

THE POLICY OF MINIMIZING OF FALLOUTS OF BANKING CRISIS IN UKRAINE

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Abstract

Ukrainian economy faced sharp decrease in 2008, which was characterized by general deterioration in macroeconomic indicators. Such situation and influence of foreign markets led Ukraine to the financial crisis which started in banking system. Ukrainian banking crisis was accompanied by changes in national legislation. There are 3 ways of minimizing of fall-outs of banking crisis in Ukraine. They are as follows: temporary administration, nationalization and liquidation. Ukrainian anti-crisis steps, which were implemented, were compared with foreign experience. The question is whether these steps were as successful as some of foreign ones or not. Analysis which was made showed imperfection of national legislation, lack of interaction between state regulatory authority and lack of effective long-term strategy.

Keywords: Financial Crisis, Banking Sector, Liquidation, Nationalization, Temporary Administration

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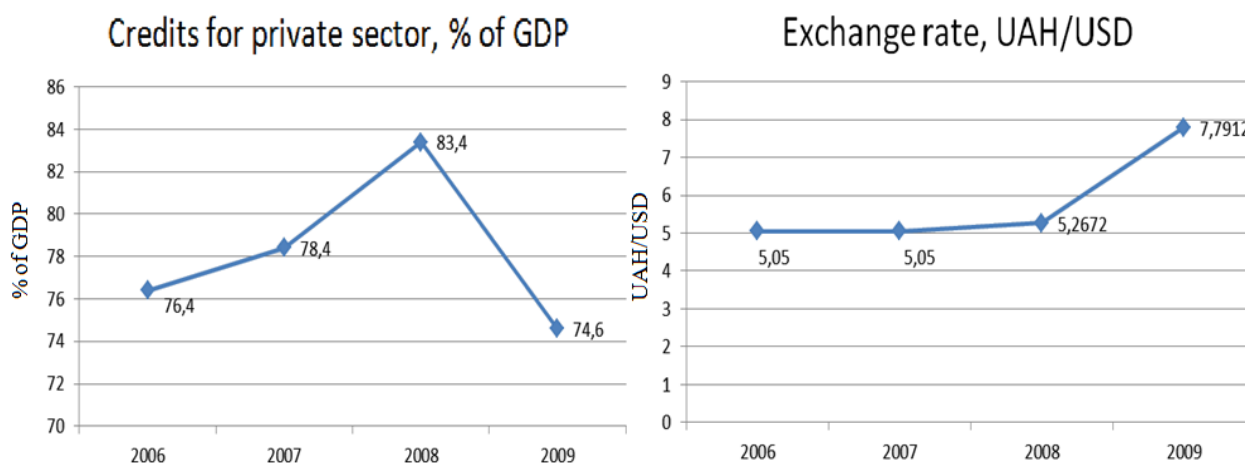
Introduction

Within several years of pre-crisis period Ukrainian economy showed steady growth. During 2005-2008 years economic growth progressed all the time and reached a peak of 6.3% per year in 2008. Besides inflation had been getting down until 2008, exports faced dramatic rise (50%). The inflow of direct foreign investments was increasing during the last 5 years. Statistically until the beginning of the crisis (within the 9 months of 2008) the inflow of direct foreign investments had been covering credit balance of current account. Gross international reserves of the National bank of Ukraine (NBU) had reached USD37bn at the end of September 2008 peak within the period of Ukrainian independence).

At the beginning of 2004 the loan portfolio of legal entities was UAH47.5bn, (USD5.94bn) and individuals' – UAH8.7bn (USD1.9bn). At the beginning of 2008 loan portfolio of legal entities had risen fivefold to UAH236bn (USD29.5bn) and individuals' – seventeen fold, reached

UAH149bn (USD18.63bn). At the beginning of 2008 63% of banks' assets had been channeling to consumer loaning.

The period of credit boom had been accompanying with nascence of "bubbles". The growth of lending is reviewed within the period of 2007-2009 years (figure 1). Until the beginning of the crisis there had been functioning in Ukraine the system of fixed exchange rate relative to USD. Within the period from 2006 to first six months of 2008 the exchange rate was 5.05 UAH/USD. The fixing of exchange rate had been stimulating the capital inflow in Ukraine which had been causing to the rise of dependence of banking system. Due to going up of inflation and fixed exchange rate competitiveness of Ukrainian export had been dropping (Segura, E., Pogarska, O., Ustenko, O., Kozyarivska, L., Kasyanenko, S.; 2009).



Source: National bank of Ukraine, SigmaBleyzer

Figure 1. Credits for private sector and exchange rate

Before banking crisis in Ukraine started to develop there were an influence of external factors and delay of reforming of national financial system. At the autumn 2008 the loyalty of all economic entities to Government, banking system and state authorities in general had sharply fallen. There are a lot of functions of the market that lost its effectiveness. This is supported by causeless increasing of demand of foreign cash on the part of individuals, growth of inflation expectations and outflow of deposits from the banking system.

As a result, within the period 2008-2009 years there were disposed USD 18bn of deposits from the banks of Ukraine. Researches showed that for July 2010 there were returned to the national banking system only 33% of deposits which had been disposed during the panic in 2008-2009 years (Kornilyuk, R., Shpytko, Y.; 2010).

Key stages of minimizing of fallouts of banking crisis

World experience shows that measures of banking system strengthening the resilience may be different. But success depends not so much on scope and selected policy aimed to its implementation. It depends more on the reforms' performance, i.e. the speed of reforms, transparency and clarity of decision-making. World practice has more than ten instruments to strengthen the resilience of the banking system. There used such instruments in Ukraine:

- bank temporary administration;
- bank liquidation;
- bank nationalization.

Liquidation is ordinary process for the banks which are unable to carry out their business effectively. In the period from 2001 to third quarter of 2008 there were liquidated 4 banks in Ukraine (appendix A).

At the early stages of the banking crisis in Ukraine, the state authorities did not understand the actual scale of the crisis and made a few indirect measures. They were focused on giving some regulators indulgences to the banks, leading to postponing the crisis.

At the end of 2008 the process of bank recapitalization began, as provided in agreements with the International Monetary Fund (IMF). There were planned to spend USD44bn for these purposes in the state budget for 2009.

2.1. Stage 1: Temporary administration¹⁶ of banks

Primary strategy of strengthening the resilience of the banking system in Ukraine has been chosen temporary administration in bad performing banks¹⁷. Since December 2008, NBU has appointed the temporary administrators in 27 banks (14.44% of total amount of banks). These financial institutions accounted about UAH72bn (USD9bn) of assets (over 10% of total amount of assets of the national banking system) and UAH44bn (USD5.5bn) public funds (i.e. 21% of all savings entrusted to the banks). There are 18 banks in Ukraine in which the temporary administrator have been appointed for a period of one year (Appendix B). This term is the maximum permissible under the efficacious national legislation (in two big banks, the term was extended for one year, as provided in legislation of Ukraine).

Besides, implementation of supervision by central bank had been used. NBU appointed supervisors in banks that are categorized as "bad performing bank". Only 9 of the 27 banks returned to stable performing after leading out the temporary administrator. However, their financial situation remained almost unchanged. In theory the

¹⁶ Appointment of temporary administration is being made by decision of Management Board of National Bank of Ukraine. In Ukraine this administration is being represented by 1 person.

¹⁷ «Bad performing bank» - a bank, of which liquidity or solvency is reduced or remain reduced until steps wouldn't be taken for significantly improving the financial resources of the bank; correct strategic direction of its activities, increase control under the potential risk management and under quality management.

reason for this could be either ineffective functioning of temporary administrator or unstable economic and political situation in Ukraine.

The important fact is that among the 18 banks included in the first group (relative to the size of regulatory capital and assets¹⁸), temporary administrators were appointed into 5 banks, representing 27.8% of banks from the first group.

There is needless to admit that requirements which are set up either to temporary administrators or liquidators of banks if Ukraine are practically identical. Individuals who have economic or legal education, high competency and moral stature, perfect business reputation (besides if previously their actions had not led to bankruptcy of bank or other financial institution) could be liquidator or temporary administrator.

For temporary administrator experience in banking system should be not less than 5 years. Moreover person should work on managerial post more than 3 years. Certification of persons provides qualifications commission of NBU. These persons usually get the status of independent expert in case they do not have any interests, which can prevent them from impartial functioning as temporary administrator or liquidator. Besides, person can get a certificate only if there are no any conflicts of interests between person and NBU and relationships with the bank within the last 5 years (On making changes in some regulations of NBU Act; 2010).

2.2. Stage 2: Liquidation of banks

NBU has changed recovering strategy of banking institutions from the financial crisis by using more drastic instruments since the end of 2nd quarter of 2009 (Appendix C).

The main reason was fact that more than 35% of all banking institutions were unprofitable. At beginning of 2010 63 banks (from 179) have reported losses in Ukraine. In January-September 2010 total net losses of 41 banks (23.3% of the total number of banks that operated in early October 2010) was UAH13.103bn (USD1.64bn). In fact major banks have UAH9.122bn (USD1.14bn) (69.6% of total net losses of those institutions) from that figure (Banking News of Ukraine; 2010).

The issue of bad performing assets in Ukraine is solved with the IMF. The idea of sanation bank was not implemented. Although there have been discussions over

year about the establishment of such a structure. In fact appropriate changes to national legislation were made, but it did not lead to the desired result. Today the situation has changed and discussed the issue of setting-up "bridge-bank"¹⁹. This bank will be transferred only "good" assets. This will lead to the liquidation of the bank, where would be only "bad" assets. As the result the total number of banks will reduce and the bad performing banks will disappear in Ukraine.

Today one of the most disputable legal acts is already written. It concerns changes of regulatory capital of banks (Resolution of the Management Board of National bank of Ukraine from September 6, 2010, № 273). This act requires from banks to form the regulatory capital at least UAH120m (USD15m) to January 1, 2012. Besides, as it is stated in this document, banks with regulatory capital less than UAH120m (USD15m) are not allowed to expand the deposit portfolio. Researches showed that for July 2010 there were 69 banks with regulatory capital below UAH120m (USD15m) (from 176 banks). In case this document is adopted the number of banks in Ukraine will be cut down to 39.2% (Krylova, V., Nikonova, M.; 2010).

Total amount of money for capitalization for 38 banks of 69 banks comprises 20% of the amount of their regulatory capital. These banks have 68.3% of regulatory capital that should be increased. In fact it's not a big problem either and the profit of these banks could be transformed to the regulatory capital. For 31 banks the best option could be merger and acquisitions. As the matter of fact, concentration of banking capital is vital and burning question in Ukrainian banking system.

Today the bill № 0884 is written. Newly-opened banks should have authorized capital more than UAH500m (more than EUR45m). The proposed rule does not comply with European legislation. Value of the authorized capital is almost 10 times higher than the EU requirements (in EU it is EUR5m). As a result only 42 banks could remain in Ukraine (KyivPost; 2010).

Thus the issue of expanding regulatory capital remains one of the most popular and disputable at the present stage of development of the banking system. Determined by legislation guidelines will strength the concentration of capital and will strength the stability of banking system to financial crises, minimizing systemic risk. On the other hand the Association of Ukrainian banks proclaims that such policy will causing to discrimination of "small" and "medium" banks (3 and 4 groups of the banks). The result may be that the trend of monopolization of the banking sector will become more pronounced. Taking into account that access to banks' capital of Ukraine is rather difficult monopolization will include mostly Ukrainian residents. If this document is adopted, it should lead to active actions on the part of government and NBU which are aimed at changing the legislation regarding the process of liquidation of banks. Today the period of banking license revocation is 3 years.

¹⁹ Bridge-bank is the bank which holds insured deposits and good performing assets on the temporary basis which were transferred to it from bad performing bank (Finance.ua; 2010).

This term should be reduced to ensure speed and efficiency of the liquidation of the large number of banks.

In Ukraine the main drawback of the bank liquidation process is that one person only carries out this process. Based on international experience, such organization process is not appropriate. Particularly in the UK there is liquidator of the bank and the Committee of the liquidation. It creates for controlling the activities of the liquidator. The Committee consists of three persons who are appointed by the Bank of England, Financial Services Authority (FSA) and the Financial Services Compensation Scheme ("statutory fund of last resort" in the United Kingdom).

In Ukraine initiators of liquidation of banking institutions could be NBU or the shareholder meeting. There are 13 banks in which initiator was NBU and 2 banks in which initiator was annual shareholder meeting. There are more authorities that could be liquidators in international practice. Not only can be liquidators the Bank of England and shareholder meeting, but also it's FSA in the UK. In any case it's obligatory²⁰ to agree the decision of liquidation of the bank with the Bank of England (The Banking Act; 2009). According to the newly issued acts and bills in the UK (for example Financial Services Act 2010 which had been published in May 2010) country aims to diversify banking control and supervising by delegating functions from the Bank of England to more independent authorities (for example FSCS or FSA)²¹. The initiators of the liquidation of the bank could be shareholders meeting or The Financial Supervisory Authority of Norway (Finanstilsynet, earlier, before December 21, 2009 – Kredittilsynet²²) referring to Norwegian legislation. Any decision related to the liquidation of the commercial bank must be approved by King (Commercial Banks Act; 2004).

In Ukraine, NBU has taken the decision to liquidate 14 banks (out of 15, in which were revoked the banking license in the crisis period) and Economic (arbitration) court taken this decision for one bank. In general in the international experience, particularly in the UK, the decision to liquidate the bank makes similar to Ukraine legislation (by the court or central banks).

In Ukraine by the end of the first quarter of 2010, the reason of the liquidation of banks could be if

- bad performing assets were not less than 60% of regulatory capital;

- losses by the end of financial year - more than 50% and;
- for consecutive three years - over 20% of the authorized capital.

To prevent a large number of bank liquidation, NBU has changed the criteria of revoking a banking license:

- Capital Adequacy Ratio²³ (H2) less than 3%;
- In case bank lose databases with information about customers, contractors or account balances and inability to restore this information;
- NBU decides that the bank's financial recovery is not possible either (On confirmation of Regulation on certification persons for providing temporary administration and bank liquidation, Act of NBU; 2001).

Thus, in Ukraine 8% of banks are being liquidated during the financial crisis.

2.3. Stage 3: Nationalization of banks

At the same time, in Ukraine another method of minimizing of fallouts of banking crisis of banks was nationalization. Part of the nationalized banks in Ukraine is 1.6% of the total number of banks. This figure is almost the same as in the UK (1.96%) in the same period. The total number of banks in the UK and Ukraine is also practically the same – 204 banks²⁴ in the UK, compared to 178 banks in Ukraine. The main reason between Ukrainian and British nationalization is not in the share of banks which took part in it but in the quality of made nationalization.

National legislation does not have clear criteria of selection of the banks for the nationalization. The situation is slightly different abroad. If the bank has a large number of creditors who have not agreed to restructure debt, the government takes reputation risks to itself, interfering in the activities of the bank. It has two mechanisms for this: either conduct additional emission of money (as the result higher inflation), or recapitalize the bank. If there is no investor, the state conducts bank nationalization using the country's budget. Basically, the object of nationalization is the big banks. This mechanism is widely used (widespread) in Ukraine and abroad. But ways of the nationalization are different. In the UK for nationalization was elected four banks that are in the list of 10 largest banks in the country (by assets). Besides first nationalized banks (Northern Rock and Bradford & Bingley) were mortgage banks (Banks of Great Britain, 2010). The reason for their nationalization was collapse of the mortgage market in the USA. This

²⁰ Article 100 part 2 «Banking Act 2009»

²¹ Financial Services Act 2010. – Access from: <http://www.legislation.gov.uk/ukpga/2010/28/contents>

²² Kredittilsynet is headed by a Board of Directors comprising five members (and two alternates). Two employee-elected representatives supplement the board when administrative matters are dealt with. Members and alternates are appointed by the Ministry of Finance for a four-year period. The day to day management is in the hands of the Director General who is appointed by the Ministry of Finance for a six-year period. The director general is supplemented by a management team of four deputy directors general, a general counsel and a head of communications. Kredittilsynet is organized in three supervisory departments, an administration department and support functions at various levels.

²³ This indicator is calculated by state authorities and based on national standards. Basel III rules, which presents the details of global regulatory standards on bank capital adequacy and liquidity, does not covering calculating of this indicator

²⁴ British Bankers' Association. – Access from: <http://www.bba.org.uk/about-us/member-list>

collapse has negative influence on the UK banking sector. After 5 years, in 2013, it is going to denationalize 4 nationalized banks. They will be selling by parts (Koksharov, A.; 2009). Today it's difficult to estimate the effectiveness of nationalization in the UK, although the first steps were made economically reasonable and balanced. At the same time experience in the USA shows that nationalization can be successful. The USA could not only prevent from the collapse of the banking system but also this country makes the profit from the nationalization. Ukrainian experience casts doubt on the argumentation for the selection of banks for nationalization. In 2009, the share of bad performing assets of "Rodovid-bank" (one of three nationalized banks) and "Nadra Bank" (one of the candidates for nationalization) together accounted for about 80% of the bad performing assets of the national banking system.

In Ukraine the state spent for the nationalization of banks about UAH9.57bn (USD1.196bn). In particular, the "Ukrzazbank" spent UAH3.2bn (USD0.4bn) (share of the state, listed in the capital - 84.21%); Bank Kyiv – UAH3.563bn (USD0.45bn) (99.93%) and "Rodovid bank" – UAH2.809bn (USD0.35bn) (99.97%) (Newsru.ua; 2009). As the matter of fact two banks (from those 3 nationalized) belong to the first group ("Ukrzazbank" and "Rodovid"); Bank Kyiv - to the second one. Current financial position those banks casts doubt on the effectiveness of the policy of nationalization. This policy has failed in giving the necessary impetus for banks to exit the negative (poor) financial situation. At the beginning of 4 quarters of 2010 net losses of "Rodovid-bank" were UAH4.209bn (USD0.53bn). Thus, state participation in capital of banks (especially large) leads to the weakening of competition, and consequently - reducing the effectiveness of the banking system in general. Moreover the risks of lending remain high enough in Ukraine. Therefore many foreign banks begin to withdraw capital from Ukraine (HSBC, Commerzbank) or their policy is expectations (anticipation) (Deutsche Bank).

Obviously, nationalization has failed improve financial results in any of the banks in which it was conducted. Therefore inadvisable choice of "candidate banks" for nationalization made inefficient using its in Ukraine. Moreover, the important issue in the process of minimizing of fallouts of banking crisis of Ukrainian banks is misunderstanding that nationalization is only an intermediate stage of banking recovery. As the result there is no clear mechanism for further state action related to the denationalization of nationalized banks. But the main achievement of the nationalization in Ukraine is the return of public confidence in financial institutions and the state interest in effective controlling and regulation of their activities.

Conclusions

As a result, objective causes of financial crisis in Ukraine led to fundamental problems in banking sector. NBU could not solve the problem by simply changing banking legislation and implementing administrative measures.

That is why there was realized strategy which involved several mechanisms of minimizing of after-effects of banking crisis. Relying on international experience, it could be noticed that chosen strategy was economically sound and appropriate for Ukraine but it could not come effective. Main reason to this was absence of clear separation of powers between state authorities. Due to scope of functions of NBU in banking supervision was too wide it could not put in order its functions which were focused on coping with crisis. There are two ways of solving this problem. The first one is in establishing separate institution which will be responsible for appointing of temporary administration to the financial institutions and control over it (experience of the UK). For Ukraine such mechanism could be more radical. Another way of solving is in delegating some authorities to institutions which are already functioning (for example, State Commission of Regulating of Market of financial services in Ukraine).

Risks in banking sector depend on regulatory capital of the banks. NBU estimates these risks as high enough. That's why strict regulation and rather ineffective policy of liquidation and nationalization leads to centralization of banking capital. The purpose of every steps of NBU is to do centralization of banking capital.

In July 2010 there were worked out draft bill "About system of guaranteeing of individuals' deposits" by representatives of Fund of guaranteeing of individuals' deposits (FGID), NBU and representatives of World Bank in Ukraine. This document allows delegating some authorities in working with bad-performing banks to FGID.

After NBU found some bank as bad performing one, this bank started to work under FGID. FGID appoints temporary administration, examines the situation with the bank and within 2 months prepares the plan of adjustment and leading out the bank from the market. Besides, draft bill involves that while the bank became accountable to FGID it lost the status of legal entity. There is search of the ways of leading out the institution from the market – how to make this process the cheapest for the fund. The main aim of the reform is implementing new mechanisms, which involve opportunity preventive measures intended to bad-performing banks and minimizing of payments from the assets of the fund (within the last 2 years there were paid UAH3.2bn (USD0.4bn) from UAH3.8bn (USD0.475bn) which were paid within all period of fund's functioning).

Due to delegating some functions from NBU to FGID, central bank will focus on supervising while FGID will get the instruments and motivation for optimizing of expenses and accelerated leading out of problem financial institutions from the system.

One more reason of ineffective anti-crisis policy was absence of long-term planning while realizing it. Mechanisms which were oriented on short term of implementing very often were prolonging and rarely reached a final aim. Besides, there was no clear approach to selection of banking institutes for nationalization. Even nowadays this question remains disputing. Points of view

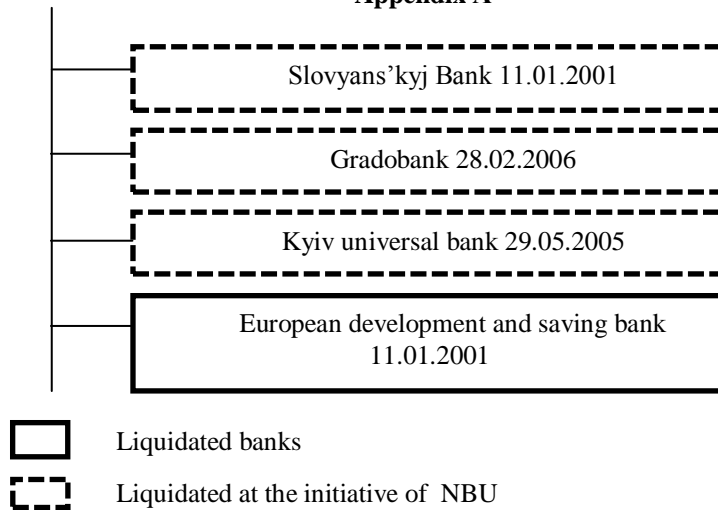
differ between NBU and international experts of World Bank and IMF.

On the whole quantitative analysis of the mechanisms of minimizing of after-effects of banking crisis in Ukraine which were implemented proves that chosen strategy was suitable. Besides, international standards were respected in the context of the order of implementing these instruments. However questions which concern further functioning of banking institutions, to which these mechanisms actively applied still remained unsettled.

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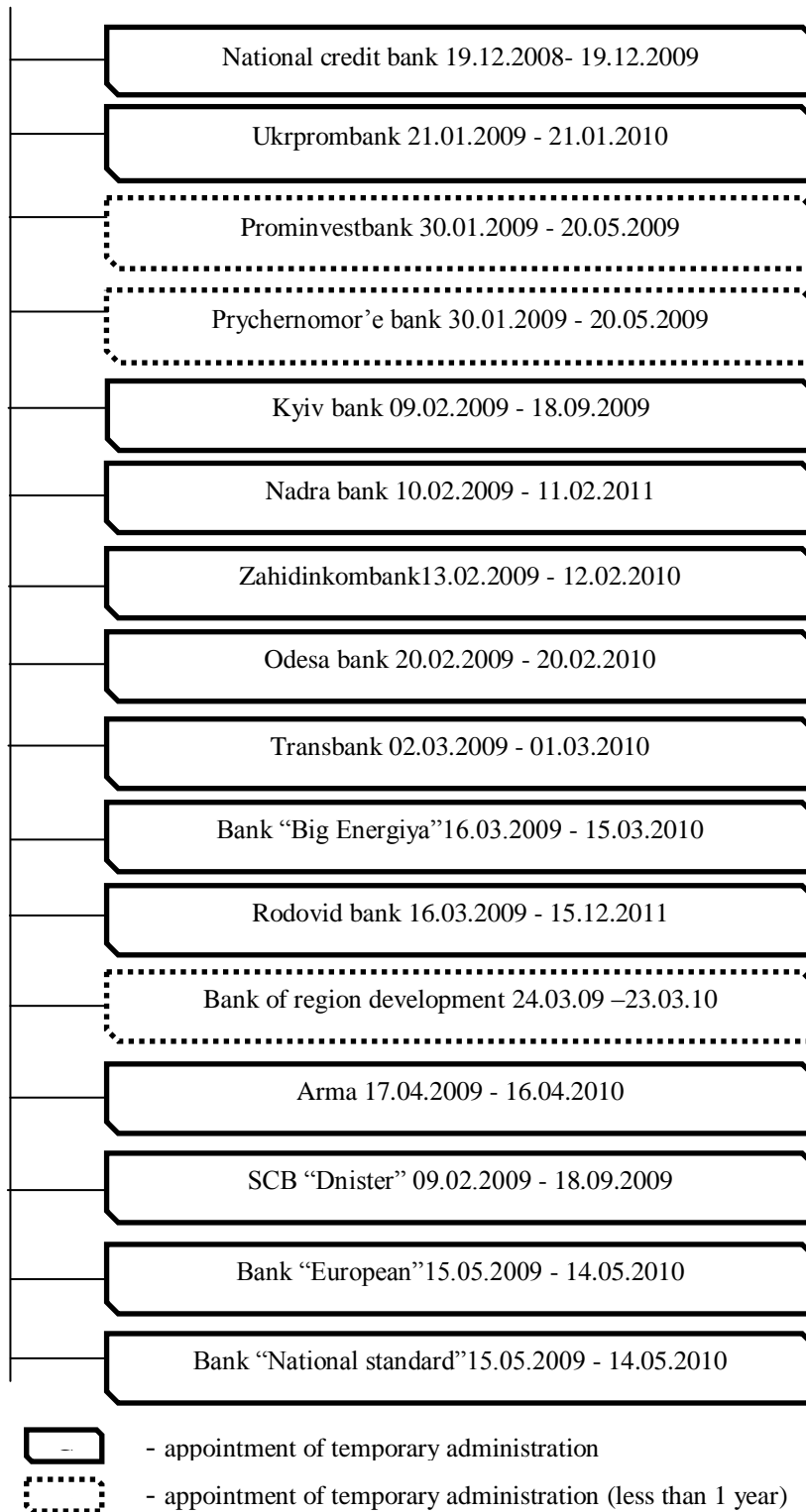
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Appendix A



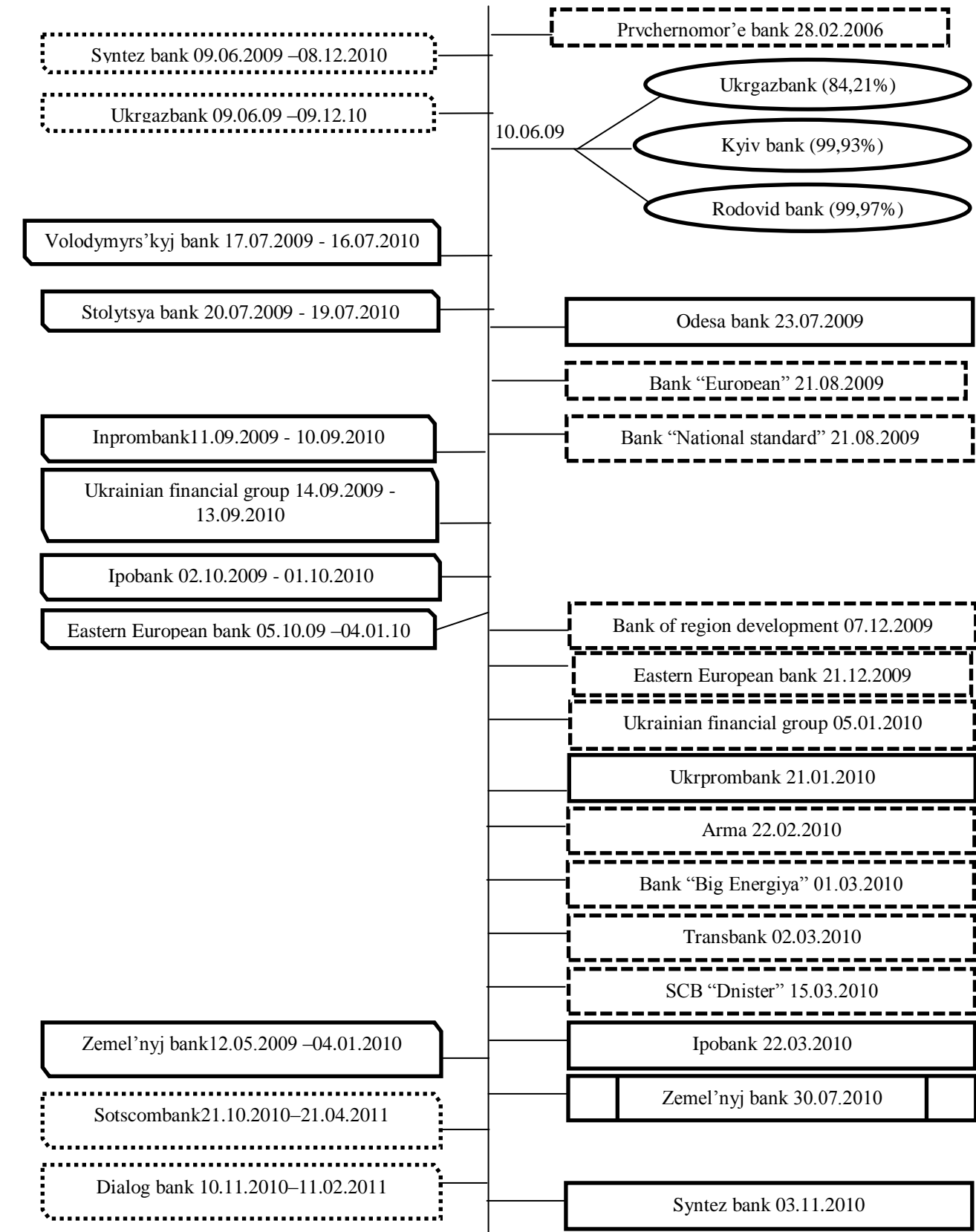
Source: worked out by authors on the basis of data of the National bank of Ukraine <http://www.bank.gov.ua>

Appendix B



Source: worked out by authors on the basis of data of the National bank of Ukraine <http://www.bank.gov.ua>

Appendix C



○ - nationalized banks □ - liquidated banks (decision of the commercial court)

Source: worked out by authors on the basis of data of the NBU <http://www.bank.gov.ua> //www.bank.gov.ua