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Comment

A get-tough approach has been the only way to reform Ukraine's under-regulated, corruption-ridden financial system, writes the country's central bank governor.

Massive lending to related parties. Opaque ownership structures with the real owners hiding behind a mass of nominal directors. Window-dressing of financial reports. Fake correspondent accounts at foreign banks. Politically motivated lending by state-owned banks, resulting in large losses and a subsequent massive injection of public funds. Money laundering as a bank's business model. Shareholders and management walking away from failed banks with clients' money, escaping charges for driving them to bankruptcy...

Sounds like a horror movie? Impossible in real life?

Wrong. It was a common way of doing financial business in Ukraine before 2014. We call it 'the oligarchic banking model': most of the banks (except foreign- and state-owned ones) belonged to local oligarchic groups, which used them primarily as vehicles to finance their activities, effectively through the banks' retail deposits, against a background of reckless regulatory forbearance.

This is no longer the case. The new team, which came to the National Bank of Ukraine (NBU) in 2014-15, aimed to profoundly transform the country's banking system and was committed to turning it from an ugly duckling into a beautiful swan. Now, two years on, we are positive that the landscape of Ukraine's commercial banking has been dramatically changed and the foundations for a sounder and healthier financial sector have been established. The banking system is now showing clear signs of recovery as deposits are flowing back into the system, the banks are cautiously optimistic on new lending activity, and capital adequacy and financial ratios are improving.

Nevertheless, the mission is still only half completed. More changes in prudential regulation and supervision practices are required to secure sustainable lending recovery and enhance banks' resilience and capacity to withstand shocks.

THE BURDEN OF THE PAST

In 2014-15, Ukraine's economy and banking sector experienced the deepest crisis since the country's independence was achieved in 1991. It was caused by structural imbalances that had been building up during the past decade, a lack of adequate regulation and efficient supervision, as well as military conflict and loss of territorial integrity.

Hence, looking back to mid-2014, the challenges have been enormous and required a comprehensive approach. We started by prioritising our key short- and mid-term goals and by developing a roadmap that later evolved into a fully fledged programme for banking sector reform until 2020.

Our team had to start the task with a thankless process of banking sector clean-up. Many institutions did not perform as classic financial intermediaries. Some were identified as being involved in illegal operations or serving as funding vehicles for shareholders' businesses. Our position was firm. Those banks that did not address properly the NBU's concerns were withdrawn from the market.

So far, more than 80 banks (or 45% of the total number, and with them about one-third of the sector's assets) were sent into receivership due to insolvency, involvement in money-laundering activities or non-transparent ownership structures. In terms of market impact, our experience is unique and unprecedented in the global banking supervision history. While inevitable, the clean-up triggered a temporary loss of confidence in the banking system. Nevertheless, the painful process has reshaped the Ukrainian banking system. Only solvent, fully transparent banks have a place in the market.

The NBU put pressure on banks to reveal their real ownership structures, previously disguised behind numerous special purpose vehicles and asset management companies. Ukraine's banking sector is now fully transparent, which would have been inconceivable just two years ago. The key consequence of this reform is that the ultimate beneficial owners of the banks can now be held legally accountable for driving them into insolvency.

Improving the work of the Deposit Guarantee Fund was yet another major challenge related to the clean-up process. We managed to improve legislation and strengthen the institutional framework so as to streamline bank insolvency and liquidation procedures and facilitate repayment of lost retail deposits.

In 2015, the NBU launched a diagnostic study of the Ukrainian banking system as part of the Ukraine-International Monetary Fund co-operation programme. The study, comprising an asset quality review and stress testing, has already covered the 40 largest banks (with the next 20 banks on the agenda) and revealed a pressing need for additional capital. The stress-test methodology was carefully designed to allow in-depth analysis of every single large credit exposure.

SWEET LIE OR BITTER TRUTH?

Our staff looked into the finances of thousands of corporates to assess their solvency and estimated impact on banks' capital. This was a unique experience that the NBU and supervisors in other countries had never had before. Capital losses were huge against the backdrop of economic collapse in the occupied eastern territories and massive hryvnia depreciation. For a while we allowed institutions to operate with zero capital as it was completely wiped out at most banks following adverse external shocks. Capital duly served as a buffer against unexpected loss events related to an infringement of the country's sovereignty.

Overall, the NBU gave local banks up to three years to bring their capital adequacy ratios above normal pre-crisis levels of 10%. Most banks have fulfilled the prescribed capitalisation programmes well ahead of schedule, while a few have yet to close capital gaps. The licences of two large banks were withdrawn, because their shareholders were not able to cover the capital shortfall.

High proportions of non-performing loans and incorrect presentations of asset quality in banks' financial statements remain a challenge. The diagnostic study helped uncover loopholes in banking regulation and identify window-dressing practices and overstatements of credit portfolio quality by banks. All this led to hidden capital shortfalls, which were properly revealed by the NBU. To rule out such risky practices in future, the NBU recently introduced new credit risk assessment rules for local banks.

In compliance with Basel principles of banking supervision, new rules require credit risk estimation based on the 'expected loss' concept. The new rules will come into effect from early 2017. Prudential credit risk assessment methodology will provide a basis for accounting provisions. If the estimated credit risk is higher than International Financial Reporting Standards-based provisions, the excess is directly deductible from the regulatory capital. The new rules will lead to full and timely recognition of credit losses and give banks a strong incentive to improve internal risk management practices.

Besides the diagnostics, we have invested huge resources and efforts in identifying banks' transactions with related parties. Prior to 2014, underwriting loans to banks' related parties at favourable terms was a common practice and a long-term blight on the banking sector. Some of the related businesses never had any intention of repaying the loans. Therefore, the NBU obliged banks to reveal the true story and bring related lending volumes in line with the required prudential ratios over the next three years. Several large banks with a high concentration of related party loans in their portfolios went bankrupt. Some large institutions are in the midst of unwinding lending to related parties. Completion of the programme will free up considerable resources for lending to unrelated businesses on market terms.

HOSTAGES TO VESTED INTERESTS

Representing about one-third of total banking assets, Ukraine's state-owned banks historically lacked operational independence and the government interfered heavily in their day-to-day activities. Lending to companies of politically exposed persons was common and undermined banks' financial health for many years. To keep them afloat, the government was generous in providing fresh capital to state banks solely to cover huge credit losses pertaining to unwise lending decisions. These banks were a source of significant systemic risk for the financial sector.

This vicious circle has finally been broken, and state banks have rethought their lending strategies. We are moving towards improved corporate governance and risk management practices at state banks. We believe state banks must find their niches, narrow their specialisms and develop viable business models based on profit maximisation principles.

The NBU and the government expect that state banks will manage to attract reputable investors in the medium term who will help in modernising these institutions and making them fully competitive with private banks in terms of customer care standards.

NEAR-TERM PRIORITIES

Starting from 2015, the NBU has been explicitly entrusted with the function of maintaining financial stability as well as price stability. We are determined to design effective micro- and macro-prudential supervision. A risk-based, forward-looking approach to the supervision of individual banks is being implemented. To prevent the accumulation of systemic risks and to properly address possible shocks in the future, the NBU is developing a toolkit of macro-prudential instruments.

We are also mindful of the crisis's adverse effects: many local banks have a low risk appetite despite having excess liquidity. This is partly due to legal loopholes that make protection of creditor rights somewhat challenging. Yet following a painful transformation period, Ukrainian banks will be fully prepared to increase loan underwriting: a fully fledged recovery may start as soon as 2017.

Due to the shifting flexible exchange rate, cleaning up the banking sector and securing the NBU's institutional independence, we have successfully shifted to inflation targeting. Inflation is declining, and so is the key policy rate. We are now in a cycle of declining interest rates, which should support a further reduction in banks' funding costs and boost demand for new loans. After all, a healthier banking sector is poised to become an efficient funding supplier to local businesses and households and a powerful driver for Ukraine's economic growth. TB

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