Banking in Ukraine: Changes Looming?

Two main risks of the Ukrainian banking industry are liquidity and currency risks

Natalya Dushkevych and Valentin Zelenyuk

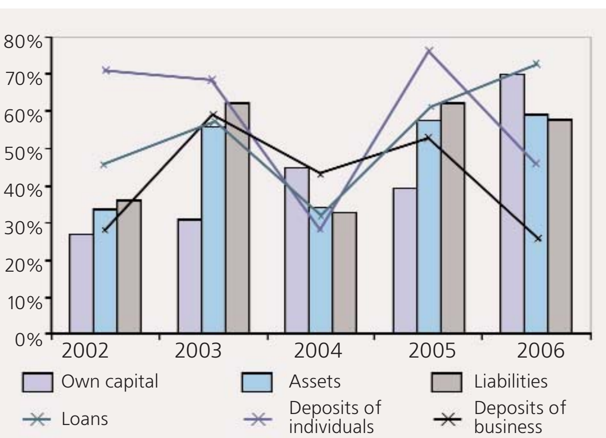
During the last decade, the banking industry in Ukraine has exhibited an enormous growth in assets (see Figure). The number of commercial banks went from 76 at the beginning of independence to a peak number of 230 banks in 1995 and to 193 banks in 2006. There remain only two state-owned banks with about 12% of the total assets — a much lower share than e.g. in the Czech Republic (24%) or Russia (35%). The industry is quite competitive with no one bank having a dominant position. The Herfindahl-Hirschman index of business concentration has stayed at around 400 points for many years, which is similar to the levels in the UK or France.

Big international players, such as Citibank, ING and HVB entered Ukraine before 2000 but did not make it into the top 20 banks in terms of assets. The last two years, however, showed a markedly increased interest from foreign investors in Ukrainian banking. The new wave of foreign acquisitions started in 2005 when Raiffeisen International purchased the second largest Ukrainian bank, Aval. Other big international players followed promptly, increasing the proportion of foreign ownership from about 15% in 2004 to about 30% by the end of 2006.

In 2006, about 65% of all FDI into Ukraine went to the banking industry. Not surprisingly, the prices skyrocketed: in early 2007, Swedbank agreed to pay about US$750 million for the 19th largest Ukrainian bank, which was equal to three quarters of what Raiffeisen International had paid for the second largest bank just 17 months earlier. At the same time, the stock market price for banks taken over by international players has increased dramatically, signalling a higher level of trust from investors.

However, it is also very likely that the proportion of domestic banks in Ukraine will remain much higher than in the above countries. This is because relative to other transition countries (except Russia) Ukraine has many more large domestically owned business groups, which own or control local banks. For example, the largest Ukrainian bank, Privatbank, is associated with one of the largest FIGs in Ukraine, the Privat Group.

Annual Growth of Main Banking Indicators



Industry Shakeout Likely

Thanks to increased competition, the Ukrainian banking industry is ranked higher by the World Bank than in most transition and even some developed countries. However, the weakness of many small banks, with some being on the verge of bankruptcy, is likely to lead to an a massive exit of banks and the consolidation of others. International experience shows that many industries go through a “shakeout” period around the 15th year of their development. The Ukrainian banking, which is already in its 17th year, also demonstrates a decent level of maturity in providing primary services — another factor considered critical for inducing an industry shakeout.

A large wave of bankruptcies — the worst-case scenario — could be prevented (or minimized) by encouraging mergers and acquisitions of small banks, many of which suffer from managerial and marketing deficiencies. Until recently, foreign investors have kept away from buying such banks, mainly because of their inadequate transparency. The recent legislative initiatives should help to increase transparency, yet the process has been going too slowly despite increasing threats.

What are the main risks to the Ukrainian banking industry? One is the increasing liquidity risk. Most of the bank liabilities are short-term deposits and current accounts, while most assets are mortgages and other long and medium-term loans. This threat is unlikely to materialize if trust in the banking system continues to increase, no large-scale negative economic shocks ensue, economic growth continues and incomes keep rising. Yet, the presence of so many uncertainties makes the system vulnerable.

The second is an increasing currency risk. While many loans are taken in US dollars, most deposits are made in the local currency (hryvnia). This is because the interest rate for dollar loans is 1.5 times lower than for the *hryvnia* ones, while the exchange rate has remained virtually unchanged in the past years. An external shock causing devaluation of *hryvnia* is likely to cause a credit crisis, as many borrowers with hryvnia-denominated incomes will find it hard to meet obligations.

The National Bank has considered various measures to discourage loans in hard currency. Yet, this is unlikely to solve the problem as the "remedies" are applied to the consequences rather than to the root of the problem. In our opinion, a more market-oriented solution would entail switching from the pegged to floating exchange rate regime, together with inflation targeting. This should stimulate convergence of interest rates in domestic and hard currencies.

Overall, the industry dynamics suggest that the Ukrainian banking is about to go through substantial changes and the result will depend on how well it addresses the risks and transparency issue.

Natalya Dushkevych is at EERC (Kyiv School of Economics) and Kyiv Economics Institute, KEI. Valentin Zelenyuk is at Kyiv Economics Institute, KEI, EERC and Millennium Capital. The views expressed in this article are those of the authors and do not represent the views of above organizations. **BT**