part of an overall strategic plan to better coordinate policy and implement integrated banking supervision in support of "safety and soundness " A new law is being drafted which is universal in focus This may be risky, and probably should be phased with the introduction of strict firewalls Tentative passage is set for mid-1999 The new law would enshrine many of the norms being introduced at the regulatory level, including minimum capital, capital adequacy, insider loans, large loans and exposures, classification standards and provisioning requirements, and other common features found in commercial banking laws

- *The Law on Securities and Stock Exchange* was introduced in 1992 New regulations were introduced in 1996, including the establishment of a Securities and Exchange Commission Problems associated with clearing, settlements and re-registration for corporate securities have undermined confidence in the mechanics of Ukraine's capital markets Through 1997, this was partly due to the absence of printed share certificates endorsed to the purchaser of shares, making it difficult to achieve a legally valid and enforceable transfer of title to securities Existing securities registration practices were considered vulnerable to unscrupulous behavior, particularly when the issuer could act as its own registrar Further development of independent registrars is needed to overcome this obstacle

- Ukraine recently amended its Law on Pledges to conform more closely to EU standards However, to date there has been little testing Banks generally disbelieve they can lay claim to assets in the event a borrower defaults except when the borrower signs an agreement There may be some ability to do so on moveables—joint signatures are needed on moveables for transfer that is legally recognized—but this does not seem to be as universally accepted for fixed assets This notion has been reinforced over the years by asset stripping There have also been instances of multiple claims on properties, reflecting problems with both *property registration* procedures and *lien perfection* All of this undercuts the willingness of banks to provide long-term loans, although uncertainty about the future and limited funding resources are more compelling reasons for short-term lending and asset management patterns Banks' responses have frequently been to accept only cash (e g , deposits) and government securities as collateral for loans, and to insist on the opening of cash accounts for a period of time before credit applications are entertained Some of the better managed banks also conduct site visits to ensure that information provided in credit applications is accurate and reasonably valued

- Ukraine lacks experience and commercial training of specialized bankruptcy judges and liquidators for both *in-court and out-of-court adjudication* While the shadow economy has its own rules, the court system and other legal mechanisms for *bankruptcy and liquidation* are relatively untested This will become more of an issue in the coming years as banks are required to better manage their assets Some preliminary grounding has been put in place with the liquidation of about 47 banks However, standards for the certification of professional liquidators are lacking as is the general secondary market and infrastructure needed for such asset disposition Existing arbitration procedures are not considered effective as a means of resolving contract disputes Work on a collateral registry is underway, but to date, the Law on Bankruptcy has generally been ineffective due to weaknesses in judicial infrastructure (e g , absence of specialized courts, lack of trained judges), lack of clarity about whether a liquidator can investigate a debtor's financial affairs, the higher ranking of liquidation costs to secured claims, and a general lack of tradition The ranking of liquidation costs is a particular deterrent Banks are required to pay a five percent charge of the total filed claim to the court—this is net of the bank's own legal fees for representation—without any assurance that the court will rule in favor of the creditor Even if the court does, this could take years Thus, there are numerous disincentives for creditors, and this has undermined or corrupted risk-taking by banks in a period of hard budget constraints

1 3 Regulatory/Supervisory Ukraine is at the beginning of a long process dedicated to building effective regulatory and supervisory capacity for the banking system There are several strong points to efforts achieved to date, largely with targeted donor assistance These include development of an ambitious strategic plan for the NBU's banking supervision department, an increasingly clear mandate for supervision to enforce regulations, the introduction of new regulations which get prudential norms closer to international standards, movement towards adoption of IAS for the generation of more meaningful information, investment in information technologies to assist with the timely flow of information, improvements in the organizational structure of banking supervision to encourage better coordination of information and policy, and an integrated supervision approach which leverages off of a combination of on-site inspections and off-site surveillance These are all positive steps forward which, in due time, should strengthen the institutional capacity of the NBU to monitor for risks in the banking system as banks themselves engage in riskier activities It is particularly important that donor support be sustained in these areas to help NBU address existing risks, to plan for contingencies, to contain future risks, and to generally build capacity It is likely that the emergence of a banking crisis would be exacerbated by the curtailment of such needed support There are still many weaknesses with regard to regulations and supervision New regulations have recently been introduced, and it will take some time for banks to effectively adapt In some cases, such as minimum capital, regulations support the existence of very small banks which may add to the cost of supervision Additionally, it will take time before sufficient human capital is developed to ensure supervision is able to identify, evaluate, monitor and contain risks in a timely fashion However, significant progress is being made with the provision of technical assistance for on-site inspections, off-site surveillance, and general policy coordination These are all necessary building blocks for effective supervision If the supervisory function is indeed weak, the trend is favorable as long as support is sustained **Score 2**

- *Licensing requirements* and regulations are being tightened in the banking sector with the introduction of new regulations, and the drafting of a new Banking Law which is tentatively scheduled to become effective by mid-1999 Minimum capital is now ECU 1 million for banks While still a very small sum for a bank, it represents an increase from ECU 0 1 million at June 1, 1996 More importantly, there are as many as 42 licenses that banks can obtain based on compliance with regulatory norms [3] As of mid-1997, only eight of 178 operating banks had all 32 licenses for operations [4] In one sense, this is a highly inefficient and overly administrative approach In most market economies, only one or a handful of licenses are issued However, NBU utilizes its control over the licensing process to enforce its mandate for effective oversight of the banks The threat of a license being revoked provides the NBU with greater leverage and "moral suasion" when encountering a bank that may not be in compliance Until new laws on both the NBU and commercial banks are passed reinforcing the banking supervision department's independence and mandate to enforce regulations, this will remain a pragmatic tool for NBU to use for effective oversight Meanwhile, a positive trend may have begun with the apparent change in policy regarding foreign banks Previously, NBU restricted entry of foreign banks to a total of 15 percent of total banking system capital and 35 percent of individual bank capital as an attempt to encourage foreign banks to acquire domestic banks This strategy did not work, and NBU appears to have now recognized that fewer restrictions along these lines will be beneficial for development of a well-capitalized, modern banking system

- The existing and draft Laws on the National Bank and Banks provide a *clear legal basis and mandate for the NBU to supervise* the banks This includes banks as "universal" institutions engaged in securities and other capital markets activities NBU is currently getting grounded in the fundamentals of supervision in support of "safety and soundness " It remains to be seen how long it will take supervision to effectively oversee the broad range of activities built into the concept of universal banking However, NBU is planning on increasing staff for oversight from 486 to 574, of which 45 additional staff would be for on-site inspections and 25 new staff would be for off-site surveillance [5] Combined with significant levels of training, comprehensive as well as targeted inspections of major banks, development of an early warning system and computerized Uniform Bank Performance Report, NBU capacity is expected to increase in the coming months and years as new legislation is adopted and as banks adapt to changing market conditions Immediate weaknesses include the poor quality and insufficiency of information which can be analyzed and then utilized for corrective action—examples include inadequate or inaccurate information for maturity and gap analysis in assessing liquidity and foreign exchange risk, as well as a more general analysis of currency risk, sector concentration, and maturity mismatches and their overall impact on earnings and asset/portfolio quality One of the key challenges to NBU will be its ability to develop needed information systems to obtain a better reading of the financial and operating condition of banks it regulates A second key challenge will be to retain highly skilled and professional people, or to at least have a mechanism in place to replace such people when they are offered positions elsewhere As found in all economies, another challenge will be the continued enforcement of professional standards, particularly given financial and other temptations that are offered to regulators in what would constitute a breach of professional ethics if accepted

- *Penalties* for regulatory non-compliance by bank managers and employees can be assessed, as they can for board members as well However, to date, NBU regulators have apparently been reluctant in many cases to exercise their enforcement powers Banks and regulators are legalistic in their conceptions, and compliance-driven This is also true in terms of analyzing capital adequacy, asset quality, and liquidity positions There is clear evidence that banks are exercising some measure of prudence in the way they manage their resources, partly the result of new regulations Complaints and pressure from banks to ease up on some of the regulations also indicates that banks are feeling pressure as a result of new regulations Some of this is due to the strictness of some regulations, such as the reversal of interest after 30 days if not serviced, the deduction from Tier II capital of bank investments in non-bank companies in excess of 20 percent of capital, and the restriction on fixed assets to bank total capital NBU likewise retains reasonable control over the process due to the power

[3] Approximately 32 licenses apply to "banking" operations, while another 10 or so licenses apply to "non-banking" activities, primarily related to capital markets and other "universal" banking activities

[4] See Landy, "Developing Sound Banks in Transitional Economies Structural Reforms in Ukraine," CASE, September 1997

[5] This would bring total on-site staff to 247 and off-site staff to 141

to revoke a license However, compliance with regulations can and frequently has been fictional due to accounting standards that have not provided an accurate reflection of the financial condition of banks Gradual conversion to IAS is a first step, in conjunction with new regulations, to ascertain the magnitude of insolvency in the banking system, and to provide a more reliable framework for ongoing supervision in the coming years That more than 40 banks have been put into liquidation shows that NBU is serious about enforcement in the banking sector However, these have generally been small banks The real test will come with the larger ex-state banks that have long served as administrative channels for mandated lending or soft lending to SOEs [6] Likewise, there is incongruity between efforts to impose discipline in the banking sector while progress in the real sector lags Banks themselves are likely to complain if there is a perception of being singled out for strict oversight while non-bank companies are not subject to similar oversight Meanwhile, the supervisory function will likely remain focused on compliance rather than risk management, although the recent introduction of on-site inspections and CAMEL ratings—focused on capital, assets, earnings and liquidity—should enhance the NBU's ability to evaluate the condition of the banks for safety and soundness, and eventually for the quality of management

- Levels of *disclosure* are generally inadequate, and practices reflect traditions dating back to the Gosbank period Where disclosure levels are improving, there is then the question of accuracy Banks are only beginning to convert to IAS, and much of this is still in the pilot stage It will likely take another year or two before branches and home offices are well connected through adequate MIS, and before both management and regulators are using such information for risk and portfolio management purposes The entire notion of open disclosure and transparency is relatively new for Ukraine, and is likely to hold back institutional and market development On the other hand, initial progress is being made in terms of banking In addition to gradual conversion to IAS, disclosure requirements to regulators and compliance from banks is improving Whether this means the banks are increasingly safe and sound is another matter, but banks do appear to be increasingly in compliance with NBU requirements Regular reports are required, and risk management considerations are built into these requirements It remains to be seen how quickly Ukraine is able to develop more open disclosure policies, procedures and standards based on accurate information One factor that might serve as a catalyst is the attraction of prime-rated foreign investment in the financial sector, as these kinds of firms are accustomed to working with and generating far greater volumes of information for active markets

1 4 Payments System The payments system functions well in Ukraine, and is reputed to be the best among FSU countries The system is based on electronic funds transfers—checks are not used Real time gross settlement is reported to take place within 20-30 minutes Ukraine currently processes about 500,000 transactions per day, and capacity exists for significantly greater volume Notwithstanding other problems in the economy, the payments system is considered highly effective and efficient, and reasonably well protected from credit, liquidity and systemic risk Credit risk is essentially non-existent as the recipient receives funds only after the payer has written such payments off his account and transferred them to the payee account Liquidity risk is substantially reduced due to the prevalence of real time settlement Systemic risk is reduced due to the exclusion of overdrafts Thus, despite risk management weaknesses at the banks, the payments system applies controls that substantially mitigate a crisis through the payments system This helps to provide some underlying stability to the interbank market Assuming the NBU focuses on the largest banks' activities—the interbank market is currently

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6 The NBU appears fully aware of this potential challenge NBU mentions five large banks—Prominvestbank, Ukraina, Ukrotsbank, Eximbank, and Savings Bank—as representing the major concentration of problems in the banking sector See "Strategy of Developing Bank Supervision of the National Bank of Ukraine for 1998-2000 "

dominated by two banks (e g , Bank Ukraina and Privat Bank)—and requires banks to maintain sufficient reserves, these risks should be identifiable and mitigated The electronic payments system provides additional defense for these efforts The payments system has also helped reduce the incidence of fraudulent interbank payment documents **Score 4**

- Ukraine has a modern *clearing and settlement* system This has provided the banking system and economy with the benefit of electronic bank transfers, and no major float It has increased the speed and reliability of payment transactions while eliminating the need for cable and postal acknowledgements The system is viewed as cost effective, reliable, supported by compatible hardware and software, and easy to operate The system also enforces a measure of discipline, as settlements participants have necessary data for liquidity forecasting, and any transactions that could cause an overdraft are automatically blocked While this could cause unnecessary problems for participants with back-up lines of credit or alternative sources, it is also a prudent measure to protect against a liquidity run on the payments system Essentially, some of the design principles have reduced or eliminated credit, liquidity and systemic risk This helps to provide some underlying stability to the interbank market The system has also reduced the incidence of fraud

- *Management MIS and technology* development related to payments systems are considered sound, as are internal systems, procedures and controls Payments and relevant information between payer and payee seem to flow through the system without problems This includes the transmission of secured documentation for transactions without reported incidences of fraud, unauthorized payment orders, or other irregularities A new generation system of electronic interbank settlements is being developed to increase the convenience to users Key components include an account monitoring system, a time transfer system, and a clearing system

1 5 Accounting Ukraine's accounting standards are slowly evolving towards international standards Banks are required as of January 1, 1998 to report according to IAS To accommodate this conversion as well as regulatory reporting requirements recently introduced by NBU, NBU has introduced a new chart of accounts While Ukrainian accounting standards—principles and procedures—have not yet been officially introduced that are IAS, the new chart of accounts for bank reporting is broadly consistent with the IAS framework Key weaknesses that currently exist in the banking sector with regard to the production of accounting information include fragmented branch reporting, the need for improved verification of journal entries (e g , for the detection of possible fraud regarding credit and securities transactions, registration of collateral and guarantees), and the general need for stronger internal controls Key banking sector weaknesses with regard to the use of accounting information include the general notion that the information produced is primarily for regulators, and that it is of marginal usefulness for management purposes Notwithstanding these weaknesses, it is expected that banks will learn to utilize accounting information increasingly for management purposes, and not solely for regulatory reporting purposes It is also expected that as banks adapt to new standards, that companies in the real sector will likewise begin to report accordingly This will be particularly true if Ukraine is to attract needed foreign direct investment, as well as to move forward and more fully develop its capital markets In both cases, IAS will be a fundamental element of valuations, due diligence, and investment decision-making (both for direct investment and portfolio investment) New standards will, among other things, bring "market-based" values of companies closer to reality due to new standards for provisioning and allowable deductions Ukrainian accounting standards currently distort income statement and balance sheet measures in the enterprise sector, thereby distorting the quality of banking portfolios and contributing to a misrepresentation of banks' earnings and balance sheets As Ukraine experienced significant portfolio outflows in late 1997—symbolizing the limited depth of its markets and its vulnerability to "hot money"—it will be in the interests of Ukraine from a macroeconomic as well as a structural point of view to accelerate the conversion of systems to IAS This will have to be comprehensive, from charts of accounts that are useful in generating meaningful information all the way through to transparent methods of disclosure for both public and private consumption All the major international accounting firms are active in the Ukraine, and this should help with the process **Score 2**

- Ukraine is at the beginning of the process of conversion to IAS A new chart of accounts for banks has been introduced to facilitate movement towards an IAS framework, and eventual adoption of *international accounting standards* for banks (and, presumably, for large enterprises over time) This should eventually become a virtual precondition for listing on the stock exchange, as well as for meaningful direct investment from abroad However, few Ukrainian companies are within this sector—one source estimates the number of "blue chip" firms to be about 50 for the whole country, many of them multinationals [7] Both the accuracy and usefulness of accounting information, and the willingness to disclose this information are bound to remain problematic Beyond that, Ukraine is a long way from understanding how to use internal and external accounting information for management purposes This appears to be true in banks as well as in the enterprise sector

- Proposed banking legislation notes the general reporting requirements of banks to supervisory authorities This is part of the normal reporting process to monitor liquidity and solvency, and precisely the kind of compliance that the banking supervision department monitors In the absence of a reasonable explanation, failure of a bank to comply with such reporting requirements would constitute a violation that NBU would have a firm legal basis for punishing NBU also closely monitors monetary and foreign exchange trends as part of its interest rate and exchange rate policy

- There are several training programs and institutes in Ukraine for training in accounting In the banking sector, Ukraine has received significant levels of technical assistance from USAID and the EU to assist with the introduction of the new chart of accounts NBU is expected to issue new instructions on accounting procedures and records in 1998 based on results from pilot tests of the new chart of accounts in 15 commercial banks, the general capacity of banks to report according to general IAS as of January 1, 1998, and findings from on-site inspections and external audits In terms of specific banks, chief accountants are reputed to be competent, but limited in terms of banking experience

- As of early 1998, all of the major international accounting firms had offices in Ukraine These firms are involved in the external audits of the major banks

1 6 Rating Agencies/Systems The major international rating agencies became active in the Ukrainian market in 1997 Ukraine's ratings in February 1998 were generally unfavorable in terms of the long-term outlook There are no domestic rating agencies, although one firm "ranks" banks based on financial measures In general, there appears to be only limited information on banks and companies Part of this may have to do with traditional reluctance to disclose information, as well as the quality of information that has been provided to date Conversion to IAS and introduction of stricter standards of governance and scrutiny might improve the situation, but this will take time More information is available on government securities and debt, largely due to financing needs and market requirements The potential exists for domestic rating agencies to play a useful role in market development, but a weak economy and traditional non-disclosure have undermined such potential to date **Score 2-**

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[7] There are reputed to be about 150 multinational companies which have representative offices in Ukraine However, only a fraction currently have running operations

- Ukraine received ratings from Moody's in 1997 Moody's rated Ukraine's long-term bonds as B2, and long-term bank deposits as B3 These ratings generally reflect poor or undesirable investment quality questionable assurance of the ability of the issuer to cover principal and interest, and poor financial security Short-term notes and bank deposits were rated NP, or not prime That rating generally constitutes a lack of confidence in the issuer's access to firm bank lines of credit or other back-up financing to meet obligations during periods of market stress

- There is no known *domestic initiative* to establish a rating agency for bills, bonds or other securities There is also no known initiative to establish a central credit information system, although NBU intends to utilize CAMEL over time to establish an internal rating for individual banks The initial early warning system provides a start in this direction, and on-site inspections will significantly augment this knowledge base To assist with credit ratings for individuals and companies, banks might consider collaborating through an association and/or through NBU Credit rating information on individuals and companies is currently undermined by the limited market demand due to the predominance of the shadow economy, combined with the limited availability of useful and meaningful information due to confidentiality concerns Such a weakness will likely delay levels of consumer credit in bank portfolios, or add to the risk of such credit as banks seek more profitable lines of business This could also lead to higher spreads charged on loans to smaller businesses as a result of poor information, keeping bank financing unaffordable to many firms in the real sector While banks will be prudent to limit their exposure accordingly due to poor information and limited security, the absence of adequate information also reinforces the negative spiral which has contributed to eight years of negative growth in Ukraine's economy, and the strict cash orientation enforced in the shadow economy

1 7 Financial Media No particular effort was made to assess the financial media However, there are several newspapers that report financial information Press coverage of tax, legal and accounting issues is considered satisfactory There is an effort to utilize the media to instill financial discipline in banks [8] There is one English-language journal which provides broad and seemingly responsible coverage of government and economic issues Media coverage is generally considered responsible **Insufficient Basis for a Score**

1 8 Professional Associations No particular effort was made to assess associations in Ukraine However, there are a few professional associations in Ukraine for financial sector individuals and groups The major association in banking is the Association of Ukrainian Bankers, which has been a useful institutional vehicle for coordinating donor-financed training activities in accounting, financial management, and other areas of relevance for banking The Association has also been active in lobbying for input into the drafting process, although not always in a manner that reflects an adequate understanding of market-based banking and international norms Some programs offering financial training that is administered by associations lead to certification Standards are generally considered to be highly professional **Insufficient Basis for a Score**

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[8] For instance, the NBU is apparently releasing estimated provisions for banks' loan losses While this may add to a lack of public confidence, it also provides the incentive to banks to benefit from good news coverage when financial conditions are sound

1 9 Academic No particular effort was made to assess the number or quality of academic institutions in Ukraine Nor was there a systematic effort to speak with business/management school officials However, there are prominent schools and institutes in Kiev, Lvov, Odessa and other major urban centers There are also some think tanks that make a significant contribution to economic and financial sector development **Insufficient Basis For a Score**

1 10 Miscellaneous There has been slow movement towards privatization and modernization of the telecommunications market While Ukraine earlier allowed cellular operations, the major telecommunications monopoly, Ukrtelekom, is still wholly state-owned Privatization may begin in 1998 The telecommunications sector has improved in major metropolitan areas in recent years, but still is considered inefficient, unreliable and costly by global standards Further, companies have reported the need to pay a nearly $900 "unofficial" payment for installation per line, up from $550 per line in 1994 [9] Ukrtelekom's reputation is respected with regard to capacity provided for critical financial sector institutions such as the electronic payments system However, branches have trouble connecting by phone with head offices Hence, basic services for most companies and households is weak to non-existent Postal services appear adequate, and largely irrelevant to the banking sector due to the efficiency of the electronic payments system Safekeeping from a physical and logistical standpoint also appears adequate, although the reliance on cash adds to security risks between the NBU, banks' home offices, and bank branches No systematic effort was made to review this **Insufficient Basis For a Score**

- The privatization of Ukrtelekom may move forward due to the likely proceeds to be generated from the sale during a period in which the government is desperate for cash There has been limited movement to demonopolize the sector by allowing cellular phones However, mobile phones in Ukraine cost four to six times what they cost in the UK, and are well above rates in Poland [10] For landed systems, the waiting time for line installation is two-three years in Ukraine, possibly explaining why so many companies appear willing to pay "unofficial" fees for installation Fiber optic cable is only 2,600 km, about 10 percent of that found in Poland[11] where the population is 80 percent that of Ukraine and the state telecommunications has yet to be privatized Ukrtelekom is estimated to need $10 billion in investment[12] for improvements in *telecommunications* system capacity, which would likely include a substantial increase in fiber optic cable to reduce the waiting time for installation, and to provide a significantly wider offering of services The state is currently consolidating the regional units into one company prior to privatization Characteristic or Ukraine's poor performance in attracting foreign direct investment, Motorola was prepared to invest in Ukraine in 1997 This would have significantly increased telecommunications capacity However, this major investment fell through over a number of disagreements regarding contract terms after a deal was reputed to be agreed to Among other things, such an investment might have increased satellite offerings as well as increased competition in cellular phones As for existing telecommunications capacity for banks, most bank branch communication with head offices is via the electronic payments system with secured e-mail lines or via telex Telephone connections are difficult

- The postal system is considered adequate Investment in the electronic interbank clearing system has relieved the postal system of the need to furnish volumes of payments acknowledgements

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9 See Kaufmann, "Why Is Ukraine's Economy—and Russia's—Not Growing?," *TRANSITION*, April 1997

10 See "Business Monitor," *Kiev Post*, April 28, 1998

11 See "Business Monitor," *Kiev Post*, April 28, 1998

12 See "If not now, when?," *Business Central Europe*, March 1998

- No effort was made to review the safekeeping practices of banks Some banks are focusing on custodial services as a source of fee income However, the transport costs of cash are higher in Ukraine than in other countries where more deposits are held in banks This partly reflects security risks Such risks are offset partly by the respected efficiency of the payment system However, there may be risks here related to the supply of software by outside vendors to banks

II ECONOMIC FACTORS AND INDICATORS Ukraine's economy is generally weak from a structural standpoint, with mixed reviews from a macroeconomic standpoint that are bound to worsen over time unless direct investment increases and structural reforms accelerate The good news from a macroeconomic standpoint is that monetary policy has been effective over the last two years in bringing down the inflation rate Year on year, the inflation rate (CPI) was only 10 percent at end 1997, compared with 40 percent at end 1996 and hyperinflation just a few years earlier Ukraine also does not appear to have a significant current account problem, with a deficit averaging about 3 5 percent since 1995 However, there are warning signs of rising fiscal deficits, increasing debt, and general crowding out of potential private investment Such a trend could ultimately spiral downward, manifesting itself in a balance of payments crisis as a result of depleted foreign exchange reserves, exhausted debt capacity, and unsustainably high interest rates offered on securities Ukraine has shown itself to be vulnerable to portfolio investment Combined with a poor track record in attracting direct investment, Ukraine's balance of payments are likely to depend increasingly on donor financing unless there is a major acceleration of strategic privatization There is potential interest rate and exchange rate risk due to Ukraine's financing needs in the event donor financing gets off track For such a scenario to be avoided, Ukraine will have to accelerate structural reforms This will require better performance in attracting foreign direct investment and accelerating the privatization of large-scale enterprises Even more fundamentally, changes over time will have to include tax reform, administrative reform, and reduced public expenditure The sooner these changes occur, the sooner Ukraine should begin to benefit from economic growth The Ukrainian private sector is primarily in the shadow economy, with growth constrained partly due to a poor enabling environment characterized by corruption, fraud, and excess bureaucracy This is closely linked to an arbitrary and inefficient tax system which is poorly administered Public expenditure will need to be reduced to bring down fiscal deficits in the absence of a viable fiscal base Meanwhile, structural reforms focused on economic competitiveness should have development of a viable tax base as one of its key medium- and long-term objectives to restore confidence One of the key risks to Ukraine's ability to accomplish needed reforms is political Officially registered unemployment is likely to increase with reforms, and it is questionable if government will have resources for the needed social safety net that has slowly deteriorated in recent years even without reform Overall, current fiscal problems may serve as a mixed blessing Given the government's cash crunch, it may have little choice but to accelerate privatization of key enterprises in the energy, chemicals, airline and telecommunications sectors Short of this, the economy is likely to continue into its ninth year of attrition **Score 2-**

2 1 General The economy is weak in Ukraine While monetary policy has succeeded in bringing down Ukraine's high inflation rates, in most other categories, the outlook is negative Fiscal deficits are high The stock of debt is growing as a percent of GDP, particularly domestic debt, reinforcing a "crowding out" syndrome which only adds to public expenditure at a time when fiscal deficits are deepening While current account figures are not worrisome, the structure of Ukraine's capital account weighted towards portfolio investment exposes the country to volatility, as experienced in late 1997 Meanwhile, the sheer weakness of Ukraine's real sector activity provides little hope for growth, precisely what is needed for a broadening and deepening of Ukraine's financial markets to reduce the country's overall vulnerability to balance of payments swings Official statistics showed average enterprise losses to approximate 5 8 percent of GDP in 1996,[13] a figure that likely worsened in 1997 due to the lack of working and investment capital Ukraine's foreign trade balance was positive in 1997, but based on a $2 5 billion decline in imports rather than growth in exports Meanwhile, the current account worsened due to a reduction in the surplus in nonfactor services Thus, Ukraine's general economic outlook is negative with the exception of an improving inflation rate scenario Particularly worrisome is the weak fiscal position of Ukraine, and the negative implications this is likely to continue to have on Ukraine's debt profile Unless a major reversal of trends occurs, there is a growing possibility that fiscal deficits and mounting interest payments on debt will lead to a balance of payments crisis **Score 2-**

- *Real GDP growth* was estimated to be negative 3 2 percent in 1997, the eighth consecutive year in which Ukraine registered negative real growth [14] GDP was estimated officially to be UAH 92 5 billion,[15] or about $49 billion at year-end exchange rates However, these figures are subject to discrepancies due to the size of the shadow economy, estimated to approximate half the official economy If the shadow economy is factored in, total GDP approximated $78 billion [16] Some growth was registered in trade—about 2 8 percent for 1997—but all other major sectors showed declines Transport and communication and construction registered the severest declines in 1997, at 12 3 percent and 12 0 percent, respectively Industry and agriculture were each down about 1 8-1 9 percent, an important downturn as these two sectors represent nearly half the economy While purchasing power parity figures are not yet released for 1997, they declined from $3,699 in 1992 to $2,206 in 1996 Thus, PPP measures should bring per capita income figures down to little more than $2,100 by end 1997 This partly explains the subsistence economy which drives much of Ukraine, as well as the predominance of arrears and barter in official transactions

- The registered *unemployment* rate is 2 3 percent,[17] a fiction in light of the implosion of the economy since 1990 This figure equates to about 650,000 people being out of work However, with the steady decline in output over the years, many people are retained without any measure of significant productivity This is one of the issues that enterprises and banks will both have to contend with in the coming years as they shed unneeded labor to conserve scarce cash for needed investment This is evident in the banking system, as banks will need to reduce overhead ratios and invest in information systems to function competitively

- Monetary policy has been one of the few successes in Ukraine in recent years, as demonstrated by the quickly declining *inflation rate* The inflation rate as measured by year end CPI was estimated to be as low as 10 percent at year end 1997 compared with 40 percent at year end 1996 [18] On an average CPI basis, the inflation rate was estimated to be 16 percent in 1997, compared with 80 percent in 1996 and 891 percent in 1994 [19] Thus, irrespective of measurement, there was clear progress in 1997 on the inflation front While this may partly reflect demonetization of the economy, it also reflects a measure of financial discipline that will be needed to restore confidence in the economy and financial assets for future growth

- *Exchange rates* have been set by a pre-announced policy in which an exchange rate band is set In January, 1998 the exchange rate band was set at UAH 1 8-2 25 per US dollar, up from the earlier

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[13] See Yushchenko, "Money burning problems of demand and supply development in Ukraine," National Bank of Ukraine *Herald Digest*, January 1998

[14] From the Harvard Institute of International Development

[15] See "Bulletin of the National Bank of Ukraine," December 1997

[16] Estimates from the Harvard Institute of International Development based on a GDP figure of UAH 148 6 billion for 1997

[17] See "Bulletin of the National Bank of Ukraine," December 1997

[18] From the Harvard Institute of International Development

[19] From the World Bank

UAH 1 7-1 9 per dollar corridor set in May 1997 and then UAH 1 75-1 95 in October 1997 The policy may be difficult to sustain In one sense, Ukraine does not have a severe current account deficit—a 3 4 percent deficit was estimated for 1997, about average since 1995 Nor does Ukraine appear to have a large stock of external and domestic debt—about 29 percent at year-end 1997 On the other hand, foreign exchange reserves are low—gross reserves only cover about six weeks of imports, and net foreign exchange assets are considered slightly negative Most importantly, Ukraine has fared poorly in attracting direct investment while exposing itself to mobile portfolio investment Thus, while current account and debt stock issues may not point to an overvalued exchange rate, the growth of debt flows as a percentage of GDP combined with the structure of Ukraine's capital account may prove worrisome at current exchange rates More importantly, with the government almost certain to run up deficits far in excess of the 2 5 percent of GDP target for 1998, it will need cash to operate Even with expenditure reduction, this will require higher interest rates to increase T-bill sales and to maintain confidence in the currency, and/or a further depreciation of the exchange rate to further reduce the costs of entry to portfolio and direct foreign investment Assuming dollar and other hard currency assets exceed UAH liabilities, this may not be problematic for Ukrainian banks in the near term However, any dramatic shift could also lead to a further reduction in confidence, making it more difficult for banks to play a useful intermediary role in the economy The recent tripling of interest rates in Russia to maintain/restore confidence in the ruble will only make this challenge more difficult Such developments also point to the need for an IMF agreement, and major improvement in the fiscal balance and public administration

- *Fiscal deficits* represent a growing problem for Ukraine In 1997, these deficits were estimated to be 5 6 percent of official GDP However, off-budget funding from the "state material reserve" for agricultural inputs and energy supplies added an extra UAH 1 billion to the total This brings the explicit fiscal and off-budget deficit to about 6 7 percent of official GDP for 1997 However, factors which implicitly add to the deficit, such as arrears on tax payments and other exemptions to individuals and firms contribute to the overall inability of the government to meet its basic obligations to the public The worsening foreign reserve position combined with increasing reliance on domestic debt—about 45 percent of which is funded by banks—represent a worsening of the fiscal position compared with 1996, when budget deficit financing needs were nominally less than half the needs in 1997 and about two-thirds of GDP based on IMF calculations [20] Thus, any default by the government could have calamitous effects on the banks with substantial positions in the T-bill market The government has approximately UAH 1 95 billion in Treasury bill repayments to make in June and July, 1998, and a total of more than UAH 8 1 billion for 1998, which might put upward pressure on interest rates While this would be positive for banks' earnings from securities, it would add to the costs of government, and further weaken prospects for economic growth In all likelihood, such a scenario would raise prospects for a balance of payments crisis which could directly harm bank earnings At a minimum, fiscal and debt-related weaknesses could lead to a "prolongation" of debt service and repayment to banks, exacerbating liquidity and solvency problems

- *Debt and debt service* represent potential problems for Ukraine, although they have not yet surfaced as critical While Ukraine's stock of official debt to GDP was less than 30 percent at end 1997, the domestic portion increased This was largely to finance the comparatively larger fiscal deficit in 1997 Meanwhile, the government also issued a $750 million Eurobond at a 16 2 percent yield to pay down wage and pension arrears While 16 2 percent is attractive compared to local currency rates, this represents the highest yield ever attached to a Eurobond, and an approximate $120 million per year debt service charge for the government Ukraine's glaring capital account weakness is its inability to

[20] In 1997, budget deficit financing needs were UAH 5 2 billion (based on IMF methods), or 6 7 percent of GDP In 1996, budget deficit financing needs were UAH 2 5 billion (based on IMF methods), or 4 4 percent of GDP While the GDP figures are not consistent with those developed by the National Bank of Ukraine or HIID, they still indicate that financing needs for the consolidated budget deficit were about 50 percent greater as a share of GDP in 1997 compared to 1996 See Harvard Institute for International Development *Quarterly Monitoring report*, March 12, 1998

attract dırect ınvestment Thıs has led to a relıance on debt or portfolıo flows The latter fled ın late 1997, exposıng Ukraıne's vulnerabılıty largely to Russıan and other FSU ınvestors Total debt servıce was 7 2 percent of export earnıngs ın 1997, wıth the percentage slıghtly hıgher to the FSU at about 9 1 percent However, wıth a weak economy, steady current account deficıts, and weak dırect ınvestment figures, Ukraıne's debt and debt servıce fundamentals could soon deterıorate

Table 1 General Economıc Indıcators

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Real GDP Growth	-2 6%	-11 6%	-13 7%	-14 2%	-23 0%	-11 8%	-10 0%	-3 2%	
Per Capıta Incomes									
GDP ın $			404	269	445	723	864		
PPP ın $			3,699	3,299	2 633	2 368	2,206		
Regıstered Unemployment	0 0%	0 0%	0 3%	0 3%	0 3%	1 6%	2 3%		
Inflatıon Rate—CPI (yr-on-yr)		161%	2,730%	10,155%	401%	182%	40%	10%	
Yr-end. Exchange Rate									
UAH Ruble*				456	2,940	3,870	3 40	3 19	
UAH US$*			638	12,610	104,200	179,400	1 889	1 899	
Fıscal Deficıt/GDP		+15 0%	25 4%	16 2%	7 8%	4 9%	3 2%	6 7%	
Debt Servıce/Current Account				1 3%	11 0%	8 8%	6 4%		
Total Debt/GDP					27 7%	23 7%	23 9%	28 9%	
Gross External Debt ın $ bn.			0 5	3 7	7 2	8 1	8 8	9 6	

* *Note* Ukraıne s currency was the Karbovanet untıl late 1996

Sources Bulletın of the Natıonal Bank of Ukraıne, HIID World Bank, EBRD

2 2 Prıvate Sector Development The "enablıng" envıronment ın Ukraıne ıs one of the weakest ın the regıon Whıle prıvatızed enterprıses numbered about 57,000 and total small prıvate busınesses numbered as many as 93,000[21] ın 1997, the prıvate sector share of GDP was estımated to be only 50 percent ın mıd-1997 [22] Most of these enterprıses are small-scale and of lıttle consequence to the offıcıal economy, although they serve as a bulwark of the shadow economy Most have been prıvatızed largely through "ownershıp transformatıon" methods—management and/or employee "buyouts"—wıth lıttle ıncremental capıtal, strategıc ınvestment, or change ın governance and management Meanwhıle, most of the "larger" ındustrıal enterprıses and farms remaın ın state hands Wıth regıstered unemployment at only 2 3 percent at end 1997 and eıght consecutıve years of negatıve GDP growth, ıt ıs apparent that the real sector has yet to restructure for long-term competıtıveness Prıvate busınesses are hındered by the crıtıcal need for admınıstratıve reform ın the publıc sector to free the prıvate sector from needless ınspectıons and taxatıon Pervasıve fraud and corruptıon, and ınconsıstent, unclear and cumbersome lıcensıng and permıt requırements only serve to undermıne the tax base and drıve the economy

[21] The EBRD estımated that there are 93,000 small busınesses that are prıvate Thıs would mean nearly 40,000 busınesses that are new as opposed to prıvatızed

[22] See EBRD *Transıtıon Report 1997* It ıs unclear ıf thıs estımate applıes to total estımated GDP, or estımated offıcıal GDP The shadow economy, whıch ıs prıvate but ınformal, ıs estımated to be about equal to half of offıcıal GDP, or about one-thırd of total Thıs would mean the prıvate sector was responsıble for about UAH 75 bıllıon ın GDP, of whıch nearly UAH 20 bıllıon would be ın the formal sector and the balance ın the ınformal sector

increasingly into the informal sector A 1996 survey[23] indicated that average "unofficial" fees for businesses to obtain services was a high volume business, with payment frequency per visit or service ranging from half the time (e g , "visits" by tax inspectors) to most of the time for most "services" (e g , enterprise registration, visits by health and fire inspectors, phone installation, export-import license registration) to all the time for border crossing Rates in 1996 included $894 per telephone line installation, $278 per import license registration, $211 per border crossing, $176 for company registration, and $123 per export license registration Most charges were about the same in 1996 compared to 1994, although rates for phone installation and import license registration had materially increased while rates for export licenses had materially decreased These payments, along with smaller payments for each visit by tax, fire and health inspectors, have contributed significantly to a "very high increase" in the unofficial economy, with only war-burdened Georgia and Azerbaijan showing higher growth among a large sampling of European and Central Asian transition countries Enterprises in general continue to show increasing losses In 1996, "accounting losses" were nearly 6 percent of GDP, exceeding wage and other arrears several times over and making it virtually impossible to operate [24] Net inter-enterprise arrears, mainly in the state sector, approximated UAH 28 4 billion at end 1997, or 31 percent of official GDP Much of this is financed by promissory notes, much of which is quasi-money of dubious quality Wage and pension arrears approximated UAH 6 2 billion at end 1997, or nearly 7 percent of GDP (and nearly identical to the fiscal deficit for 1997) In general, Ukraine's private sector is essentially informal, and operating on a cash basis in the shadow economy The formal sector remains largely state-controlled Until the enabling environment improves and there is a political mandate to move to a market-based economy, the Ukrainian economy will remain uncompetitive, inefficient and poverty-stricken **Score 2-**

- *Sector value-added* in the Ukrainian economy has experienced a shift towards services in the 1990s, mainly due to the collapse of agriculture and industry Services accounted for 50-52 percent of GDP by 1994-95, and this figure has likely increased since Meanwhile, industry has declined from half to about one third of GDP Agriculture has declined from a quarter to about 10-15 percent of GDP Even in services, many sectors are in decline Trade is about the only area which showed growth in 1997, and this was 2 8 percent after a 12 percent decline in 1996 Other services areas likewise showed declines, as did industry and agriculture If average salaries are an indication of comparatively strong sectors of the economy, the leading sectors in Ukraine today would be finance and insurance, communications, and public administration Likewise based on average salaries, the most prosperous regions are the City of Kiev, Dnipropetrovsk and Donetsk As for *employment*, official statistics indicated that the unemployment rate at end 1997 was 2 3 percent, or 677,901 registered This would equate with a workforce of about 29 1 million,[25] of which an estimated 28 5 million are officially employed However, as shown in the persistence of wage/pension arrears, inter-enterprise arrears, and declining PPP income figures, many of those officially employed are not working or being paid Many are likely working in small-scale informal services (e g , transportation, construction, trade) and subsistence farming

- *Private sector value-added* and employment are both low in the formal sector, but have been growing steadily through the 1990s with the expansion of the shadow economy Private sector value-added was

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23 See Kaufmann, "Why Is Ukraine's Economy—and Russia's—Not Growing?," *TRANSITION*, April 1997

24 See Yushchenko, "Money burning problems of demand and supply development in Ukraine," National Bank of Ukraine *Herald Digest*, January 1998

25 The Bulletin of the National Bank of Ukraine mentioned that there were 28 3 million able-bodied people in the workforce at January 1, 1997

estimated by EBRD to account for about half or more of Ukraine's GDP, much of it informal [26] The small business sector comprised 93,000 enterprises, and was responsible for about 10 percent of GDP and employment Other sources claim the non-state sector accounted for 58 percent of industrial output, and that privatized companies accounted for 40-45 percent of agricultural and industrial output in 1996 However, it is hard to verify these numbers Private sector growth has resulted virtually by default due to the erosion of the state sector The downward spiral of the economy has led to a gradual reduction in subsidies to loss-making state enterprises—either directly from fiscal sources, or through banks—while ownership transformation of formerly state-owned companies has transferred assets but done little else to invigorate the economy *Employment in the private sector* is difficult to estimate due to the predominance of the shadow economy, which involves state and private enterprises However, if GDP is about half from the private sector, it is likely that a majority of the workforce is "employed" by private enterprises (including self-employment), most informally

- *State sector value-added and employment* represent a steadily declining segment of the economy State shares in the economy have generally been declining due to the introduction of a privatization program in 1992 and reduced subsidies as a share of public expenditure About 57,000 enterprises have been privatized since the privatization program began While most are small-scale, some are medium- and large-scale, thereby impacting GDP and employment figures As for subsidy reduction, the "national economy" represented UAH 3 9 billion (about $2 1 billion) in expenditure—about 12 percent of total consolidated budgetary expenditure—in 1997 This compares with Karbovanets 7 1 billion ($3 4 billion), or 37 percent, in 1992

Table 2 Private Sector Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
GDP ($ bn)*			24 0	32 7	38 0	37 0	44 0	48 8
o/w Agriculture (%)	24 4	24 4	20 8	21 5	14 6	13 6		
o/w Industry (%)	34 7	45 8	44 6	29 7	35 0	34 4		
o/w Services (%)	40 9	39 8	34 6	48 8	50 4	52 0		
Private Sector GDP ($ bn)								24 4
State Sector GDP ($ bn)								24 4
Employment ('000)*								
o/w Private Sector ('000)								
o/w PS in Agriculture('000)								
o/w PS in Industry ('000)								
o/w PS in Services ('000)								

* *Notes* GDP and employment are "official and do not take into account estimates of the shadow economy GDP figures are from local currency units, and then converted to US dollars at average exchange rates employment figures are estimates

Sources Bulletin of the National Bank of Ukraine, EBRD

2 3 Money, Savings and Credit Monetary policy has been successful in recent years in taming the inflation rate The GDP deflator from 1990-95 was hyperinflationary, at 1,040 5 percent [27] Based on CPI figures at year end, the inflation rate had dropped to 40 percent by end 1996 and 10 percent by end 1997 However, due to problems throughout the rest of the economy, about half of all money is held outside the banking system This percentage has increased through the 1990s—in 1991, 12 5 percent of currency was held outside banks, rising to 20 percent in 1992,

[26] See EBRD *Transition Report 1997*

[27] See *World Development Report 1997*, World Bank

27 percent in 1993, 38 percent by 1995, and 49 percent by end 1997 This has been driven by several factors, which include the growth of the shadow economy, which reportedly operates strictly on a cash basis, lack of confidence in the banking system, and a desire to withhold information from tax authorities [28] These developments have had a broadly negative impact on savings and credit, and have made it difficult for banks to play a significant intermediary role in the economy This is indicated by the percentage of broad money to official GDP—only 11 6 percent in 1996 and 13 6 percent in 1997 Deposits were only 6 6 percent of official GDP in 1996 and 6 9 percent in 1997 Thus, low levels of resource mobilization make it virtually impossible for banks to play much of a role in economic growth **Score 2+/3-**

- *Policy design and implementation* are the responsibility of the NBU In theory, monetary policy is based on setting an exchange rate band, and then setting interest rates within this band However, because of the country's weak fiscal and funding position, it has had to focus on short-term financing through its Treasury bill market This has led to a restoration of high interest rates to attract financing under conditions of scarcity—restrictive monetary policy, reduced portfolio investor interest from abroad, and limited funding available from domestic banks for the purchase of government securities The average weighted yield in the T-bill market was as low as 21 4 percent in September 1997, and had been at or below 30 percent since May 1997 Average weighted yields have ranged from 46-49 percent since December 1997 in response to outflows in the fourth quarter of 1997 In addition to the higher yields, the volume of funds raised has increased considerably and steadily since December 1997 Based on current redemption schedules, such trends will have to continue, adding considerably to overall debt service, mainly on a short-term basis It is this trend that is identified as possibly the single greatest short-term risk to Ukraine's balance of payments, possibly ultimately prompting a downward spiral characterized by fiscal collapse and default on obligations NBU utilizes a series of instruments to implement its policy, mostly Treasury bills and bonds Treasury bills were issued with one- and two-month maturities in the fourth quarter of 1997 when Ukraine faced major portfolio outflows (Yields were 41 49 percent on one-month bills, and 44 27 percent on two-month bills) However, T-bill maturities have generally ranged in maturity from three to 18 months In 1997, total sales were about UAH 8 billion, of which 83 percent ranged from six-twelve month maturities [29] Given the higher interest rate scenario and existing redemption schedules, liquidity will likely remain tight for banks through 1998, and possibly into 1999 The government has succeeded to date in attracting increasing levels of needed financing from domestic markets On the assumption that yields remain high, it remains to be seen how long this cycle can continue, particularly as the debt service burden increases and tax revenues decrease

- *Data collection and forecasting* appear adequate for many monetary measurements However, the quality of information at the structural level of the economy is weak This is compounded by the large share of informal sector activity in the overall economy, which complicates forecasting efforts

- Ukraine has taken *regional and global considerations* into account due to its efforts to balance its relations with Russia and other former Soviet countries with interests in the West and elsewhere It has broadly adopted legislation consistent with international practices removing trade barriers Ukraine also signed a EU Partnership and Cooperation Agreement in 1995, and achieved IMF Article VIII status in mid-1997 However, implementation of many of these agreements has been undermined by bureaucratic entanglements, corruption and fraud This has been reflected partly in terms of Ukraine's low levels of foreign direct investment, which totaled $1 3 billion from 1989-1996, or only $25 per

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[28] Tax authorities reportedly can investigate and block deposit accounts which exceed $400 in value This is a major disincentive to placing funds in banks

[29] The Bulletin of the National Bank of Ukraine reported UAH 8 3 billion in funds attracted to the budget through 1997 bond sales HIID shows 1997 figures of UAH 7 9 billion in T-bill sales

capita on a cumulative basis [30] Ukraine is also in a sensitive position with regard to regional agreements due to periodic tensions with Russia over Crimea, and due to its reliance on Russia and Turkmenistan for energy resources The latter is particularly true in the aftermath of Chernobyl

- *Management* of monetary resources is the responsibility of NBU, and based on setting an exchange rate band for the hryvnia against the dollar and other currencies The current band is UAH 1 8-2 25 per $1, and this has held since it was announced in January, 1998 Instruments used include the NBU discount rate as the base rate, reserve requirements, credit auctions, collateralized lending, REPO operations, T-bills, and direct intervention to shore up the hryvnia exchange rate

- There is limited *liquidity* in the banking system About half of all currency in circulation is held outside of banks, mostly by households (UAH 4,164 million in November 1997—equivalent to about one third of total money supply), but also by enterprises (UAH 1,549 million in November 1997, or about 12 percent of the total money supply) As for banks, there is an interbank market which helps to provide overnight financing However, there are limited capital markets for term financing or equities Banks are generally required to hold about 15 percent of liquid assets in reserve These are required to be at least 20 percent cash-in-vault, and no more than 80 percent in government securities

- *Deposits* increased again in 1997—from UAH 5 3 billion in 1996 to 6 4 billion in 1997 However, such increases remain small as a percent of official GDP—about 1 2 percent in 1997 About half of total money supply was held outside the banking system at year end 1997, mainly by households Public confidence was damaged during the hyperinflationary period of the early 1990s, when savings and pension accounts lost value These accounts were not indexed or replaced financially, but instead have been compensated through the distribution of vouchers in the privatization program These efforts have not restored confidence Nor does the right of tax inspectors to investigate and block accounts exceeding the equivalent of $400 in value provide impetus to efforts to restore confidence Deposit insurance legislation is currently being drafted to provide narrow and affordable coverage In the interim, there is a state guarantee on deposits held with the State Savings Bank Deposits at some failed institutions have likewise been covered to help restore confidence in deposit safety

- *Credit* increased in real terms in 1997 This was partly the result of an interim shift away from government securities in the second and third quarters of 1997 when yields came down Outstanding credit increased from UAH 5 4 billion at end 1996 to UAH 7 3 billion by end 1997, with the increase being fairly evenly divided between local and foreign currency loans However, there is concern about the quality of these loans Some estimates of nonperforming loans have exceeded 40 percent, which would put the total nonperforming loan figure at UAH 2 9 billion (about $1 5 billion at year-end 1997 exchange rates), or 1 83 times paid-in capital of the banking system If these figures are correct, the banking system might then be nearly insolvent On a simple net basis, outstanding loans exceeded deposits by UAH 886 million at end 1997 Thus, even if nonperforming loans are not as high as UAH 2 9 billion, they are certain to exceed the net figure of loans to deposits This clearly is cause for concern with regard to deposit safety and availability

- *Rates* generally declined through the third quarter of 1997, at which time portfolio outflows prompted the need for higher rates to attract funds needed for government financing The year-end base interest rate was as high as 252 percent in 1994, and had come down to 11 percent for most of 1997 However, portfolio outflows, reportedly back to Russia, led to a liquidity crisis, prompting the refinancing rate to spiral up to 35 percent by November, 1997 (Rates later increased in February 1998—the NBU discount rate was set at 44 percent, and the Lombard rate increased to 45-48 percent Rates were poised for a dramatic increase in June 1998 after the tripling of the Russian discount rate to 150 percent in late May, 1998 A subsequent agreement announced in mid-July between Russia and IMF helped to restore some confidence, with the possibility of a favorable spillover effect in Ukraine if

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[30] The figure through 1997 is about $1 7 billion, or about $33 per capita This averages about $4 per year per capita

reforms are ımplemented) Local currency deposıt and lendıng rates at year end 1997 showed unusual prıcıng patterns,[31] perhaps due to tax or accountıng consıderatıons It ıs assumed that there was lıttle actıvıty beyond three months, and that prıcıng abnormalıtıes mattered lıttle ın the marketplace due to such levels of actıvıty However, the upward spıral ın refinancıng rates ın late 1997 added sıgnıficant costs to banks The ınterbank rate ıncreased twofold between July and December, from 16 6 percent to 33 7 percent, respectıvely Meanwhıle, net spreads narrowed sıgnıficantly to "legal entıtıes"—from 27 5 percent ın July to 12 9 percent ın December Whıle net spreads on exposure to "natural persons" ıncreased durıng the same perıod—from 18 8 percent ın July to 22 0 percent ın December—banks had less exposure ın thıs category Thus, the ıncreased refinancıng rate and addıtıonal ıncrease ın reserve requırements had the dual effect of reducıng margıns and puttıng pressure on lıquıdıty

Table 3 Money, Savıngs and Credıt Indıcators

	1990	1991	1992	1993	1994	1995	1996	1997
Money Supply Growth (%)				758	568	173	35	7
Broad Money/GDP (%)				31 8	26 2	12 7	11 6	
Year-end Base Interest Rate (%)*			80	240	252	110	40	35
Commercıal Bank Rates (UAH)								
Interbank < 30 days (%)								33 2
3-month T-bill (%)						155	77	31 7
One-year tıme deposıt (%)			68 0	187 3	171 0	61 2	34 3	18 9
One-year loan (%)			76 0	221 1	201 7	107 1	77 0	42 7
Net Domestıc Credıt/GDP (%)*			83 8	30 6	24 2	15 5	15 0	16 4
o/w Claıms on Gov't*			30 0	2 9	7 6	7 3	7 4	8 1
o/w Claıms on SOEs*			51 0	26 3	11 9	6 7	6 1	5 8
o/w Claıms on Prıvate Sector*			2 8	1 4	4 7	1 5	1 5	2 5

* *Notes* Year-end refinancıng rate and net domestıc credıt figures for 1997 are from November

Sources Bulletın of the Natıonal Bank of Ukraıne EBRD IMF, HIID

2 4 Fıscal Fıscal developments ın 1997 showed a deficıt of nearly 7 percent of GDP Thıs was largely due to deterıoratıon ın the government's abılıty to collect revenues, ıtself a functıon of structural weaknesses ın the economy Revenue collectıon declıned more than 10 percent Meanwhıle, expendıture was relatıvely flat, but would have accounted for a 3-4 percent of GDP deficıt even ıf revenues collected had matched 1996 totals Major areas relatıve to budget where revenue collectıons came up short were for the Chernobyl plant, socıal funds, VAT and personal ıncome taxes The authorıtıes consequently "over-collected" from the enterprıse sector by nearly 50 percent above what was budgeted Thıs lıkely explaıns some of the harassment reported by the enterprıse sector at the hands of the tax authorıtıes Meanwhıle, nearly two-thırds of expendıture was for socıal funds and socıal/cultural ınstıtutıons—presumably health, educatıon and other socıal ınfrastructure Unlıke other countrıes where expendıture appears to be the maın culprıt behınd budget deficıts and hıgh ınterest rates, Ukraıne ıs faced wıth the challenge of revıvıng ıts economy to expand the fiscal base to ensure ıt has needed revenues for basıc socıal

[31] For natural persons, ınterest rates on accounts less than one month were 36 7 percent, but only 30 1 percent for three-twelve months and 19 7 percent for accounts longer than one year For legal entıtıes, demand deposıt rates were 24 4 percent, hıgher than tıme deposıt accounts exceedıng one year for natural persons Also, deposıt accounts from one-three months paıd hıgher rates than accounts from three-twelve months Lendıng rates to natural persons showed sımılar ınconsıstencıes as deposıt rates, wıth longer term loans prıced to be progressıvely cheaper the longer the term

services This will require political will, and tax and administrative reform Short of major reforms, Ukraine runs the risk of its fiscal problems leading to an unsustainable debt load that could ultimately prompt a balance of payments crisis As banks are a major source of financing for the government through purchases of T-bills, such fiscal deterioration could have a major adverse effect on the banking sector **Score 1+/2-**

- Fiscal *policy, design and implementation* are currently focused on being able to provide basic services during a period in which the real sector is weak, and when revenue collection is undermined by non-compliance in the real sector and corruption among public officials Ukraine has experienced fiscal deficits of 5-9 percent since 1993 However, Ukraine requires changes in its tax rates and methods of collection to be able to get closer to balance The real sector is non-compliant partly because of cash shortages, and the natural tendency to shield income from tax authorities when rates are high or the economy is sluggish Lower rates and improved provision of services will gradually help in broadening the base

- *Data collection* and accuracy of *forecasting* are considered inadequate due to the informal economy, as well as problems in organizational structure which lead to differing sources and uses of information Revenue and expenditure figures were both off target in 1997—revenues by nearly 11 percent, and expenditure by nearly 8 percent Further, there were significant variances (e g , greater than 25 percent) on five of 14 major budgetary line items

- Budgetary processes and procedures are still generally *centralized* There is some movement towards municipal bond markets, but these are at the embryonic stage The State budget accounted for about 58 percent of consolidated budget revenues and 66 percent of expenditures

- *Collection* of tax revenues is based on fairly high personal and corporate income tax rates under existing economic circumstances, the burden of which is partly escaped through "unofficial" payments Notwithstanding recent efforts to push ahead with tax reform, rates still represent a contributing factor as to why many households and firms operate in the shadow economy Personal rates are as high as 40 percent Payroll taxes are assessed at a costly 48 percent rate Corporate profit tax rates are 30 percent A flat VAT system adds 20 percent to the cost of goods and services Ukraine has a Fund for the Chernobyl power plant financed from payroll taxes to the extent payroll taxes are paid Excise taxes on alcohol, tobacco and fuel are also in effect in a country where purchasing power has steadily declined for years, and where interest rates on local currency approximate 50 percent In 1997, about half of revenue collections were from VAT (28 percent) and corporate taxes (21 percent), while another quarter (26 percent) came from "other "

- *Fraud and corruption* are apparently a severe problem in Ukraine The tax inspectorate is considered to be, at a minimum, inconsistent in its treatment of enterprises Tax authorities along with health and fire inspectors are considered a frequent source of harassment These problems are also considered pervasive in offices where licenses and permits are required Here, too, audits are arbitrarily conducted, and penalties are meted out without any apparent guidelines or consistency Such weaknesses in the enabling environment undermine confidence in government institutions, resulting in lower revenues collected The share of the shadow economy in GDP has grown steadily since 1989,[32] and is broadly estimated to approximate half of official GDP While there is no definitive way to measure the full extent of fraud and corruption, it appears that it is a major problem that keeps Ukraine from developing a viable economy

[32] See EBRD *Transition Report 1997*

Table 4 Fiscal Indicators

(UAH *million*)	1992	1993	1994	1995	1996	1997	1998*
Total Expenditure	19 2	572 5	6 306 5	24 302 8	34 182 8	33 345 0	39,200 0
Total Revenue	12 3	496 2	5 231 0	20 689 9	30 218 7	27,148 6	35,900 0
Consolidated Budget Deficit*	6 9	76 3	1 075 5	3 612 9	3 964 1	6 196 4	3 300
Consolidated Deficit/GDP	13 8%	5 1%	8 9%	6 6%	4 9%	6 7%	2 5%

* Measure is *the deficit* therefore a negative sign = fiscal surplus 1998 figures are baseline projections

Source Bulletin of the National Bank of Ukraine HIID

2 5 ***Exchange Rates*** Exchange rate policy has been reasonably steady since the new currency—the *hryvnia*—was introduced in 1996 The macroeconomy has achieved some relief from high inflation rates due to effective monetary policy, while the current account deficit has averaged 3 5 percent over the last three years Questions about future exchange rates pend increasingly on the ability of government to bring down fiscal deficits, to restore confidence among portfolio investors, to attract higher levels of direct investment, and to come to agreement with external donors on new debt In a worst case scenario, government finances would collapse, there would be a further reduction in confidence, portfolio outflows would further increase, Ukraine would attract little to no direct investment, and there would be a breakdown of negotiations with the IMF Under such circumstances, the exchange rate would likely not be sustained within the existing or a minimally expanded band This is particularly true given low levels of reserves—net foreign reserves are marginally negative—and increasing debt service against a decline in 1997 export sales levels of nearly $1 billion [33] While this scenario may not be probable, there may be a worsening of circumstances that could prompt a further devaluation of the currency The global market fallout in May 1998 which prompted the Central Bank of Russia to triple ruble interest rates to 150 percent is likely to have spillover effects in Ukraine for the foreseeable future This makes agreement with the IMF all the more necessary to trigger significantly greater investment from direct and portfolio investors **Score 2**

- Exchange rate *policy, design and implementation* have been based on a policy of announcing an exchange rate band that is expected to hold for six months or longer The current band is UAH 1 8-2 25 to US$ 1 The previous band, announced in October 1997, was UAH 1 75-1 95 to the dollar Exchange rates at year-end 1997 for the dollar were UAH 189 9 By April 1998, they were about UAH 204 Through late May 1998, the exchange rate had not threatened to fall below UAH 225 since the band was announced in January, 1998

- *Data collection and forecasting* have generally been considered adequate since the government introduced a strict monetary policy in 1995 Exchange rate stability is the key function of monetary policy, which has also focused effectively on bringing down the inflation rate If there are weaknesses in data collection, these have more to do with the level of informal sector activity which is not captured in official statistics, and vulnerability to ruble-denominated trade, which accounted for about half of exports in 1997 However, monetary policy in Russia has been strict and focused on maintaining confidence in the currency over the last few years, and this should help Ukraine's efforts to implement effective monetary policy Thus, in terms of exchange rates, the medium-term challenge appears to be keeping the hryvnia in balance with the ruble without devaluing to the point where external debt service becomes excessively costly Ukraine is vulnerable to financing shocks via Russia

[33] Export sales decreased $979 million in 1997, largely due to declining exports to Russia and other FSU countries This aggregate decline represented a 4 8 percent decrease from 1996 Exports to FSU countries declined $2,956 million, or 24 percent from levels achieved in 1996

and other FSU countries, as demonstrated in late 1997 and again in May 1998 On the positive side, Ukraine did increase exports to non-FSU countries in 1997, and the 3 4 percent current account deficit in 1997 (about the average since 1995) is not viewed as problematic Efforts to further open up the market will help in the long run

- The exchange rate policy is adjusted to reflect movements in the dollar and the ruble, the two most prominent foreign currencies used in Ukraine Dollar movements largely drive concerns about external debt financing costs, on which Ukraine is dependent for balance of payments support The dollar is also widely used as a form of insurance—previously against hyperinflation, and currently to protect against possible unanticipated exchange rate depreciation Ruble movements are important because of the high level of trade with FSU countries—exports and imports of goods and services to/from FSU were 55 percent of total in 1997, and about 43 percent of official GDP [34] A portion of the shadow economy also engages in cross-border activities, both in FSU countries as well as in Poland and elsewhere Thus, policy and units of measure reflect Ukraine's focus on *regional and global* considerations in the development and implementation of its exchange rate policy Total dollar trading on the various markets totaled $32 4 billion in 1997, up from only $7 9 billion in 1995 [35] Thus, dollar and overall foreign exchange trading is rising in importance to the Ukrainian economy, with the Ukrainian Interbank Foreign Exchange Market (UIFEM) playing the major role, accounting for 60 percent of 1997 trading compared with only 24 percent in 1995 This is largely due to nonresident activity being funneled through this market, which is also partly due to UIFEM's slightly higher foreign exchange rates [36] This market is probably the area of focus regarding events that could trigger a balance of payments crisis in Ukraine—every net $1 billion decline would approximate 2 percent of GDP, prompting the likelihood of rising interest rates to attract needed financing

- *Risk management* practices may be satisfactory under the circumstances from a broad monetary standpoint, but there are weaknesses at the structural level due to poor information, unconsolidated reporting, and possible disinformation A risk for the future will be complex hedging instruments and strategies based on assumptions that could backfire in the market, and then lead to costly losses There is also concern with regard to banks' off-balance sheet contingencies—guarantees, trade finance—although no major problems have surfaced to date However, while problems exist, there are also signs of improvement No major open positions are allowed at the banks New NBU regulations will limit individual and global open currency positions, including on a weighted time-to-maturity basis NBU is intensifying its monitoring of bank portfolio and liquidity measures to ensure that potentially destabilizing positions are avoided Banks and companies are thought to routinely match their foreign currency risk and asset-liability positions, although concerns about exchange rate stability have prompted long dollar asset positions for confidence Thus, while not overly complex, practices appear to be prudent for now However, there are still potential risks associated with the actual accuracy of information reported by banks to NBU regarding maturities and concentrations of currency holdings, levels of bank collateralization/securitization for loans that carry exchange rate exposure, and overall volatility in global markets and their impact on Ukraine's exchange rate and underlying monetary stability

- Gross *reserves* were about $2 3 billion in November 1997, about $350 million more than at end 1996 The November 1997 figure equates with only about six weeks of imports, a fragile level but better than coverage levels recorded in earlier years [37] Net foreign reserves were reported to be about

[34] Total exports and imports of goods and services were $38 3 billion, or 79 percent of 1997 GDP To/From FSU totaled $21 0 billion, or 43 percent of 1997 GDP

[35] See Bereslavska, "Hryvnia in the Vortex of Market Elements," National Bank of Ukraine *Herald Digest*, January 1998

[36] See Bereslavska, "Hryvnia in the Vortex of Market Elements," National Bank of Ukraine *Herald Digest*, January 1998

[37] Gross reserves to total imports at year end were 0 5 weeks in 1992, 0 1 weeks in 1993, 1 8 weeks in 1994, 3 2 weeks in 1995, and 4 7 weeks in 1996

negative $10 million at end 1997, reflecting Ukraine's vulnerability to portfolio flows and debt service

*2 6 **Balance of Payments*** Ukraine's balance of payments figures showed some weakening in 1997 The current account deficit increased to 3 4 percent of GDP from 2 7 percent in 1996 This is not an alarming rate, but it was combined with an overall decrease in trade volume, mainly with FSU countries Trade in goods and services declined 8 4 percent in total, and by 23 4 percent with the FSU region However, the country's capital account showed vulnerability to portfolio investment compounded by growing domestic debt—which generally needs to be serviced in 12 months or less at higher rates—and poor performance in attracting direct investment The general financing weaknesses experienced by Ukraine are rooted in structural weaknesses and the absence of measures and institutions to build a competitive economy Thus, until major structural reforms are introduced and effectively implemented in government (e g , tax, public administration) and the real sector, and more fully advanced in the banking and financial sector, balance of payments problems are likely to persist **Score 2-**

- *Current account* movement was unfavorable in 1997 The deficit increased from 2 7 percent to 3 4 percent The positive news was a current account surplus of $2,649 million with non-FSU countries, up from a mere $111 million in 1996 Ukraine currently has trade relations with 170 countries, thus diversification across products and markets is in process [38] Growth markets for Ukrainian exports in 1997 included Turkey, China, Indonesia, Germany, Italy and Spain However, nearly half of Ukraine's exports were in metals Trends in Asia and growing economic turbulence in Russia may mean reduced metals exports for Ukraine in 1998 Ukraine still relies heavily on trade with FSU countries—55 percent in 1997 The major weakness in the current account was the nearly $3 billion decline in exports to FSU countries This reflects Ukraine's sensitivity to a vulnerable market which will not be corrected until structural reforms are implemented to achieve competitiveness and to assist Ukraine in further expanding and diversifying trade with more prosperous and less volatile economies Ukraine is also vulnerable to trends in Russia and Turkmenistan due to its dependence on these countries for its energy supplies, and increasingly to interest expense on domestic and external debt

- Ukraine's current account is open,[39] as shown in the relative ease with which domestic and foreign currency can be exchanged as well as by the limited gap (if any) between parallel and official exchange rates It is expected that the *capital account* will be open in the near future However, Ukraine's capital account position and financing needs are shaky Gross reserves at year end 1997 approximated six weeks of imports—Ukraine's coverage has ranged from virtually zero coverage as recently as 1993 to a high of six weeks at year end 1997 Net *foreign reserves* were marginally negative, at about negative $10 million Direct investments have been limited In particular, the spark to the economy that Ukraine could experience from foreign direct investment has not materialized Meanwhile, cash needs in Russia combined with Western portfolio concerns about risk and better opportunities elsewhere led to significant *portfolio outflows* in late 1997 This has led to increasing reliance on debt, primarily domestically financed through the T-bill market on top of the recent $750 million Eurobond flotation Ukraine experienced both inflows and outflows in 1997 Inflows from portfolio investors increased in the first half of 1997 as the inflation rate came down to manageable levels and the exchange rate showed stability and even appreciation However, Ukraine is still

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[38] See "Ukraine Balance of Payments for the Third Quarter of 1997," National Bank of Ukraine *Herald Digest*, January 1998

[39] Ukraine achieved Article VIII status in the IMF in May, 1997 This status requires the country to undertake obligations to avoid restrictions on international payments and transfers, to observe a non-discriminatory foreign exchange policy, and to allow convertibility of foreign exchange balances deposited abroad

perceived to be highly risky, and many funds are unwilling to invest in government securities and other paper unless T-bill yields are very high Because of the risk premium associated with the Ukrainian market, some portfolio investment was redirected in the middle of 1997 out of Ukraine as T-bill yields began to decline and substitutes in the corporate debt market were absent However, the biggest surge in portfolio outflows came later in 1997 when market concerns about Russia surfaced A recurrence of concerns about Russia in late May, 1998 and its potential effects on the Ukrainian market reflect the vulnerability and risk associated with the Ukrainian economy

- *Direct investment* has been weak for years due to a weak selection of companies in which to invest, slow privatization, and a counterproductive administrative environment which deters investment from domestic and foreign sources Capital is less a problem than the choice of investments,[40] largely due to the risks associated with the operating environment of Ukraine and sluggish privatization Limited interest from foreign investors has resulted from problems of commercial, tax and land codes which lead to broken contracts, changing terms of agreements, and limited investment These problems are aggravated by discretionary and inconsistent application of tax laws, customs regulations, licensing procedures, and company registrations To remedy these problems, ineffective but frequently changing legislation further reduces certainty and confidence, thereby undermining aggregate direct investment Thus, a slew of cumbersome bureaucratic procedures, contractual misunderstandings, corruption, and uncertain economic conditions have led to some of the poorest FDI figures in the world In 1997, FDI was less than $400 million On a cumulative basis, FDI was only $1 27 billion from 1989-96, or $25 per capita [41] Thus, through 1997, cumulative per capita FDI was only about $33, or $4 per year per capita since 1989 The per capita figures place Ukraine among the lowest of transition economies, ahead of only Armenia, Belarus, Georgia, Tajikistan and Uzbekistan FDI may be attracted in some privatization transactions, namely in the energy, airline, telecommunications and chemicals sectors However, FDI will also have to be for new ventures, or incremental FDI in existing ventures, due to the costs and management complications associated with turnaround ventures in the agro-processing and industrial sector The United States, Germany, the Netherlands and the United Kingdom accounted for about 47 percent of cumulative FDI from 1991 through mid-1997 [42] The Russian Federation accounted for only 7 percent, although it is possible that this is understated [43] FDI was primarily in the food industry (20 percent), trade (17 percent), mechanical engineering and metal processing (8 5 percent), and chemicals (6 percent) [44]

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[40] See "Foreign Direct Investment in Ukraine," *OECD Working Papers*, 1997

[41] See EBRD *Transition Report 1997*

[42] See "Foreign Direct Investment in Ukraine," *OECD Working Papers*, 1997

[43] Some Russian FDI may be sourced from companies registered in Cyprus Cyprus also accounted for about 7 percent of cumulative FDI in Ukraine from 1991 to mid-1997 according to the OECD Working Paper study cited above

[44] See "Ukraine Balance of Payments for the Third Quarter of 1997," National Bank of Ukraine *Herald Digest*, January 1998

Table 5 Balance of Pavments Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
Trade Balance ($ bn)*	-12 7	-3 4	0 6	-2 5	2 5	-2 3	-1 1	0 4
Current Acct. Balance ($ bn)		-2 9	-0 6	-0 8	-1 4	1 5	-1 2	-1 3
Remittances/Transfers ($ bn)								
Capital Account and Reserves ($ bn)*							0 3	2 1
Portfolio Flows ($ bn)						0 0	0 2	1 6
Direct Investment ($ bn)								
o/w Domestic								
o/w Foreign			0 2	0 2	0 1	0 3	0 5	

* *Note* Trade balance includes goods and services Capital Account and Reserves = capital account less financing in 1996-97

Sources Bulletin of the National Bank of Ukraine HIID EBRD IMF

III BANKING STRUCTURE AND SYSTEM PROFILE The Ukrainian banking system is now almost wholly private in ownership, but in most cases weak by international standards There were 227 registered banks at year-end 1997, but paid-in capital was only UAH 1 6 billion (about $838 million), or about $3 7 million on average Total capital was estimated at UAH 3 3 billion (about $1 75 billion), but these capital figures are all prior to an estimated $1 billion or more in provisions or writeoffs for nonperforming loans and potentially reduced fixed asset valuations In general, loan classification, collateral and capital are all suspect in terms of accuracy and/or quality Of Ukraine's total number of banks at end 1997, 22 had foreign capital participation—including six which were 100 percent foreign-owned Nearly 50 banks are slated for liquidation, while another 20 or so are in rehabilitation This brings the number of operating banks down to about 180, of which most are considered impaired and/or marginal Most banks represent small captive finance or "pocket" banks that were part of the old Gosbank system During that period, they served as administrators for funds gathering and payment functions rather than as commercial institutions generating profits and losses based on risk assessment and management Their owners tend to be unrestructured state enterprises, and/or recently privatized SOEs that still operate on the basis of old governance and management practices Rather than being considered banks, the vast majority of these should be considered commercial finance companies Some banks are making efforts to better manage resources and risk, and new prudential regulations are putting into place measures that may help protect banks and the system from unwarranted or systemic risk However, most banks are very small—minimum capital is just ECU 1 million—and most banks did not even have that level of capital until it was required by end 1997 Many of the larger banks, including existing state-owned banks and the larger ex-state banks, could be insolvent Ukraine is currently in the process of introducing a new chart of accounts and moving accounting standards closer to IAS Once implemented, the magnitude of overvalued assets and nonperforming loans, and consequent needed provisions and write-offs will be known However, many of the larger banks might be insolvent after provisioning for losses and writing off what is unrecoverable Meanwhile, most banks have liquidity problems from a practical funding standpoint (although they are in compliance with regulatory requirements), largely due to the weak deposit base they have and reliance on an interbank market composed of other banks with comparable problems Nearly half of the total money supply is circulating outside the banking system, and the State Savings Bank controls about 33 percent of household deposits (an estimated 20 percent of total held with banks) which are then invested in government securities Non-deposit sources of funding for banks are likewise scarce Only the interbank market provides overnight or very short-term liquidity needs Banks generally do not issue paper or other securities for additional financing on formal markets, although promissory notes are now circulating throughout the economy and may constitute a risky form of quasi-money It is currently unknown how this affects banks from a funding or collateral/investment perspective Equity is limited to small contributions from shareholders which, after IAS is applied, may be negative in value There are draft laws on the National Bank and for commercial banks which would bring existing legislation more in line with international standards There are also signs that Ukraine may be willing to permit more foreign entry into the banking system However, it will take time before a safe and sound banking system emerges in Ukraine Even with progress in the financial sector, lagging progress in the real sector will only limit the market for banks and other financial institutions **Score 2-**

- ***Overview*** Ukraine's banking system is only at the beginning of a long process to restore confidence and play a more meaningful intermediary role in support of economic growth and competitiveness Balance sheet indicators are generally weak—funding sources are limited, a high proportion of loans are estimated to be nonperforming, and "other" assets are often overvalued According to NBU, "large" banks are among the most troubled from a balance sheet standpoint, and their resolution might well be costly financially and/or politically Until confidence is restored in the banking sector, funding will continue to be a problem Adding to this dilemma are high cost structures based on excess overhead Banks frequently have too many branches, too many personnel, inefficient procedures and outmoded information systems Ukrainian banks will likely have to undergo major operational and financial restructuring simultaneously This will mean that branch closures, the release of employees, investment in new information systems, and the introduction of modern procedures and controls will have to coincide with the estimated $1 billion or more financial cost of provisioning and charge-offs Margins likewise declined in 1997, making earnings more of a challenge in a weak and uncompetitive economy **Score 2-**

- There were 227 registered banks in Ukraine at end 1997 The *structure* of the banking system shows concentration, with the leading 20 banks accounting for about 80 percent of assets and the top seven banks among them accounting for about half of assets [45] However, these figures are prior to conversion to IAS, and before the exact magnitude of nonperforming loans, overvalued assets, provisions and writeoffs has been determined Several of the larger state-owned or ex-state-owned banks might have negative capital once BIS guidelines for loan losses are applied At a minimum, these banks might well have impaired capital Required provisions are likely to exceed $1 billion, which would exceed the total capital of the largest banks where most of the problem loans are held, and account for nearly 60 percent of estimated total capital Prior to write-offs, the banking system could be segmented into five broad groups based on end 1997 figures These include seven "large" banks with total assets as a group in excess of UAH 10 billion, another tier of 13 medium-sized banks (generally eighth through 20th in asset size), about 138 other registered and operating Ukrainian banks, 22 foreign banks,[46] and about 47 banks targeted for liquidation Large banks generally have pre-writeoff balance sheets with values exceeding UAH 250 million (about $130 million), while medium banks' balance sheets generally exceed UAH 80 million (about $45 million)

- *Competition on the asset side* is increasing, but is still limited due to the small number of blue chip customers in Ukraine and the captive finance relationship of most banks with their shareholders Recent regulations aimed at reducing connected lending and concentrations of exposure may stimulate some diversification and competition The trend in mid-1997 towards narrower spreads from T-bills was a contributing factor towards increased lending Credit increased in real terms in 1997, which may have also reflected a slight shift away from government securities in the second and third quarters of 1997 when yields came down Outstanding credit increased from UAH 5 4 billion at end 1996 to UAH 7 3 billion by end 1997 This is equivalent to UAH 32 million per bank, or about $17 million in outstanding loans per bank at year end 1997 As a proportion, the increase was fairly evenly divided between local and foreign currency loans By end 1997, 71 percent of outstanding loans were denominated in hryvnia This compares with an average 75 percent from 1994-96 Thus, in addition to increasing lending, there was a slight increase in foreign currency lending as a proportion of total In terms of sector distribution, about half of short-term hryvnia loans are to state enterprises, and the other half are to non-state firms and households As for long-term hryvnia loans outstanding, about 60

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45 The World Bank shows that a combination of existing state banks, former state banks, and private banks with share capital in excess of UAH 20 million accounted for about 73 percent of assets and deposits, 70 percent of lending, 65 percent of capital, and 56 percent of profits at end 1997 However, these figures are unaudited, and are also pre-tax The number of banks in each category was not specified Eximbank, one of the two state banks, was excluded

46 As of late May 1998, 23 foreign-owned banks had licenses to operate in Ukraine, of which seven were wholly owned

percent are to state firms In foreign currency lending, nearly two-thirds were outstanding to non-state enterprises On a term basis, 89 percent of outstanding loans were "short-term," as they have been for years [47] Most credit flows today are short-term due to prudent risk aversion—tightened bank lending practices in the face of stricter prudential regulations, and limited funding sources However, an undetermined portion of these loans may be booked as "prolonged", or short-term loans that have been rolled over or capitalized for an indefinite period Estimates of nonperforming loans in 1996 approximated 40 percent, many of which are "prolonged " This would approximate UAH 2 9 billion in nonperforming loans, 1 83 times paid-in capital at year-end 1997 and 45 5 percent of year-end 1997 deposits placed with banks While the figure may be less than this, nonperforming loans are still high enough to severely impair capital and to threaten the safety of deposits

- Significant concentration remains on the *funding* (deposit mobilization) side State Savings Bank held 33 percent of retail deposits and an estimated 20 percent of total deposits at year end 1997 A significant percentage of corporate deposits were held in the former state-owned banks—Prominvest, Ukraina, Ukrsotsbank—as well as in Privatbank In general, competition is constrained by the sheer limits of funding available to banks, and the concentration of deposits in a handful of banks Deposits increased in 1997—from UAH 5 3 billion in 1996 to 6 4 billion in 1997—but such increases remain very small as a percent of official GDP [48] This fact is further reinforced by official GDP being about two-thirds of total, and well below levels Ukraine could achieve with the introduction of major structural reforms With UAH 6 4 billion in total deposits held with banks at end 1997, this averages UAH 28 million per bank, or almost $15 million Deposits held at November 1997 consisted mainly of enterprise demand deposit accounts (UAH 2 1 billion), household time deposit accounts (UAH 1 0 billion), enterprise time deposit accounts (UAH 575 million), and household demand deposit accounts (UAH 561 million) There were also UAH 1 6 billion in foreign currency savings, and a small sum of trust funds held on account Such a breakdown also indicates that households held nearly UAH 4 2 billion in currency outside of banks, and enterprises held UAH 1 55 billion Thus, unlike many other countries where households account for a large segment of the deposit base, it is this sector which appears to be withholding its resources from the banks In November 1997, households accounted for UAH 1 55 billion in hryvnia deposits and an undetermined amount of foreign currency deposits However, they held nearly UAH 4 2 billion outside the banks Tight monetary policy, a weak fiscal base, growing debt servicing requirements, and the lack of confidence in banks by households makes it difficult for banks to obtain the funds needed for major competition in lending and other core banking activities

- In terms of *coverage*, most activity is lending and investment in government securities, with limited services for households or enterprises aside from basic safekeeping, processing and transfers Total credit at end 1997 was estimated to be about 32 percent of assets [49] On a *stock* basis, credit to enterprises at year-end 1997 accounted for virtually all credit— UAH 6,950 million was out to enterprises, while the balance of only UAH 345 million was outstanding to households If the estimated nonperforming loan figure of 40 percent is accurate, and as most performing loans are considered short-term, this could mean Ukraine's banks provided nearly UAH 4 4 billion in lending flows in 1997—about UAH 24 million on average after netting out the 47 banks slated for liquidation If the $1 billion estimate of needed provisions is subtracted from year end 1997 total credit, lending flows in 1997 were as high as UAH 5 4 billion, or about UAH 30 million per operating bank [50]

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[47] Short-term loans averaged 89 3 percent of total from 1993-96 on a consistent basis

[48] In 1997, the incremental change in deposits was 1 2 percent of official GDP However, the aggregate was only 6 9 percent

[49] These figures are from the World Bank

[50] Assumptions for these estimates include (i) year-end 1997 total credit of UAH 7,295 million (from The Bulletin of the National Bank of Ukraine), (ii) 60 percent of UAH 7,295 million = UAH 4,377 million, or UAH 24 3 million on average when divided by 180 operating banks, (iii) $1 billion = UAH 1,899 million at year-end 1997 exchange rates, (iv) UAH 7,295 million less UAH 1,899 million = UAH 5,396 million, or UAH 30 0 million on average when divided by 180 operating banks, (v) all loans are

Meanwhile, banks also routinely hold a sizable portion of their assets in government securities This figure was estimated to be about one third of total assets [51] The balance of assets are held in real estate—which is very likely overvalued relative to "fair market value" despite a recent NBU rule restricting banks' fixed assets to a book value equal to total capital—and required cash and reserves New legislation will permit universal banking It is difficult to determine how much "universal" banking currently exists As for services, there are no reliable data on fee income or trade-related income for banks Banks are currently exploring factoring and leasing, as well as activities that generate income without heavy balance sheet exposure Some banks are trying to generate fees from processing payments, providing payroll services, and serving as custodian However, these efforts are largely undercut by disincentives in the real sector due to enterprise and household concerns about blocked accounts or additional tax payments

- In terms of *financial statement indicators* and contingencies, reliable data are not available Ukrainian accounting standards have not traditionally included provisioning requirements or depreciation schedules which provide an accurate reflection of cash flow, earnings, or net worth The NBU and banks are in the process of converting reporting systems (e g , new chart of accounts) to generate reliable information At one level, earnings are considered strong due to high spreads and monopoly positions For instance, pre-tax profits for 1997 were estimated[52] to be UAH 921 million (about $472 million at average exchange rates) On the other hand, cost structures and non-earning asset levels are high, as are tax rates on profits Many banks are likely still deducting administrative charges after profits are placed in capital accounts It is uncertain if these estimates include provisions Thus, combined with needed investment in new information systems and technologies, overall earnings as well as ROA and ROE figures are likely overstated or unsustainable at best Key challenges in the near term will be to more precisely determine the magnitude of overvalued assets and nonperforming loans and their impact on capital, risks associated with off-balance sheet items through affiliates and others, and general margin analysis Estimates of nonperforming loans exist—a range of 17-40 percent—as do estimates of needed provisioning—a minimum $1 billion However, additional issues need to be worked out These include which banks are responsible for which guarantees that they provided as banks when they were state-owned Likewise, banks have exposure to privatized enterprises which are now different legal entities from the enterprise to which the bank originally extended loans and/or guarantees that are, at a minimum, "prolonged " Questions abound regarding the legal status of debtors, and the ability of banks to hold debtors accountable for loan, guarantee and other obligations To date, bankruptcy procedures have served debtors, not creditors Provisions, charge-offs and prospects for recapitalization or liquidation may all hinge on answers to these and other questions As for off-balance sheet items, NBU is introducing stricter reporting requirements regarding guarantees, letters of credit, and third party trade transactions to get a better sense of potential risks However, current information does not provide an accurate estimate of the risks and potential costs that exist As for margin analysis, some reliable information is available Margins appear to have narrowed in 1997 Average weighted net spreads (interest rates on credit less deposits) at end 1997 were 23 8 percent on local currency transactions and accounts, as compared with 45 9 percent in 1995 and 37 2 percent at end 1996 This accounts for about three quarters of lending activity Net spreads on foreign currency loans were about 4 2 percent in dollars and about 26 3 percent in rubles at end 1997 Thus, net spreads remained positive in real terms in 1997, but declined from earlier periods Ukrainian banks are reported to have high cost structures based on excess overhead resulting from too many branches, too many personnel, inefficient procedures and a lack of modern information systems These problems suggest that banks will need to go through major operational restructuring exercises that lead to branch closures, the release of employees, investment in new information systems, and the introduction of

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assumed to be short-term, with long-term loans all assumed to be part of the 40 percent nonperforming loans or part of the $1 billion to be provisioned for, and (vi) estimated flows are annualized

[51] Net credit to government at year end 1997 was estimated to be UAH 8 1 billion (from The Bulletin of the National Bank of Ukraine and the IMF) Total assets were estimated to be UAH 22 5 billion (from the World Bank)

[52] From the World Bank

modern procedures and controls for efficient banking and sustained profitability All of this will coincide with the earlier challenge raised regarding banks having to face up to overvalued assets and nonperforming loans, and the financial cost of provisions and charge-offs

- In terms of *funds flows*, banks' funding sources are primarily short-term from household and corporate sources A significant portion of bank resources flow to NBU in the form of investments in government securities for portfolio purposes, or in the form of 15 percent reserve requirements In the case of the latter, which were 11 percent for most of 1997, a minimum of 20 percent needs to be held in cash while up to 80 percent can be held in government securities There are also allegations that the actual implementation of reserve policy is not uniform, and that some banks are receiving some forbearance from regulatory authorities Comprehensive balance sheet or funds flow data are incomplete However, major funding elements appear to include about 30 percent of total from deposits, about 20 percent from the interbank market, and about 15 percent from total capital About one third of funds appear to be used for credit to the non-government sector, with another 5-10 percent of total assets in reserve Fixed asset values are unknown The major gap in both estimates of sources and uses is the role of NBU (re)financing and funds placed in government securities These are likely about one third

- Some of Ukraine's banks have international *correspondent networks* *Payments systems* are considered efficient, which increases confidence in transactions However, limited formal economic activity limits financial activity, which translates into few highly active relationships

3 2 Ownership The banking system in Ukraine is now primarily private in ownership, with only two banks considered state-owned State Savings Bank and Eximbank However, the manner in which most banks became private was in the form of "spontaneous corporatization" or "ownership transformation " Governance and management are generally considered weak, particularly as owners are still frequently the state enterprises which the banks served administratively during the Gosbank period This kind of ownership transformation has not led to incremental capital for the banking system, which is needed for the development of a modern banking sector and system Only 31 banks—or 14 percent of the total number of banks in Ukraine—had year-end 1997 capital of at least ECU 5 million, the EU minimum and still exceedingly small by global standards Until there is meaningful investment in the banking system combined with international standards of governance and management, it is unlikely that Ukraine's banks will be able to provide the range of banking services needed to accommodate growth and development in the Ukrainian economy New regulations represent a start towards breaking the connected patterns of financing that have been a major cause of weakness and insolvency in Ukraine and other banking systems However, new ownership based on new investment and management will ultimately be needed for real transformation New laws and regulations alone will be insufficient **Score 1+/2-**

- At end 1997, Ukraine had 227 banks These included two state-owned banks, 22 banks with partial or total foreign capital, and 203 other banks Among the 203 non-state Ukrainian banks, about 47 were slated for liquidation Only 31 Ukrainian banks are thought to have more than ECU 5 million in capital prior to any writeoffs

- Ukraine's *domestic* banks can be segmented into four groups The seven largest banks—which include (in no particular order) Prominvest, Ukraina, Ukrsotsbank, Eximbank, Savings Bank, Privatbank, and Aval—account for about half of total assets prior to writeoffs A second group of 13 banks accounts for another 30 percent or so of assets NBU has slated nearly 50 banks for liquidation The balance of the nearly 120 banks accounts for about 20 percent of total assets

- Ukraine's *foreign* banks at year end 1997 included 22 institutions, of which six were wholly foreign-owned (A seventh foreign bank, and wholly foreign-owned, entered the market in early 1998) Together, the six accounted for only 2-3 percent of credit, deposits, assets or capital However, these banks are not expected to subject themselves to high levels of balance sheet exposure until there is less risk associated with the Ukrainian marketplace In the meantime, foreign banks are likely to focus on blue chip clients as well as trade finance, payments processing, and other fee-generating activities which entail limited risk and where these banks enjoy a competitive advantage Foreign entry may increase now that the practice of restricting foreign ownership to 15 percent of total capital appears to have been abandoned

3 3 Governance and Management Governance and management are perceived to be weak in Ukraine, largely due to distorted incentive structures characterized by limited transparency, low levels of capital, the absence of strategic investment, and continued ownership weaknesses in both the banking system and the economy at large Modern standards of corporate governance are rarely practiced due to weaknesses of supervisory board structures, the absence of viable internal audit functions, and weak, fragmented, or non-existent information This undermines the ability of boards to devise suitable strategic plans for banks, and to oversee management performance within these plans The benefits of primarily "private" ownership in the banking system are offset by many owners still being state-owned enterprises, or privatized enterprises that still operate according to old state-owned ways Under existing economic circumstances, management is by necessity short-term and "survivalist" in focus **Score 1+/2-**

- According to the Law on Economic Associations, the *legal* process for forming and registering a company in Ukraine is fairly straightforward and takes one to three months However, due to problems associated with permits, licensing and taxation, many firms remain small and unregistered to avoid arbitrary payments For formally registered firms, registration costs net of share capital range from $500-$1,000 As for banks, NBU is the licensing authority NBU administers more than 40 kinds of licenses within a "universal" banking context, of which 32 are for core banking operations [53] The Banking Law provides clear guidelines for types of corporate structure, the obligations of directors and management teams, minimum capital, restrictions on insider lending, and reporting requirements to NBU

- *Cross-ownership* has been permitted in the banking system since the beginning of the two-tier system Most banks are owned by enterprises, serving primarily as captive finance units Recently adopted restrictions on insider lending are meant to reduce connected lending However, because of the generally weak legal framework regarding holding companies, bankruptcy, and joint and several liability, these rules are considered fairly easy to circumvent It appears that hard budget constraints on banks have been the main force behind changes in traditional lending patterns, although NBU is tightening its oversight of banks and will be paying regular attention to evidence of insider lending More broadly, Ukraine is introducing a universal banking system Banks are the most prominent institutions in the financial sector, and it is anticipated that the evolution of universal banking in Ukraine may follow patterns in continental European countries where banks play a major role in capital markets, brokerage and insurance Ukraine's movement towards universal banking will continue to provide a legal framework for cross-ownership In the future, it can be expected that banks, investment funds, brokerage houses and insurance companies will have ownership stakes in each other New legislation in April 1997 established the regulatory framework for non-bank financial institutions Such legislation may need to be modified to ensure adequate firewalls are in place to

[53] For a distribution of the number of banks with numbers of licenses for banking operations in mid-1997, see Landy, "Developing Sound Banks in Transitional Economies Structural Reforms in Ukraine," CASE, September 1997

avoid imprudent practices that could destabilize the financial system NBU recently introduced a rule in which any bank investment in excess of 20 percent of capital needs to be deducted from Tier II capital This may provide some restraint on banks from engaging in excessively risky investments, although the underlying fundamentals of the investment, the market, and the management of those risks will play a greater role in determining if this rule is effective However, at a minimum, the rule assigns a 100 percent risk weight to investments above the 20 percent threshold

- *Minority shareholders* are in a weak position in Ukraine There is no protection for minority shareholders in the event that a company makes a bid for less than all the shares of a target company While shareholders are permitted to block new share issues, it is also reported that there is little minority protection against dilution Thus, even if there is a legal basis for some protection, practice can deviate In most cases in Ukraine, both boards and minority shareholders are passive, and companies are run by managers with a strong position

- Governance in the banking sector is weak in Ukraine Ownership transformation has done little to change traditional methods of management and governance Risk management is limited to short-term liquidity concerns, and to some degree managing foreign exchange exposure Policies and procedures for improved *oversight* of bank management are in place in some banks, but frequently overlooked or ignored In some cases, branch managers have few limits placed on their activities In many cases, information is so inaccurate or outdated that it creates enormous opportunities for fraud and deception Examples of risk include incorrect ledger entries regarding the face value of credit, the registered value of collateral or guarantees, the nominal value of investments in securities, gains/losses resulting from securities trades or other investment transactions, and a range of cash management practices Such informational weaknesses and fragmentation undermine the potential effectiveness of boards and committees to play a useful internal oversight role This latter problem is also compounded by the structural weakness in Ukraine of the role of directors—strong management board compared to weak supervisory boards, combined with the virtual absence of an internal audit function In the absence of qualified financial managers, adequate information, and a corporate mandate for effective oversight, there is little that supervisory boards can do to contribute to effective corporate governance on behalf of shareholders

- There are no apparent restrictions on *compensation*—salaries and benefits—of bank directors, managers and employees However, new prudential regulations and enforcement actions will limit dividend payments and require reduced expenses when banks fail to comply with liquidity, capital, and other regulations As for NBU, while salaries are not high, payments are generally more regular than elsewhere in the economy Thus, the attraction of the civil service for the time being includes confidence in receiving payment as well as the benefit of training This may help in the interim with the build-up of an effective corps of regulators during the transformation to an effective commercial banking system

3 4 Non-Bank Competition Weak as Ukraine's banks generally are, they face little competition from non-banks The local stock exchanges have only about 150 company listings, of which many are non-tradable and illiquid These represent shares in "privatized" firms There is very limited insurance activity in Ukraine, although there are an estimated 231 insurance companies Premium revenues are likely limited by the small scale of operations, the absence of reliable actuarial data, and the limited liquidity of insurance firms themselves to cover damage claims Most activity is presumed to be in auto and other non-life insurance sectors Nor is there any major factoring, leasing or pension fund activity in Ukraine Banks are the main players in the government T-bill market, and the interbank markets for currency trading in hryvnia and foreign exchange are growing However, the equity markets show limited trading volume and weak market capitalization, undermined by a combination of macroeconomic and structural weaknesses The more active markets in government securities are due to persistent budget deficits and ongoing public finance weaknesses Increasing activity in interbank markets partly reflects frequent liquidity and funding weaknesses Market infrastructure for government securities is considered satisfactory, as reflected by the wide range of investors in the last year or two However, in the equities markets, significant work is needed to instill confidence in the safety of basic transactions There is virtually no competition of any sort from credit unions or leasing companies There is also limited if any factoring or commercial credit activity, although most banks could be considered commercial credit institutions instead of banks **Score 1+/2-**

- There were about 200 *credit unions* in late 1997, although their total assets were estimated to be less than UAH 4 million, or about $10,000 per credit union Based on this size, it is likely that most credit unions provide limited safekeeping services for depositors and little else

- There is a nascent *leasing* market beginning to develop in Ukraine, but this is still in its infancy A new Leasing Law has been adopted, and a Leasing Association is forming While there is demand for leasing services, growth is likely to be limited due to the liquidity constraints faced by companies that would be required to service leasing contracts Additional weaknesses include the absence of a seasoned regulatory framework and standard tax incentives for financial leases

- *Capital markets* activity in Ukraine is based on a three-tier Ukrainian Stock Exchange system which involves about 30 functioning stock exchanges in major cities in Ukraine, two interbank currency exchanges for hryvnia (UICE) and foreign exchange (UIFEM), and an over-the-counter (OTC) market (PFTS) for smaller firms As of end 1997, there were about 150 companies listed on the various exchanges Market capitalization was only about UAH 8 billion ($4 billion), equivalent to a meager 5 percent of official 1997 GDP About 80 percent of trading occurs on the PFTS, where more than 100 firms are listed However, this only involves about UAH 5 million in trading activity on a daily basis More than half of corporate equity trading volume on the exchanges is focused on companies in the energy, metallurgy and chemicals sectors In addition to macroeconomic weaknesses in Ukraine, capital markets development is hindered by the slow pace of privatization, the limited number of prospects under current conditions, the non-tradability of privatization certificates, and the absence of fundamental infrastructure—central depository, registration, custodial services, clearing and settlement systems The latter weakness undercuts development of the equities market, as clearing and settlement arrangements are viewed as inefficient and unsafe This is less the case in the government securities market, where banks play a major role in handling transactions and the NBU serves as issuing agent, registrar, depository and paying agent The government securities market has been active due to the government's fiscal problems, with the opening of the market to individuals and non-residents leading to an increase in activity Outstanding volume at end 1997 approximated UAH 7 6 billion, roughly equivalent to stock market capitalization, but different in that this is a liquid market Currency trading volume was equal to $32 4 billion in 1997, mainly on the Ukrainian Interbank Foreign Exchange Market where portfolio inflows are funneled Some municipalities have also issued hryvnia bonds, amounting to UAH 270 million (Municipalities are also pursuing the Eurobond market and syndicated loan market) As of end 1997, there were about 30 investment firms and brokerages with licenses to operate on the USE

- Ukraine has limited savings in the aftermath of hyperinflation in the early 1990s Prior to this, Ukraine had a generous pension and consumer subsidy program which amounted to as much as 14 percent of 1994 GDP However, notwithstanding the considerable strain experienced by the government and economy, Ukraine has been slow to introduce reforms that would streamline the system and make it less unaffordable Such reforms include raising the retirement age, which currently is in the mid-50s Ukraine has a pay-as-you-go system with an aging population, making the cash outflows greater Against a backdrop of fiscal weakness and tight monetary policy, this has led to the run-up of arrears and limited actual benefits The run-up of arrears was partly reduced in late 1997 by proceeds from the expensive $750 million Eurobond flotation Actual benefits only amount to a maximum UAH 50 per month per recipient Given the poor financial state of the budget and the absence of a three-pillar system which leverages social protection off of institutional investor capacity and a mix of public and private options, there is virtually no *pension fund activity or pension funds* to speak of in a capital markets context

- There is limited *insurance* activity in Ukraine, but not much is known about the sector A new Insurance Law was adopted in 1997 specifying increased minimum capital requirements It is presumed that the Law resembles EU insurance legislation which establishes solvency ratios, standards for governance and management, guidelines for exposure in life and non-life activities, investment rules for proceeds collected, and consumer protection rules to reduce the ill effects of asymmetric information There are reported to be 231 insurance companies registered in Ukraine, although it is unclear if these are companies or brokerages The State Committee for the Supervision of Insurance Activity is responsible for regulatory oversight

IV BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS The Ukrainian banking system is generally weak based on financial indicators Capital may well be severely impaired, with the exact magnitude currently unspecified due to poor information, the absence as of yet of IAS, and many legal issues unresolved with regard to debtors, obligations and guarantees Asset quality is likewise weak in many banks, particularly in the largest banks where the highest concentration of non-performing assets is found Management is generally weak from a risk management standpoint, although many banks now appear to be demonstrating fundamental prudence in their management of resources during a period of hard budget constraints Earnings are strained as a result of limited asset-based opportunities, reduced net interest margins, low fee income (due to a tradition of providing little more than basic services), what are thought to be generally conservative trading activities, high overhead costs, and general inefficiency Liquidity is likewise tight due to a restrictive monetary policy to keep the inflation rate down, a weak funding base, and limited debt and equity financing aside from interbank markets for overnight or very short-term funding needs The operating environment remains weak on a number of fronts, and transparency and disclosure standards are weak and undermined by the poor quality of information Ukraine's weak position means that much of Ukraine's sensitivity to market risk has already been factored into resource mobilization and other funding patterns This is reflected in high real interest rates, the short-term perspective that most financial institutions have, and the degree of disintermediation that exists in a largely informal, cash-based economy However, there is still a possibility of fundamental collapse if Ukraine's fiscal and balance of payments position does not improve, particularly as banks have significant exposure to the government securities market In the near term, key banking risks are likely to include attempts to generate extraordinary gains from risky positions and trading activities based on maturity and pricing risk (e g , interest rate, exchange rate, commodity), off-balance sheet exposure involving trade finance and guarantees, loans from banks that have been used as equity by banks' borrowers and that are now poor investments, and general problems associated with regulatory compliance and transactional fraud These concerns will be against a backdrop where foreign investors—direct and portfolio—may not (re)enter Ukraine for a sustained period, political stability may be challenged by criminal activities, and markets in general will remain concerned about the steady deterioration of the Ukrainian economy, weak institutional capacity, and sensitivity to worrying trends in Russia, CIS and global markets **Score 1+/2-**

4 1 Capital Adequacy Management practices appear to now be conservative and prudent since monetary policy was tightened in 1995, and more recently since new prudential norms have been introduced However, the magnitude of overvalued assets, nonperforming loans and future writeoffs is still not precisely identified The largest banks in many cases may have negative net worth Others may be well below the BIS-recommended eight percent for the world's strongest banks and systems on a risk-adjusted basis, let alone a much higher figure that would be considered appropriate for the risks found in the Ukrainian marketplace While most banks remain too small to be viable, the largest banks still often carry a high level of loans that have been rolled over or capitalized, without making proper adjustments for provisions, loan loss reserves, and overall capital adequacy ratios Portfolios are still heavily weighted towards government securities—which are zero risk-weighted according to BIS This is positive from an earnings and capital adequacy standpoint, assuming a zero risk weight is appropriate for Ukraine This puts additional pressure and focus on the country's underlying reserves, access to international financing, and ability to honor its obligations at a time when it has a very weak fiscal position, limited capital markets activity, and the burden of high interest charges in domestic and international markets Banks themselves also face the task of meeting capital adequacy ratios at a time when they have questionable asset quality, possibly well overstated earnings, and high costs relative to current and near-term investment needs for efficiency, competitiveness and sustained profitability Extraordinary capital injections can not be expected from privatization activity, as most banks are either too small to generate proceeds of any meaningful sort or too troubled for prime-rated banks to want to sort out Given questionable asset and earnings quality, the absence of viable capital markets, and the need for investment in information systems, it is highly unlikely that Ukrainian banks will have adequate capital to approximate international standards and to provide competitive service levels in the foreseeable future **Score 2-**

- The methodology for calculating *capital adequacy ratios* is now consistent with BIS guidelines Risk weights are generally assigned in accordance with formulas used in Basle In some cases, rules may be stricter than found in other environments For instance, bank investments in excess of 20 percent of the capital of non-bank companies is now deducted from Tier II capital However, minimum statutory capital of ECU 1 million is only 20 percent of the EU minimum—ECU 1 million is small, and significantly higher levels of capital are needed for the kinds of services that make banks competitive Furthermore, asset valuation standards are dubious in light of the absence of active and transparent markets This is particularly important with the high values associated with fixed assets that may be artificially inflated on a book basis, and thereby overstate capital on the opposite side of the balance sheet NBU has responded with a rule limiting banks' fixed assets to total capital However, it remains to be seen if this will have a practical impact on reducing potentially speculative investments in property by banks As the NBU accelerates movement towards IAS, it can be expected that many banks will fail to meet capital requirements, and that this may open the market to consolidation

- In terms of actual solvency, Ukraine's solvent banks are small while the "large" banks may be insolvent, or at a minimum, in need of corrective action Prior to adjustments, end 1997 paid-in capital for the banking system was UAH 1,592 million, or about $838 million This equates with $3 7 million per bank Total estimated capital figures of UAH 3,334 million (about $1 76 billion) average about $7 7 million per bank prior to adjustments Nonperforming loans were estimated to be as high as 40 percent of total in 1996 [54] With UAH 7 3 billion ($3 84 billion) in outstanding credit as of end 1997, anticipated minimum provisions of $1 billion approximate 26 percent of total outstanding loans at year end 1997 In light of the poor condition of borrowers and the weak legal framework regarding obligations and claims, it is not unrealistic to believe that at least 26 percent of outstanding loans are unrecoverable This would likely erase capital from the most troubled banks short of new injections

- Ukraine has fared poorly in attracting prime-rated investment into the country's banking sector (and in general) *Foreign ownership* now accounts for a mere 2-3 percent of the banking system at most, with year end 1997 figures showing only six wholly foreign-owned banks Since then, ING of the Netherlands has gotten licenses to operate, and Citibank of the United States has received approval to open up an office in Ukraine Until recently, Ukraine followed a policy which limited the foreign share of statutory capital to 15 percent of total This policy has apparently been abandoned

4 2 Asset Quality Asset quality appears to be improving on a flow basis as more prudent management practices are reputedly being followed Credit is being managed more carefully, and investments in government securities are providing banks with relatively safe returns However, many of the larger banks still have old nonperforming loans on their books Estimates of nonperforming loans range from 17-40 percent, or up to UAH 2 9 billion Even the smaller figure represents more than UAH 1 2 billion, or nearly 40 percent of aggregate capital in the

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[54] See EBRD *Transition Report 1997*

banking system at year end 1997—and a higher percentage of the capital of the "largest" banks Thus, asset quality is generally poor in Ukraine Further, because most banks are small, even high quality assets are not of sufficient volume to generate the earnings required for these banks to become sufficiently competitive There are also concerns about bank lending to affiliates and other parties which have then used resources for poor investments In some cases, these loans may have been collateralized by promissory notes that have no effective market value Additional concerns exist with regard to sector concentration due to the traditional lending practices of the larger banks and the limited clients of the smaller banks Finally, non-earning and low-earning asset levels represent a major proportion banks' balance sheets due to speculative or costly investment in real estate and the maintenance of high reserve requirements **Score 2-**

- Ukraine's regulations address *large exposures connected/related party/insider lending nonperforming loans interest accruals provisioning and exposure limits* in a manner that moves Ukraine closer to Basle and EU guidelines However, because these have only recently been introduced, they have not yet had time to reverse earlier practices which were wholly inconsistent with BIS Virtually all of these key problems are still on the books of the largest banks, accounting for nonperforming loans as high as 40 percent of total and at least 17 percent of total in mid-1997 In addition, fixed assets are currently carried at what appear to be optimistic estimates rather than market-based valuations or transactions Thus, it is likely that half to two-thirds of the aggregate balance sheet of the banking system needs to be readjusted downward to reflect underlying value and quality

- *Tax treatment for loan loss provisioning* has recently been modified with adoption in mid-1997 of the new Law on Corporate Income Tax The new Law provides banks with the opportunity to expense provisions for loan losses on a certain portion of their aggregate loans—up to 40 percent by January 31 1999, and then declining to 30 percent by January 31, 2001 and 20 percent from 2002 on While this is notionally consistent with international practices—specific loan losses are tax deductible, but general loan losses are not—the regulation appears arbitrary in setting specific limits The Law's ceiling of up to 40 percent matches estimates in 1996 of nonperforming loans Since then, international auditors have had a chance to conduct external audits Thus, the 40 percent limit may be suitable However, in other markets, the magnitude of nonperforming loans has turned out to be greater than originally thought If this is the case in a market as volatile as that of Ukraine, it could be that several banks may need to provision more than 40 percent of aggregate loans Such a dire financial condition would also make it difficult to make tax payments, a central concern of the government given its own financial problems It is currently believed that this phased approach may be adequate for banks to provision prudently without weakening the tax revenue stream to the government The phased tax structure regarding provisions is also meant to serve as a disincentive to excess risk-taking at a time when banks' risk management capacity is weak and the system is undergoing a structural shift

4 3 Management Ukraine's banks are generally viewed to have weak management Governance is weak, experience is limited, and incentives have largely remained distorted in the post-Gosbank period Likewise, the underlying infrastructure and information base needed for prudent management is lacking in Ukraine The overriding challenge in the coming years is financial and operational stabilization in conjunction with efforts to build institutional capacity for market expansion and sustainable growth As part of that ambitious effort, bank managers will need to learn how to utilize new kinds of information and systems for portfolio management purposes across sectors—banking, capital markets, real estate, insurance—and to operate within prudent risk tolerance levels In banking alone, this will include a vast array of changes to monitor for and manage the varied portfolio, maturity, exchange rate and pricing risks associated with credit, securities, fixed asset investment, asset-liability management, off-balance sheet items, and general operations Likewise, boards will have to introduce effective internal audit functions, and adapt to new standards of internal oversight based on proper utilization of information to determine suitable strategic plans that meet the return requirements of shareholders while being compliant with laws and regulations In the interim, Ukraine would best be served by building on incentives, systems and institutions that focus on the reinforcement of safety and soundness for a long-term restoration of confidence in the banking system Ukraine would also be far better served by accelerating prime-rated investment into the local market, particularly from those institutions that could serve as a spur to core intermediation functions—deposit mobilization and lending—as a means of restoring confidence and instilling discipline If such an approach is adopted, that would require a bold willingness to allow banks to fail to make it more attractive for competitive, prime-rated banks to enter retail markets **Score 2-**

- Ukrainian banks will face a series of management challenges over the next several years From a macroeconomic standpoint, Ukraine's successful monetary policy regarding inflation rates has been partly undermined by loose fiscal policy and the impact this has had on interest rates The latter makes funding expensive, and it adds to the risk of volatility and the impact this can have on asset quality and balance sheet exposure All of this raises concerns about exchange rates While Ukraine's current account is not seriously out of balance, the same pressures that drive up interest rates might also lead to downward pressure on the exchange rate to attract funds and investment from abroad All of these uncertainties make it more difficult for banks to engage in any activities that are medium- or long-term in focus Meanwhile, such underlying weaknesses narrow the base of prospective customers the banks have, particularly if prudential regulations are enforced with regard to insider lending, concentrations, and other practices that have been common until recently Banks demonstrated in 1997 that they were willing to increase lending to companies on a short-term basis if yields on government securities declined This may occur again, which will mean that banks will have to properly manage credit This will also impact capital adequacy ratios, as risk weights for loans are presumed to be 100 percent while investments in government securities are zero Banks will also face enormous pressure on earnings even if net spreads increase This is due to high existing cost structures combined with the need to invest in hardware, equipment, personnel and systems for future competitiveness and a broader array of services This, presumably, will help banks develop fee income opportunities which will grow as their more successful clients grow For this to happen, banks themselves will need to grow to provide a critical mass of services, which means that banks will have to plan to manage in an environment which will likely have fewer banks However, before banks grow, they will have to provide the needed $1 billion or more in provisions and writeoffs, and adopt a more accurate accounting of bank values that can be used for external financial as well as internal management purposes The provisioning exercise will shrink the balance sheets of the largest banks, effectively rendering the banking system relatively small as a whole Even the "largest" banks post-provisioning are not likely to be particularly large, although they will clearly be much larger than the pocket banks At that point, Ukrainian banks will likely have to consider mergers and acquisitions, a relatively new development This will become more likely as an option if foreign banks enter the market as appears to slowly be happening However, foreign banks are not likely to expose themselves much to balance sheet risk until the macroeconomic and enabling environment provide underlying stability and confidence More likely, foreign banks will initially focus on the processing, trade finance, and corporate advisory services that have generated significant profits and returns for these banks in other emerging markets before greater confidence, certainty, and competition emerged In addition to all of the *market risks* mentioned above, fundamental *banking risks* in Ukraine, as elsewhere, will include credit management—introducing and following sound underwriting standards as risks increase, introducing sound and prudent loan covenants for each loan, signing meaningful legal agreements that are enforceable, monitoring borrower compliance with loan covenants, ensuring adequate reporting standards, collecting on loans, and retaining earnings from loans to build capital As in other markets, there will be a temptation by Ukrainian banks to lend to consumers as a result of turnover and higher rates However, this kind of lending and installment finance frequently carries with it higher-than-average rates of nonperformance

As Ukraine lacks transparency and adequate levels of accurate and useful information, a second fundamental banking sector challenge will be to develop needed management information systems so that banks can be more systematic in their asset management activities, rather than relying almost exclusively on "character lending" and other informal assessments. This will involve the ability of management to carry out organizational restructuring for better information flows. This should lead to enhanced management use of information which is generated in a manner that is consistent with sound strategic plans based on prudent risk tolerance limits. Such information should also provide management with tightened authority over branches which have sometimes been guilty of fraud and financial mismanagement. As managers use this information, regulators likewise should be using comparable information for regulatory purposes to strengthen underlying prudence and stability in the financial sector. Over time, Ukraine would be better served in its credit and asset management efforts by developing one or more central credit rating services. This would provide banks and other financial institutions with the capacity to systematically track individual, household, and company credit histories. A good starting point would be with/by the banks through the NBU so that banks and regulators, at a minimum, have a comprehensive data base to root out poor performers. Fraud will also have to be monitored as banks increasingly market to high net worth individuals, few as they may be in Ukraine.

- As elsewhere around the world, bank boards and management will need to continuously adjust their risk-taking strategies based on sound and timely information. This will require ongoing development and modernization of information systems for *risk management* purposes. Ukraine is barely at the beginning of the process, entering more of a "rules-based" phase in which it graduates from the old Gosbank norms partly adapted to a two-tier system, to one which introduces new regulatory requirements, accounting standards and attendant information systems which bring banking practices closer to market. It will be important for Ukraine to lay the institutional groundwork for these changes with an eye on future risks that will depend increasingly on human judgment based on accurate and up-to-date information, rather than prescriptive rules once deviations occur. This will require a major transformation in how banks are overseen by markets (over time), how their own boards provide oversight, how banks are managed by their senior staffs, and how market-based incentives are reinforced by a combination of "market self-regulation" and NBU supervision that help to maintain a focus on safety and soundness, systemic stability, and prudently managed growth. Governance will require improvements in the quality and quantity of information in the development of strategic plans and the setting of risk tolerances across lending, investment and off-balance sheet activities. The role of internal audit and its reporting to boards will have to be strengthened with an eye to identifying and evaluating risks that could undermine the solvency and liquidity positions of individual banks, and making recommendations to their boards (directly) and management (through the board) to get back on track. This will require improved internal controls, which will require investment in hardware, software and people. Bank management will need to understand the parameters of a bank's strategic plan, to properly implement the policies, procedures and structures to achieve results, and to warn the board on behalf of shareholders as well as regulators on behalf of depositors, markets and the NBU if serious unanticipated risks have been uncovered. Managers at varied levels will also need to have a keen technical understanding of the risks entailed when dealing with a host of portfolio considerations for lending, trading and investment activities—maturity, pricing, and currency issues from a portfolio standpoint, as well as the underlying quality of each asset. It remains to be seen how much progress the banks can make with regard to medium-term risk management issues. However, the current period should focus on stabilization and institutional capacity building to be prepared for a future period when fiscal policy is more in balance with monetary policy, when the exchange rate is stable due to higher levels of reserves and direct investment, when the real sector has shown some revival, and when financial sector infrastructure are more fully in place to support greater assumption of risks.

4.4 Earnings Ukraine's banks have not traditionally presented income statements consistent with IAS, although this is now beginning to change with recently introduced reporting requirements Through 1996, earnings have been overstated due to interest income on loans that, by Western standards, would be classified as loss Likewise, the failure to provision for loss loans has overstated earnings By end 1997, loan loss provisions were only 2 3 percent of total loans By March 31, 1998, it is expected that provisions will increase by UAH 440 million, thereby tripling the year end 1997 figure This quarterly figure alone represents nearly half of estimated 1997 pre-tax (and pre-provisioning) earnings on an unaudited basis Based on application of the UAH 440 million provisioning charge to 1997 estimated earnings and a 30 percent corporate tax rate, "net income" for the banks could approximate UAH 337 million for 1997—about $1 million per operating bank However, other estimates assume a needed $1 billion or more in provisions, or nearly five times the provisions expected by March 31, 1998 In any event, such provisions will reduce the flow of posted earnings from 1998 on Meanwhile, banks will also have to contend with weak client markets, shrinking net interest margins, excess overhead, and the need for investment in new technologies, systems and processes These will all put pressure on earnings in the near term **Score 1+**

- Income statements for the banking system are unavailable Even if available, they would not be consistent with international standards, and would therefore provide an inaccurate reflection of banks' earnings flows Estimates of pre-tax and pre-provisioning earnings for the banks in 1997 were UAH 921 million, or about $472 million based on average exchange rates However, these estimates are unaudited Assuming a first-quarter 1998 provisioning charge of UAH 440 million that is applied to 1997 earnings, this would reduce pre-tax profits to UAH 481 million A corporate tax rate of 30 percent would reduce "net income" to UAH 337 million (about $170 million at average exchange rates for the year), or about $1 million per operating bank *Net interest* contributions in 1997 may have increased due to increased lending However, real net spreads declined Thus, for banks that did not increase their volume of activity, it is likely that net margins declined in 1997 *Other revenues* in 1997 are likely less of a contribution to banks' earnings than in other banking markets Non-lending services tend to focus on payroll and other processing, payment services and custodial operations However, these are limited because most companies limit their holdings with banks to avoid conflicts with tax authorities This reduces other potential products and markets such as introduction of debit cards for company employees Reluctance to place funds with banks is even more pronounced in the household sector This weakens banks' net interest margins due to foregone interest income (e g , installment or commercial credit for small businesses, debit and credit cards for businesses and individuals) and higher funding costs resulting from the scarcity of retail deposits For the largest banks, some fee income is generated from servicing budgetary accounts About 25 banks apparently generate some income by servicing municipal accounts However, overall, fees and commissions are not thought to contribute significantly to bank earnings *Trading profits* are also considered somewhat limited, mainly because banks' trading activities are partly contained by the conservatism of the electronic payments system Given the focus of monetary policy on exchange rate stability, NBU is apparently very careful about banks' trading activities to protect against undue risk-taking Meanwhile, *operating costs* are still high due to high levels of personnel, and larger than needed branch networks Ukrainian banks' earnings will be further challenged in the coming years with the need to invest in new technologies, systems and training for greater efficiency While these investments are expected to generate incremental cash flow over time, banks will still be faced with the needed capital expenditure and ongoing investment to modernize operations *Provisions* for loan losses increased in 1997, but Ukrainian banks have traditionally under-provisioned Thus, loan loss provisions were only UAH 219 million at year end 1997, or about 2 3 percent of total loans By March 31, 1998, it is expected that provisions will increase by UAH 440 million, thereby tripling the year end 1997 figure Further provisions will be made through 1998-99, all of which will reduce earnings

- *Interest rates* on loans and deposits are not subject to *controls*, nor are other fees However, pricing has apparently been slow to adapt to market conditions, reflecting both the limited market for services in the real sector as well as the consequent limited array of fee income-generating services provided by most banks Banks have generated partial benefits from high net spreads, particularly as they have been derived from comparatively safe investments in government securities However, these benefits diminished in the second and third quarters of 1997 as the inflation rate came down Further, the high rates are a mixed blessing, as they reflect underlying instability and volatility which undermines the banking sector as a whole

- There is declining evidence of *mandated lending* in Ukraine, with most of the remaining lending directed to the agricultural sector However, this decline is more a reflection of the poor state of Ukraine's fiscal condition, rather than enlightened policy There is also a general perception that declining fiscal revenues reflect the successful lobbying of individual firms to be exempted from tax payments, effectively constituting an arrears-based approach to mandated lending rather than a more active approach directed through the banks However, there is apparently less mandated lending through the banking system than before, and much of it is more openly disclosed through the budget or in disclosure of the state material reserve fund—effectively an off-budget vehicle to allocate resources to the agricultural sector In 1997, the material reserve fund directed about UAH 1 billion in resources to the agricultural sector which contributed about one percent to the fiscal deficit

- There is a 30 percent corporate income *tax rate* which applies to banks, plus payroll and additional taxes As banks also play a key role in the purchase of government securities for ongoing government operations, they clearly represent a major source of funding for the government That banks will not be allowed to fully expense specific provisions for loan losses over the next two-three years is partly due to government concerns about foregone tax revenues

4 5 Liquidity Ukrainian banks face a difficult liquidity situation due to the lack of confidence in the banking system, limited non-deposit resources available for financing, weak or negative earnings, and a tight monetary policy In terms of regulatory reporting to NBU, banks appear to have adequate liquidity positions Some of the larger banks—Ukraina, Prominvest, Privat, Exim—have also managed to obtain about $50 million in the syndicated loan market from about seven or eight European banks However, in terms of actual cash funding, most banks are in a weak position and hardly able to grow Liquidity constraints are both macroeconomic and structural in nature This weakness is likely to persist until confidence is restored in the banking system, and this will be tied to larger efforts to restore confidence in Ukraine's institutions, its macroeconomic policy, and general real sector development **Score 1+**

- Ukrainian banks' *funding structures* are undermined at the deposit-taking level by an overall lack of confidence from the household sector in banks, and/or in their need for cash Households likewise distrust tax authorities The right of tax inspectors to review accounts in excess of the equivalent of $400 and to arbitrarily block accounts further deters confidence Structurally, the State Savings Bank accounts for about one third of household deposits, and an estimated 20 percent of total deposits Thus, there is a concentration of the retail deposit base at State Savings, although it has diminished in recent years Corporate deposits are largely held with the larger former state-owned banks and one private bank, Privatbank (These banks have also tapped the European syndicated loan market for about $50 million) With this deposit concentration, most other banks rely on the interbank market for overnight or very short-term needs (e g , up to about one week), and primarily the NBU for refinancing This provides a less stable funding source, making it more difficult for banks to control their interest expense and to manage their funds

- Bank management reputedly manage fundamental *sensitivities to pricing interest rate and exchange rate movements* through a matching strategy in hryvnia (assets and liabilities), or by taking a long position in dollar assets Most bank managers are operating on a short-term basis, explaining their matched positions in local currency Ukrainian banks are generally not large enough to engage in more sophisticated trading activities without incurring high transactions costs In the future, this could emerge as a source of risk But for the time being, resource scarcity has actually led managers to control their resources conservatively without incurring high transactions costs

- *Reserve requirements* are currently 15 percent, although they were 11 percent from February through November, 1997 Banks can allocate a maximum 80 percent of their reserves to government securities, but a minimum 20 percent is required to be held in cash This was changed from 70-30 percent, respectively, through most of 1997 There are reports that some troubled banks are being given preference, thereby receiving at least partial exemption from reserve requirements

- *Asset-liability management practices* indicate apparent conservatism and prudence However, until better information is generated, most banks will not be able to ensure adequate continuity of asset-liability management practices This problem is largely due to many banks providing imprudent levels of branch autonomy, failing to have adequately connected information systems, or fraud with regard to the actual entry of information into banks' ledgers

4 6 Operating and Regulatory Environment Ukraine's banking system suffers from a low level of public confidence Hyperinflation and the effect this had on savings and pensions contributed to a significant loss of confidence in the early 1990s The ongoing malaise of Ukraine's economy, the weakness of its institutions, the magnitude of corruption, and the perception that banks are among the profiteers during a difficult transition from socialism account for much of this sentiment While the State Savings Bank is presumed to carry a government guarantee for household deposits, many of its traditional clients have already lost significant savings from the earlier bout of hyperinflation Tax inspectors are not trusted, and this serves as a catalyst for the informal sector and the high level of national savings kept in the shadow economy Meanwhile, because banks have not been privatized in a manner that has significantly shifted governance and management structures, the banking sector has done little to instill confidence in the household sector Banks' traditional corporate clients are largely the same as they were before their enterprise owners As a result, banks have been (at least until recently) administrative or captive finance units of enterprises Ukraine has done a poor job to date of attracting foreign investment, which could have gone a long way in compensating for structural weaknesses in the Ukrainian economy and banking sector In terms of financial sector infrastructure, NBU is just beginning to demonstrate regulatory and supervisory effectiveness NBU needs significant strengthening to identify risks early on, and to enforce its mandate in support of crisis prevention The emerging regulatory framework generally conforms to prudential guidelines rendered by the BIS and the EU, but it will take several years to become effective This will also hinge on conversion to IAS, investments in information systems by banks, and the ability of a new wave of modern managers to both utilize information for management purposes and to recognize the need for a prudential regulatory framework in support of underlying stability in the banking sector **Score 2-**

- Ukraine is in the process of drafting legislation for a deposit insurance fund A February 1998 draft indicated that coverage would not exceed UAH 500 per depositor per bank This is modest by global standards, and the initial intent is apparently to get a fund running for about three years during which other measures to restore confidence will have achieved their objectives At a later date, coverage could be increased While the draft law contains weaknesses—foreign exchange risk, delays in reimbursing depositors, pegging the annual contribution from banks to December 31 deposits[55]—many of the features of the law are designed to restore confidence for household depositors Checks and balances are built into the governance of the fund to protect against conflict of interest Regular

[55] It is expected that many households withdraw funds towards the end of the calendar year

reporting is required Financing of the insurance fund comes from charges assessed on banks, with additional funding from the budget or other sources if needed Also, because the fund provides modest coverage, it is affordable without placing excess stress on banks or government Yet, the very risk of calls on government resources to provide coverage for deposits also gives NBU an added incentive to conduct its oversight function of the banks with added seriousness

- Ukraine has shown a willingness to liquidate small banks and two mid-sized banks,[56] but it has not liquidated a large bank This fact, combined with earlier mandated lending through larger institutions meant that refinancing was virtually guaranteed irrespective of the quality of assets and earnings Thus, Ukraine traditionally made use of *lender of last resort* financing for large banks that might otherwise have failed However, because information misrepresented the true financial condition of the larger banks, there was little if any recognition that these banks were in trouble There is now recognition that the loan portfolio of many of the larger banks should be classified as loss, and that many effectively should be written off However, NBU is only at the embryonic stages of developing a bank resolution department capable of dealing with the problems presented by the largest banks Thus, it remains to be seen if Ukraine will follow a "too big to fail" approach and provide resources for *bank rescues* However, to date, NBU has shown a willingness to let banks fail With significant pressure already in place for reduced fiscal expenditure to help restore economic growth, Ukraine will not be able to afford expensive recapitalization programs for troubled banks Further, if Ukraine decides to intensify efforts to bring in prime-rated banks *and* to provide incentives to these banks to mobilize deposits and lend, an exit strategy for troubled banks would reduce obstacles to genuine market development and encourage more rapid achievement of safety and soundness

- Ukraine's banking system is slowly becoming more competitive While there is still noticeably *high concentration* in deposit gathering and sector lending flows, this is changing For instance, regarding household deposits, State Savings Bank has seen its share of total diminish from 77 percent at end 1994 to 33 percent at end 1997 On the asset side, the balance sheets of many "large" banks will show a different picture after provisions are taken and unrecoverable assets are charged off Likewise, if Ukraine is serious about attracting foreign investment in the banking sector, this will provide additional competition More importantly, competition among banks for balance sheet-oriented business might come if there is a reconfiguration of the Ukrainian banking sector based on fewer but larger banks engaged in a range of activities that respond to many of the needs of the non-blue chip sector of the domestic economy

- While the regulatory environment has improved, there is still much to be done to enhance the *effectiveness of banking supervision* Major weaknesses include the overall lack of experience of NBU's banking supervision department, reluctance of supervisors to enforce their mandate, weaknesses in Ukraine's legal and accounting framework, and fragmented information from bank branches to bank head offices, which undermines the quality of information that flows to NBU However, on this front, there is clear cause for optimism NBU is in the process of reversing traditional weaknesses Policy coordination is in place Better information is now required of the banks Off-site surveillance and early warning systems are being put in place to identify potential risks These include 15 key indicators which provide needed threshold information on capital, asset quality, earnings, liquidity, and some foreign exchange risk measures On-site inspections have already finished full-scope examinations of some of Ukraine's largest banks These activities have continued into 1998, targeting the largest problem banks Later in 1998, more targeted inspections will also be conducted, presumably testing some of the findings and recommendations originating from off-site analysis An ambitious strategic plan is in place with firm management and direction Technical assistance is properly in place to provide needed guidance and direction to the effort to strengthen supervision, and to convert bank reporting systems to the new chart of accounts that will make it easier to convert overall reporting to IAS—which will assist both management and regulators Near-term challenges will include ongoing training of personnel, establishing confidence-building communications flows

[56] Grado Bank and Inkombank were considered mid-sized before liquidation

between banks and regulators to serve mutual interests, and properly coordinating off-site and on-site information flows to identify, evaluate and contain risks as banks become more aggressive

- Effective January 1, 1998, banks are required to produce financial statements that conform to IAS Many of the larger and mid-sized banks already produce annual reports with the help of *external auditors*, and some of the smaller banks have done so as well in recent years While Ukraine has not yet converted to IAS, the conversion process is in motion with the introduction of the new chart of accounts It is expected that regulatory pressure from NBU will accelerate movement in this direction

4 7 Transparency and Disclosure There are major concerns about the poor level of transparency and disclosure in Ukraine Much of this dates back to the Soviet period, when people held on to information as a form of protection Today in Ukraine, many organizational structures are fragmented and ineffective due to the lack of disclosure of meaningful information This applies to the disclosure of timely and accurate financial information provided by companies to banks, as well as by banks to the public The persistence of problem loans in bank portfolios, slow introduction of IAS, and rather late application of prudential norms consistent with BIS guidelines all point to comparatively weak standards of transparency and disclosure The poor quality of information reinforces this notion Nevertheless, NBU is taking the lead in promoting better standards for a more accurate representation of the financial condition of banks It is expected that as tighter requirements are applied to banks, that banks will likewise begin to apply comparable standards to their existing or potential customers Some banks are even targeting "financial consulting" to enterprises to assist them with conversion to IAS as a source of fee income for the future **Score 1+/2-**

- For years, banks did not have a framework for information disclosure that could provide a meaningful or reasonably accurate reflection of their financial condition Banks only produced *unconsolidated statements* inconsistent with IAS until 1998 Banks failed to openly account for loan losses and *nonperforming loans* Assets experienced a *revaluation* during the period of hyperinflation, although this is less an issue today with inflation rates in the 10-15 percent annual range However, incorrect valuations of assets, such as for real estate, represent similar problems in that they overstate asset quality and anticipated earnings or extraordinary gains Tax incentives are not fully in place for banks to adequately *provision for loan losses*, although some expensing will be permitted in the coming years to allow for overdue provisioning The draft Law on Banks reportedly provides for a regulatory framework that treats exposures and risks on a consolidated basis This is expected to account for *unincorporated affiliates* and other kinds of risks that can impair the financial condition of a bank on a consolidated basis Banks and investment companies are also expected to follow *mark-to-market* accounting for securities investments for their own portfolio management purposes, as well as for prudential regulatory purposes Thus, there is positive movement towards the adoption of practices and standards that should provide far more useful and meaningful information in the future

- Banks are only at the beginning of the process of adopting the new chart of accounts, converting to IAS, and identifying the usefulness of information generated Thus, banks (and banking supervision) are only at the beginning of a process to generate adequate information for internal use as well as for external disclosure IAS will ensure a certain level of *public disclosure* over time, but this will not be enough for investors to determine the magnitude of risks that banks' (or companies') strategies, portfolios and management represent Thus, it will take time for the market (and banking supervision) to adequately detect risks in the absence of useful information It will also be important over time for depositors to obtain useful and needed information, and to be given adequate assurance that deposit-taking institutions are safe and sound—particularly given that the proposed deposit insurance fund provides only minimal coverage Findings from *examinations inspections*, and regular reports to NBU are not disclosed to the public, although some statistics on groups of banks and the banking system are published Over time, market development will be required through rating agencies and investment analysts from the "outside", as well as internal bank exchanges of information (directly, through the association, and/or coordinated through NBU) for a better sense of individual banks' underlying financial positions

4 8 Sensitivity to Market Risk Events in 1997—namely the outflow of portfolio investment from Ukraine to Russia and other FSU countries, as well as outflows back to Western capital markets—provide an indication of the fragility of the Ukrainian economy and its sensitivity to market risk Events in late May 1998 reflect the potential for contagion, with stock exchanges in emerging markets around the globe being hit by a loss of confidence from portfolio investors [57] This represents an extended link in the chain of many emerging markets that are among the hardest hit when investors lose confidence and return to safer havens In the case of the Ukraine, concerns about the Russian economy in the aftermath of the Asia crisis in late 1997 led to portfolio flight due to apparent cash needs back in Russia to maintain confidence in the ruble This set off a run from Ukraine, which forced the NBU to significantly raise interest rates to try to stabilize the hryvnia and restore confidence While exchange rates remained reasonably stable against the dollar and ruble, interest rates rocketed up to 35 percent in November 1997, and then again to 44-48 percent in February 1998 while the inflation rate continued to decline Developments in Russia in May 1998, which included a tripling of interest rates to 150 percent to maintain confidence in the ruble, represent a recurrence of similar trends and can only hurt the Ukrainian economy Ukraine's sensitivity to market risk is high, largely due to the fundamental weakness of its economy at the structural level combined with a high level of dependence on outside financing to avoid total collapse The former will take years to correct, while the latter raises the risk of an emerging debt trap that will only make it more difficult for structural weaknesses to be reversed It appears that until Ukraine is able to both broaden and deepen financial markets, it will remain highly sensitive to regional and global risks Broadening and deepening will require measures that build confidence in the future Apart from monetary policy and an adequate payments system through NBU, there is little that provides the kind of confidence investors need to compensate for the perceived risk associated with the Ukrainian marketplace In addition to legal and regulatory reforms, Ukraine will need to reverse the impediments its bureaucracy imposes on formal private sector start-ups and emerging companies This is true from a tax perspective—both rates and methods of collection—as well as from an administrative standpoint—frequency and cost of inspections, wasted time—if Ukraine wishes to bring the shadow economy into the mainstream Likewise, Ukraine will likely have little alternative than to create an enabling environment for strategic foreign direct investment There has been little domestic direct investment to date, and Ukraine will need the management expertise, information systems, and market links to move its economy forward Strategic investment will be required for SOEs that can be privatized, as well as in companies that have already had their ownership structures transformed and are now officially classified as private companies Such an environment would then provide the banking and financial sector with a greater number of targets for intermediation and services Absent such developments, Ukraine will continue to struggle through an imploding scenario characterized by a shadow economy, a steadily weakening fiscal position, and continued inability to provide needed public services in a transparent fashion that promotes confidence in public institutions **Score 1+**

[57] The Russian market lost more than 40 percent of its value from January to May, 1998 Losses were also registered throughout CIS markets, ex-socialist Central European markets (e g , Hungary, Poland), major Latin American markets, and South Africa

- Ukraine's banks likely experienced reduced earnings in 1997 due to mid-year compression of net spreads, continued high cost structures, and increased provisions for loan losses Profits were reported to be UAH 921 million at January 1, 1998, although these estimated profits were prior to provisions and tax payments and based on unaudited figures Using these figures, year-end ROA would approximate 4 percent while year-end ROE would be 28 percent [58] Both are satisfactory from an investor standpoint, but because they are not IAS, it is very likely that earnings are highly overstated Likewise, earnings and return ratios would clearly diminish after the application of provisions and taxes Based on other informal estimates of UAH 337 million in ' net" profit, 1997 ROA and ROE would be about 1 5 and 10 2 percent, respectively Audited statements will provide a more accurate estimate of banking sector earnings for 1997 Meanwhile, there are significant cost pressures on banks net of provisions that will put pressure on earnings As banks contend with diminishing earnings, they will likely feel pressure to extend credit on a short-term basis at high rates with as much turnover as possible, and with fees and compensating balances attached to increase returns and funding Thus, schemes used to attract funding as well as the general standards of *credit risk* management employed by banks will be a clear challenge in the coming years Banks have been prudent and apparently more risk-averse in the last couple of years as monetary policy has tightened and NBU supervision has imposed new prudential regulations Future credit management practices will need to observe sound underwriting standards, to apply and monitor appropriate loan covenants and their compliance, and to promptly identify and contain risks to portfolio quality It is likely that Ukrainian banks will remain risk-averse and short-term in their perspective not only because of funding and liquidity constraints, but also because Ukraine's legal framework has not traditionally provided banks with adequate protection in bankruptcy and liquidation scenarios to assume greater risk This weakness, combined with hard budget constraints, is generally managed by focusing on short-term, low-risk activities However, if banks want to increase earnings from lending, many of the higher return ventures where banks have a strong negotiating position vis-a-vis the borrower are in the smaller or mid-sized market This kind of lending would also present a series of challenges and risks, particularly as these groups are often the least willing to provide the information needed for banks to conduct proper credit risk analysis in the first place That tax inspectors are mistrusted impedes information flows, representing an example of the kind of environmental weaknesses that undermine market development

- Ukraine's banks currently face liquidity and funding shortages Reserve requirements are 15 percent, but most of the problems relate to weak deposit bases on the liability side and immobile loans and overvalued real estate on the asset side *Liquidity risk* is likely to remain high as fiscal deficits are persistent, even with a decline in expenditure Ukraine's fiscal problems are indicative of a vicious cycle in which weakening confidence reduces revenues, which only makes the government less able to provide the kinds of services needed to maintain confidence and generate revenue for services rendered Corruption and fraud are symptomatic of and add to the problem Further reductions in fiscal revenues lead to the increased build-up of arrears, which adds to the cycle of *de facto* default in the enterprise sector and their inability or unwillingness to place funds with banks, while the government increasingly crowds out the private sector Banks will likely continue to invest safely in T-bills and other securities, which may help with earnings, asset quality and capital adequacy However, such activity will do little to improve their long-term prospects for liquidity Meanwhile, prospects for rising interest rates paints a bleak scenario for the government—either adding to political pressure to ease monetary policy and resort to inflationary practices, or adding to debt service costs and continued erosion in the fiscal and balance of payments position Even if rates rise and boost bank earnings, this will have more damaging economic consequences which will include a more limited market for banks

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[58] Ordinarily, return ratios would be measured against average assets and equity rather than year-end figures However, these figures differ from NBU figures, therefore a time series can not be done with adequate confidence Further, because figures are not IAS (or GAAP), it is questionable that these measures would provide an adequate reflection of the financial condition of the banking sector even if the methodology followed was more consistent with market-based measures

- Maturity and currency mismatches will be tempting to take advantage of in the future due to earnings pressures and concerns about credit risk Thus, bank management and NBU will need to closely monitor investments in instruments with financial structures that are exposed to significant volatility in *interest rates exchange rates and pricing* NBU does not have all the information it needs regarding off-balance sheet items While some banks engage in relatively risk-free or prudent hedging mechanisms against exchange rate or interest rate volatility, this is not considered the practice of most banks yet due to their limited volume and the high transactions costs they would incur However, in the future, it may be tempting for banks to engage in trading activities for their own account and for the account of others that are risky and subject to major losses Ukraine's rapid rise in interest rates in late 1997 and again in early 1998, virtually in lockstep with the Russian Central Bank, reflects local currency interest rate risk Exposure to the ruble is another clear weakness in terms of interest rates and exchange rates, even though hryvnia-ruble rates have been fairly stable Ukraine is more vulnerable to systemic risk associated with the ruble, as occurred in late 1997 and again in May-June 1998, as Russia desperately attempted to maintain/restore confidence in the currency Over time, it can be expected that other currencies would eventually appreciate against the dollar, even though the dollar is currently strong against the DM and yen Likewise, key commodities such as oil and gas may be subject to greater pricing volatility in the future, particularly as Ukraine's energy sources are still closely tied to Russia and Turkmenistan The impact these can have on the domestic economy—at least until alternative sources are identified and operative—will need to be monitored as well for their potential impact on exchange rates, interest rates, and overall portfolio quality

- As in any banking sector, there are potential systemic risks in the event that individual banks are imprudent in the management of resources When small, these incidences can be isolated and contained However, when such activities represent the imprudence of a large bank, or where numerous institutions are vulnerable to a chain of events or transactions that can spread through the system and undermine confidence, both the private and the public sector need to be prepared One of the best lines of defense is to ensure that standards are in place and enforced for banks to prudently manage resources to be able to honor *transactions* This requires strong internal controls, high levels of accountability, and effective governance and management backed by reasonable but strict regulatory enforcement Ukraine is only at the beginning of putting these foundations in place, although the strictness and efficiency of its payments system helps To further strengthen confidence, banks need to be in *compliance* with contractual agreements, which also is tied to the transaction risk just mentioned Compliance with prudential regulations, and public disclosure of such compliance, sends a signal that banks appear safe and sound The absence of compliance again undermines confidence, and reduces efficiency Thus, regulatory compliance backed by a well functioning legal framework is needed to manage compliance risk Ukraine lacks this capacity, and will need to build on existing programs and reforms backed by technical assistance to develop this This includes a strengthened legal environment which supports the NBU mandate to enforce regulations to prevent systemic crises Such development of institutional capacity should also be consistent with prudent management by banks (and oversight by regulators) of *strategic* risk This will require a new approach to governance and management, as well as significant and costly investments in information technologies and staff training Banks will also need to introduce incentives for performance, suitable organizational structures in which management information flows, and processes and procedures for risk management capacity to develop as the market expands and becomes more competitive Finally, competitiveness of individual institutions and the market as a whole will need to increase to enhance the existing *reputation* of Ukraine's banking sector Currently, the reputation is weak, and it will take years to reduce the risk premium associated with investment and operations in Ukraine Reaching the stage where depositors, lenders, investors and regulators begin to have confidence in Ukraine will depend on strengthening the macroeconomic environment, developing the needed institutions for underlying stability in the financial sector, accelerating privatization in the real sector, introducing new methods of governance and management based on strategic investment, and creating an environment better known for transparency and accountability than is currently the case While such prospects are years away for Ukraine, they will be the necessary minimum for the establishment of confidence that is needed for a banking sector to operate safely, soundly, and professionally according to market principles and in support of a growing economy

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