

DEPARTMENT OF INDUSTRIAL ECONOMICS



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## A Rebirth of the Banking System in Ukraine ?

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Un grand merci !

# Executive summary

- During an initial period of economic euphoria after the soviet era, Ukraine started accumulating numerous factors of instability (growing payments and trade deficit, supposed-fixed exchange rate, banking sector braking into high-risk markets) without a solid institutional control. In 2014, this fragile balance collapsed with the upsurge of a conflict with Russia, during which the industrial region of Donbass was occupied and Crimea was annexed. This geopolitical crisis ended up seriously affecting the local economy and, more precisely, the Ukrainian banking sector.
- The old Ukrainian institutions, especially its unreliable judiciary system, have not been able to ensure a safe right to property. Such structural weaknesses prevented lenders from recovering their collaterals and thus triggered an over-accumulation of NPL's in the market. These have become burdens for banks, associated with frequent illegal practices and frauds that have caused losses of several billion dollars in the past years.
- Under the pressure of international partners, especially the International Monetary Fund, the European Union and the World Bank, some reforms have been achieved by the National Bank of Ukraine (NBU), which has been deeply rebuilt. These initial measures (higher prudential ratios, tighter control and transparency procedures, nationalization of too big to fail banks...) allowed to contain the systemic risk and triggered the closure of more than 80 Ukrainian banks. Moreover, the NBU pushed for the creation of a guarantee fund in charge of NPL's liquidation.
- Banks find now themselves in a crisis-stricken country, where most economic actors are not bankable. They rely on side markets (such as consumer lending) to preserve a rather high profitability rate, but their client panel remains limited. These banks operate in two main fields. The first is the over-competitive market of multinational firms: these companies are highly reliable and thus highly sought-after in such a risky country. The second market, local firms, is subject to a strong information asymmetry: it is often difficult to understand *a priori* if

an actor will be a bad payer or not; spotting good payers is a rare and precious skill.

- Nevertheless, given the high local interest rates, and the State obvious refinancing needs, most banks have seen Ukraine as an easy and accessible market opportunity. Hence, taking advantage of this financial windfall, the banks' Returns On Equity have been significantly high, especially for private international banks established in Ukraine, with rates reaching over 35%.
- But the NBU has now regained control of these rates, which are starting to decrease. The more traditional markets are beginning to redevelop. As a result, the country now needs more legal security in terms of property ownership and further reform of the Ukrainian institutional system.
- Meanwhile, some healthy economic actors have managed to play a role in the game and have found clever ways to replace banking activity. In parallel, some new promising economic sectors, such as IT and digital, are rising and may actually participate in the cleaning up of the banking system through more controlled and controllable transactions. However, the Ukrainian economy remains fragile and is waiting for a firmer consolidation and a deeper transformation, in line with the expectation of the western international community.
- The NBU has a crucial role in this transformation of the Ukrainian system: the rebuilding of this institution was extraordinarily simple in comparison with the structural transformations it triggered. Its pivotal role allowed the implementation of a sustainable transformation of the institutional, economic and political systems. However, there remain some key challenges to be solved: the success of the reform of the judiciary system, which is still gangrened by corruption, and the achievement of the land-market liberalization reform.

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# Introduction

The current situation of the Ukrainian banking sector is the result of a profound upheaval over the last ten years.

Between 2008 and 2014, the number of banks in this country of around 40 million inhabitants amounted to over 180 and the Ukrainian banking sector started accumulating uncontrolled amounts of Non-Performing Loans (NPL). In parallel, a severe monetary crisis started affecting the Ukrainian economy from 2008. The Hryvnia, Ukrainian's local currency, was devaluated from a 5:1 to an 8:1 rate following the international economic crisis of 2008<sup>1</sup>, which then suffered from a sharp decrease by 50% during the Euromaidan revolution, from 2014 to 2015, resulting in an inflation of around 45%<sup>2</sup> in 2015.

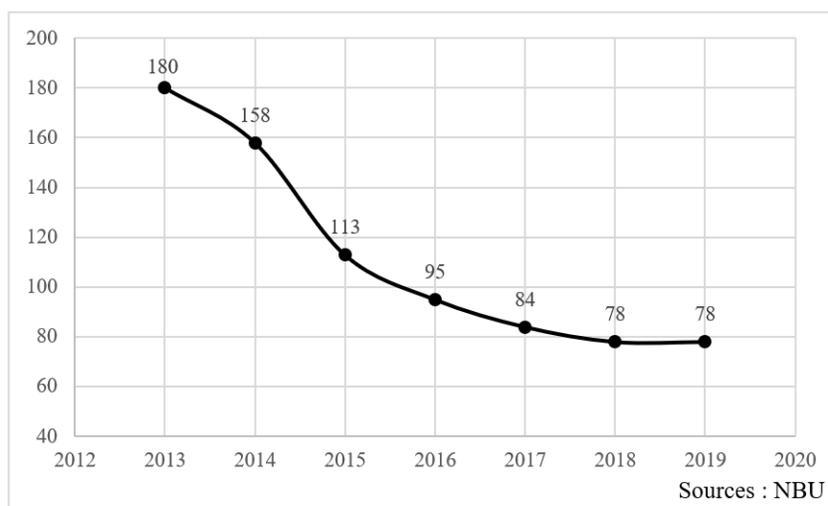


Figure 1: **Number of banks in Ukraine from 2005 to 2017**

At present, the number of banks has shrunk to 76 and 46% loans of the total Ukrainian portfolio are still non-performing. These are massively owned by national public banks, which are the main suppliers of Ukrainian private clients', and have seriously eroded the confidence in the whole banking sector.

<sup>1</sup>Cf. Figure 3: Hryvnia exchange rate variation

<sup>2</sup>Cf. Figure 7: Inflation rate

The country has currently one of the lowest loan-to-GDP ratios in the world (43%<sup>3</sup>, i.e. 3.5 times lower than the Euro area).

Even if, since the nationalization of PrivatBank (the former biggest Ukrainian bank, a too big to fail), the systemic risk has decreased, the Ukrainian banking sector remains indeed in turmoil. Gradually, and despite the uncertainties that persist, the situation is however moving towards a more efficient banking market.

First of all, this report suggests focusing on this crisis, by elucidating its symptoms and effects on the Ukrainian market. This downfall led to a period of restructuring of the Ukrainian banking sector, which will be then further described. However, this restructuring still presents some significant challenges, which may determine the completion of this institutional transition.

## Part I

# The Crisis: A symptomatic analysis

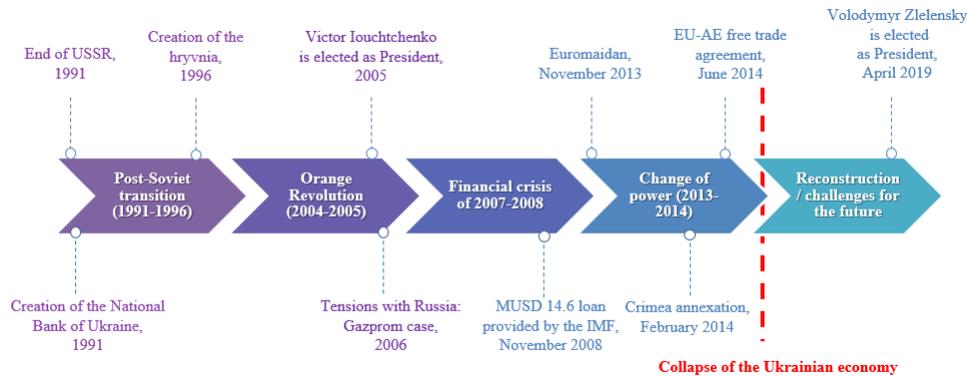
After the fall of the Soviet Union, the entire productive apparatus of Ukraine became available at an extremely low value. At that time, owning capital, even in small amounts, made it possible to buy a large part of the country's industrial and agricultural resources. Thus, oligarchs quickly managed to seize most of the local high-return sectors (mining, energy, land...) at the time of the first privatizations<sup>4</sup>. The greater their financial power, the more they contributed to the locking up of the political-media environment, hindering any institutional evolution.

This post-soviet history of the Ukrainian economy was marked by macroeconomic instabilities, which came out since the 2008 crisis. The geopolitical tensions with Russia finished unveiling the considerable risks that the banking system had accumulated. This situation thus caused systemic instabilities in the whole banking ecosystem.

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<sup>3</sup>According to a study of the BIS of 2016

<sup>4</sup>*Enjeux industriels du post-socialisme : capitalisation et entreprisation*, Bomsel 1995



## The accumulation of macroeconomic instabilities

Before the financial crisis of 2014, Ukraine experienced a decade of euphoria, enabled by favourable external conditions. The country had a high potential for deposits (in 2006, less than 40%<sup>5</sup> of Ukrainians had a bank account) and a high number of loans in US dollars before 2008 (from 2004 to 2008, the Ukrainian banks foreign debt has increased by USD 36.8 bn<sup>6</sup>). Moreover, Ukrainian growth averaged 7 percent annually between 2000 and 2007<sup>7</sup>, mostly driven by external investments.

However, during the decade before the crisis, some macroeconomic instabilities have accumulated. Payments and trade deficit started growing, with an Import/Export ratio reaching 1.22 in 2013 (its maximum since Ukrainian independence)<sup>8</sup>, and the banking sector was braking into high-risk markets without any solid institutional control.

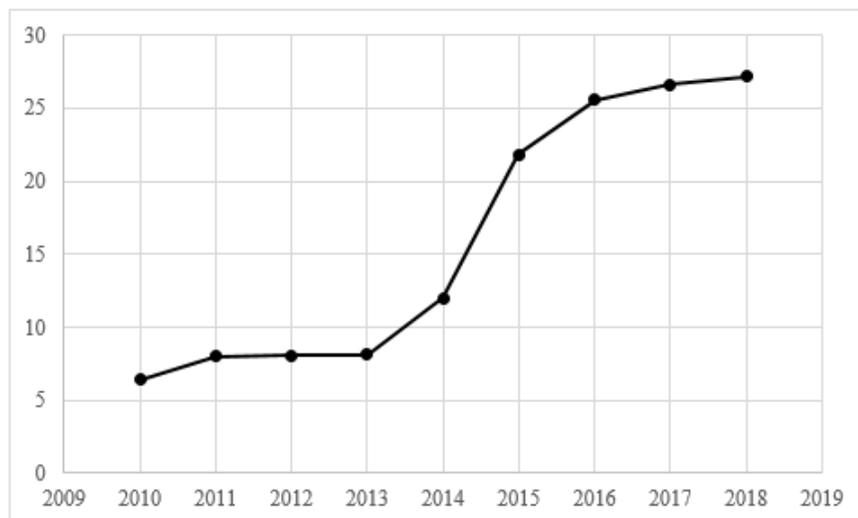
<sup>5</sup>Ukraine: Systematic Country Diagnosis, World Bank, 2017

<sup>6</sup>A Financial World under stress: Where can Ukrainian banks tap resources?, Dominique Menu, 2008

<sup>7</sup>Ukraine: Systematic Country Diagnosis, World Bank, 2017

<sup>8</sup>World Bank

## The economic impact of the geopolitical crisis



Source : NBU data

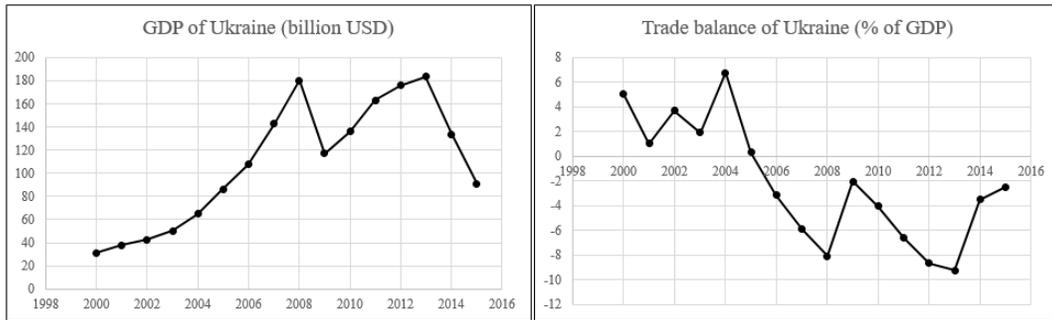
Figure 2: Hryvnia exchange rate variation (for 1 USD)

The military conflict with Russia in the eastern regions of Ukraine hit its economy. It caused a significant decrease in the industrial production and revenues in Donbass, which disrupted the confidence in the Ukrainian economy. Donetsk Region provided a fifth of the national industrial production and was one of the leading Ukrainian regions for basic industry and agricultural goods production<sup>9</sup>. This conflict also affected relations with Russia, one of its major trading partners. Consequently, the Ukrainian GDP dropped from \$183.3 to \$91.03 billion<sup>10</sup> and the Hryvnia was devalued by 50%<sup>11</sup>.

<sup>9</sup>Ministry of Foreign Affairs of Ukraine

<sup>10</sup>Cf. Figure 3

<sup>11</sup>Cf. Figure 2



source : World Bank

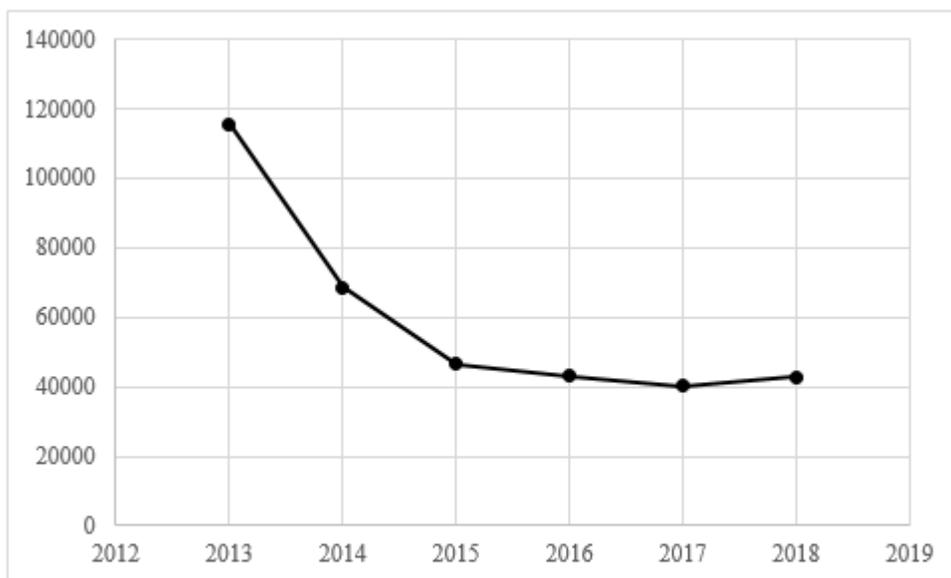
Figure 3: GDP and Trade balance evolution from 2000 to 2016

## The unveiling of the banking sector's risks by the financial crisis

The lack of information and transparency in companies' accounts did not prevent foreign investors from massively investing in the country during the decade preceding the crisis<sup>12</sup>. For instance, private companies' foreign debt grew from USD 10.8 bn in 2004 to USD 32.0 bn in 2008<sup>13</sup>. Assessing the financial health of companies was difficult since accounting standards were not uniformly applied by local economic actors<sup>12</sup>. Relations and loans between companies were also unclear<sup>12</sup>. The financial crisis unveiled these hidden risks and the lack of transparency in market practices.

<sup>12</sup>How do foreign banks analyze the requests of financing from Ukrainian banks on the international market?, Dominique Menu, 2005

<sup>13</sup>Turbulences in the Financial World: Lessons for Ukrainian banks ?, Dominique Menu, 2007



Source : NBU data

Figure 4: **Total assets in the banking sector (mEUR)**

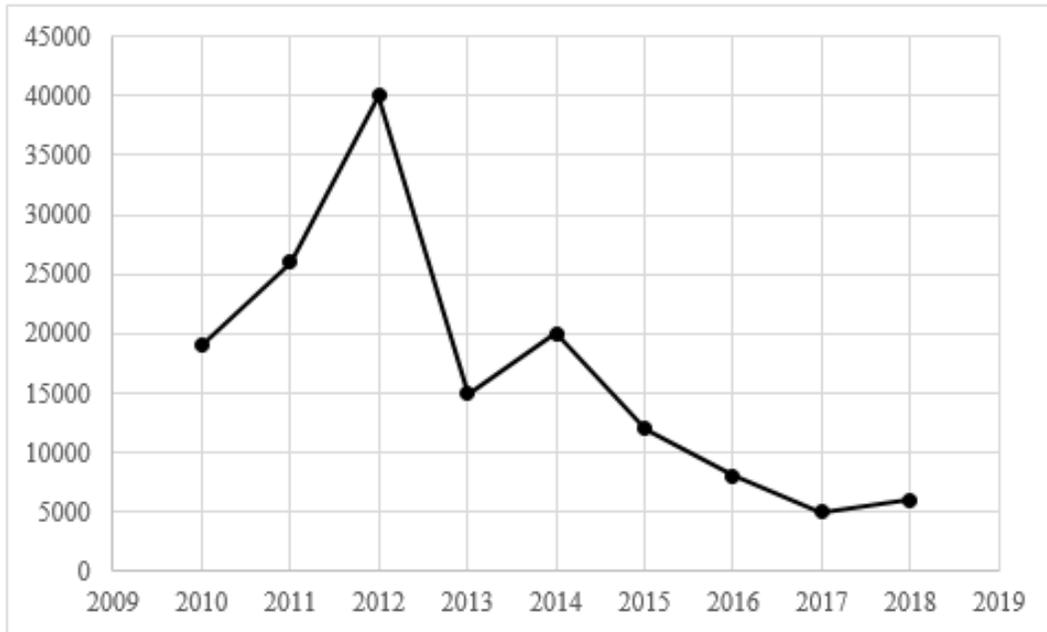
Before 2014, information on boards' composition of Ukrainian banks was extremely scarce and prudential ratios were insufficient<sup>14</sup>. Ownership remained often hidden, through offshore companies, which prevented firms from respecting mandatory legal compliance procedures<sup>12</sup>, while vested interests were almost uncontrolled and unregulated. Ukrainian deposits were often used for self investments in personal businesses of banks' owners. As a result, a catastrophic situation emerged during the crisis, with 85 bank closures and bankruptcies between 2013 and 2016<sup>22</sup>.

Additionally, the market experienced an upsurge of inter-bank loans<sup>15</sup>. During the crisis, a strong risk of payments suspension of these loans appeared, creating a severe threat of systemic crisis.

In such a situation, savings were in peril, especially after the almost collapse of the major Ukrainian bank Privatbank, which intensified the threat of a breakdown in Ukraine's economy.

<sup>14</sup>Panorama du secteur financier en Ukraine, Dominique Menu, 2015

<sup>15</sup>CEIC Data



source : NBU data

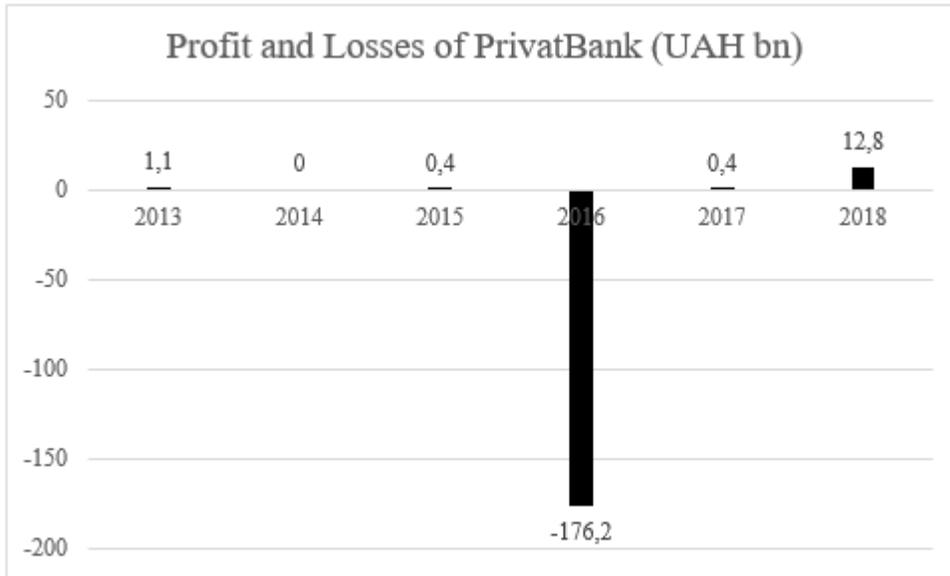
Figure 5: **Interbank loans (mUAH)**

### **Privatbank**

Privatbank still holds almost 21% of the market share in total assets<sup>16</sup>, thus representing the largest commercial bank in Ukraine. The massive systemic risk triggered by this sole bank, whose ratio of non-Performing Loans had almost exceeded 87%<sup>17</sup>, forced former President Poroshenko's government to nationalize it in 2016. Privatbank is one of the most characteristic examples of an environment dominated by vested interests and non-transparent practices.

<sup>16</sup>2019 data, NBU

<sup>17</sup><https://concorde.ua/rs/daily/item72649/>



Source : PrivatBank annual reports

Figure 6: PrivatBank profit and losses (UAH bn)

After its nationalization, Ihor Kolomoisky, who held more than 49 % of Privatbank, was accused by the association *Organized Crime and Corruption Reporting Project* of having stolen over \$5.5 billion from the bank’s fund<sup>18</sup>.

## Part II

# The Restructuring of the Banking Sector

After the Maidan revolution, three major partners, the International Monetary Fund, the European Union and the World Bank, started providing financial support to the Ukrainian government to foster the development and implementation of institutional reforms.

On February 27, 2015, the IMF agreed on the allocation of a first Ex-

<sup>18</sup>Financial Times

tended Fund Facility of four years amounting to around \$17.5 billion<sup>19</sup>. This disbursement was conditioned on strong economic reforms with particular stress on transparency, financial stability, and free-market policies. The IMF has been, indeed, the most important actor of the NBU's rebuilding, supporting the design of new sustainable grounds for the development of a healthy banking system. In parallel, the EU-Ukraine Association Agreement (signed in May 2014), designed a financial support plan to facilitate the rapprochement with Ukraine. It provided a 1.5 billion € budget, disbursed between 2014 and 2018<sup>20</sup>. Finally, the World Bank also provided an important financial assistance of \$5.5 billion in May 2014<sup>21</sup>.

Consequently, after this new shift in Ukraine's political and economic spectrum, banks reoriented their businesses towards European and Western partners while abandoning their previous activities with Russia.

The banking sector experienced a cleaning-up process, mainly fostered by a restructuring of the NBU. A new rebalancing of the situation was progressively achieved, as a result of this new regulatory environment. This forced banks to explore new types of customers, products and market opportunities.

## **A cleaning up of the banking sector: restructuring the NBU**

Before the restructuring of 2014, the NBU employed almost 12 000 employees<sup>22</sup>. More than half were working on side businesses. Under the supervision of the World Bank and the IMF, the NBU began its restructuring by following the example of the National Bank of England. In this way, the NBU decided to focus on its core business: controlling the banking system. The NBU redefined its strategy and drastically reduced its number of employees to 5000<sup>22</sup>. The central bank used to be divided into 25 small regional banks, which were then gathered into one office in Kiev to implement a more efficient decision-making system<sup>22</sup>.

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<sup>19</sup>Memorandum of Understanding between Ukraine and the IMF (2016)

<sup>20</sup>Cf. interview with Trade and International Financial Cooperation department at the Delegation of European Union

<sup>21</sup>Data from the World Bank

<sup>22</sup>Cf. Appendix B: Restructuring the NBU

## What has been the new NBU's reaction to the crisis?

After its reorganization, the new National Bank started a stabilization process of the Ukrainian banking system. It identified several systemic risks of the banking market<sup>22</sup> such as credit risks, capitalization, liquidity, legislative perspective, foreign currency, banks profitability and shadow banking. To tackle these risks, the NBU implemented four key measures:

- New regulations on banks' governance and transparency
- Nationalization of Privat Bank that was "too big to fail"
- Implementation of different reserve and ratio requirements
- Monetary policy controlling key rates

These stricter rules and requirements compelled pocket banks to close. Moreover, the new NBU imposed strengthened transparency policies, which led banks, for example, to unveil the constitution of their boards. A large number of pocket banks decided to stop their activities because of these new requirements (in 2005, more than 125 out of the 162 banks held less than \$150 million as their total amount of assets<sup>23</sup>). Overall, more than 100 banks were closed. Nationalization of *too big to fail banks*, such as OschadBank or PrivatBank was also a direct effect of the NBU's new policies. Finally, to tackle the NPLs, the NBU decided to engage a rebuilding of the Deposit Guarantee Fund (created in 1995) giving it the mission to gather and liquidate them.

## A stricter control on bank's accounting systems

The drastic reduction in the number of Ukrainian banks in the last five years is primarily the result of the new accounting regulations introduced by the NBU, and not, as one might believe, by the financial crisis as such.

In fact, these new regulations imposed much greater control over the assets reported on banks' balance sheets. Where these proved to be insufficient, additional provisions were imposed, which forced them to recapitalize. The new regulations imposed a much greater control on the assets reported in the balance sheets of banks. For this reason, many banks, which were too fragile, threw in the towel and decided to close.

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<sup>23</sup>IMF country report 05/4016, 2005

## A ban of loans in foreign currencies

Among its first reactions to face the 2008 crisis, the NBU decided to ban loans in foreign currency. In fact, given the fluctuations and the inflation of the Hryvnia<sup>24</sup>, a large number of loans became uncontrollable for Ukrainians, who were often paid in local currency. The share of retail loans in foreign currency increased from 40.7% in 2003 to 65% in 2007<sup>25</sup>. This situation contributed to the financial instability of Ukraine and was thus one of the first issues to be tackled by the institution.

## The NBU control of the monetary policy

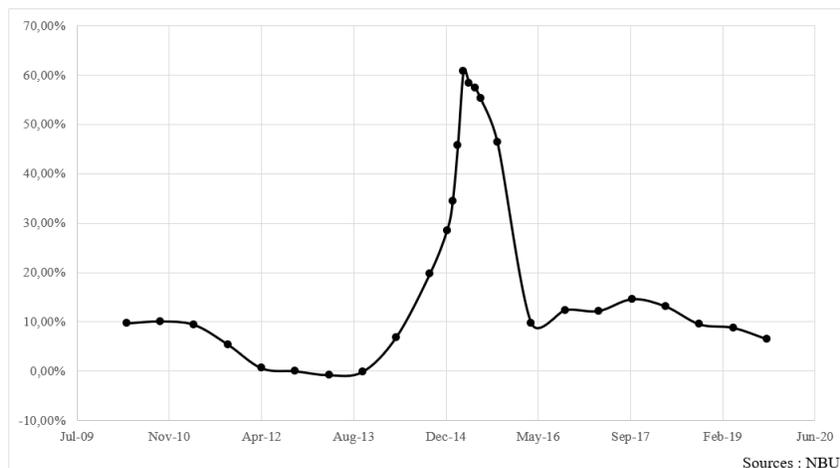


Figure 7: Inflation rate

Without considering the devaluation of 2014, inflation had always been poorly controlled in Ukraine ( $\simeq 10\%$  in the last years<sup>24</sup>). One of NBU's major objectives was, therefore, to impose a fixed inflation goal (of around 5%) to ease the long-term development of the economic activity.

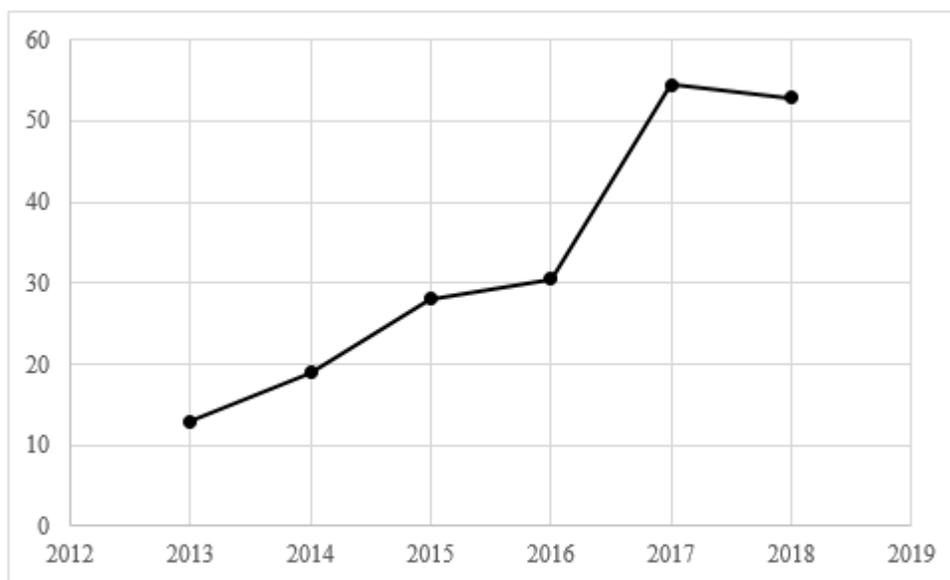
As a result, the inflation rate has started to slightly decrease from 2017<sup>24</sup>, edging down from around 10% to 7.5% in mid-2019. This strengthened NBU's confidence in a re-stabilization of the national economic activity, although the sustainability of these efforts still remains under concern.

<sup>24</sup>Cf. Figure 7: Inflation rate

<sup>25</sup>Source : National Bank of Ukraine (2016)

## Guaranty fund and NPL

Non-performing loans proliferated because of the weaknesses of the judiciary system which was unable to guarantee banks to recover their collaterals. Moreover, given the sharp devaluation of the Hryvnia, foreign currency loans became unaffordable for most Ukrainian borrowers.



Source : NBU data

Figure 8: **Amount of non-performing loans (% of total loan amount)**

Investment activities were thus disrupted. In order to support banks to recover their loans, a Deposit Guarantee Fund (DGF) was created. It gathered \$25 billion of NPLs after the crisis (80% on real estate) on which 10% of the principal<sup>26</sup> was expected to be recovered.

Supported by international specialists (KPMG, Lazard and the EBRD), the DGF designed a structure where brokers were remunerated for bringing auctions winners. Loans not sold during the auctions are pooled with healthier assets to create attractive investment packages. As of today, the Guarantee fund has recovered \$1 billion, by selling over 40% of its initial portfolio<sup>26</sup>.

<sup>26</sup> Cf. Appendix C: Recovery of Non-Performing Loans

## Description of the Banking market & the banks' business model

The high inflation rates of the past years have triggered high real interest rates (i.e. the difference between actual interest rates and inflation<sup>27</sup>) since borrowers are supposed to pay for two kinds of risks: the regular risk and the risk of inflation variations. Even if loan rates, which average 30%<sup>27</sup>, can seem enormous in comparison with western countries, these have to be compared with Ukraine's high inflation rates, that amounted to over 10% before March 2018.

Conversely, deposits in Ukraine have since been less attractive compared to loan rates (around 3 times lower)<sup>27</sup> and close or, as before 2015 and in 2017, lower than inflation<sup>27</sup>.

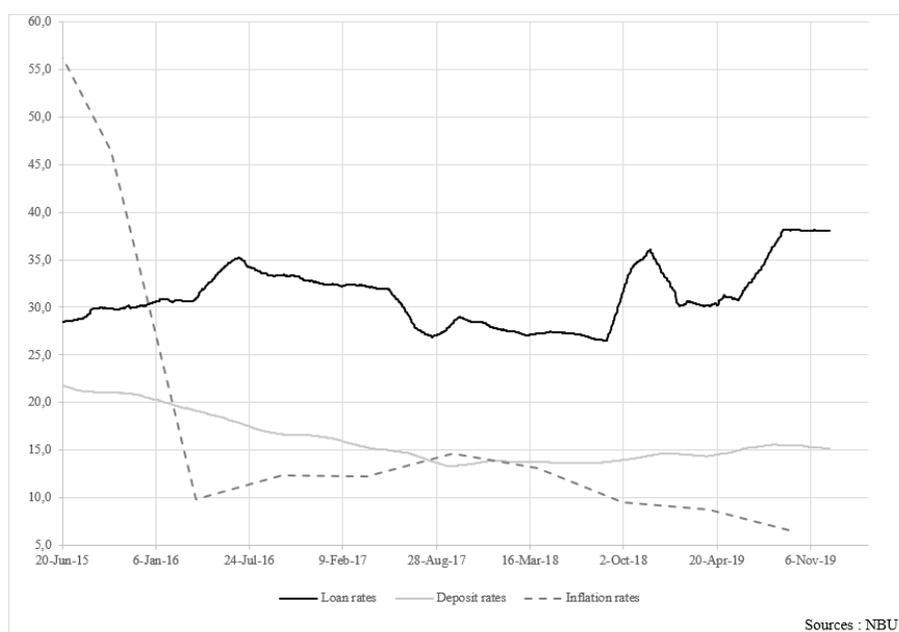


Figure 9: Interest rates for loans, deposit, and inflation rate

Given the Ukrainian highly profitable real interest rates, reaching 30% in 2014<sup>28</sup>, banks have used the State's refinancing needs as an easy and acces-

<sup>27</sup>Cf. Figure 9: Interest rates for loans, deposit and inflation rate

<sup>28</sup><https://www.bbc.com/news/business-31721332>

sible market opportunity<sup>29</sup>. Most of them, have accumulated state treasury bonds<sup>30</sup>, resulting in ROEs of around 35% for some private banks<sup>31</sup> ; state-owned ones still staying unprofitable.

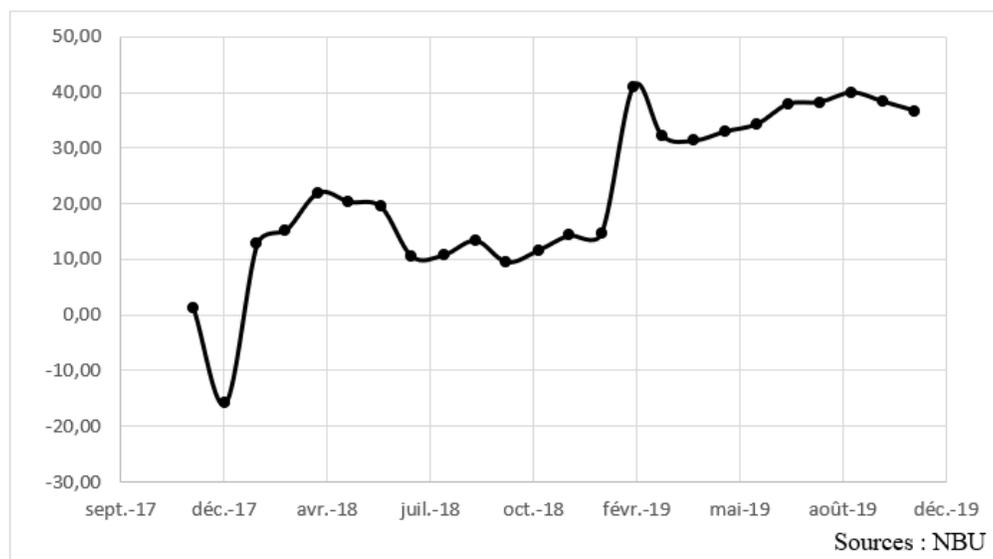


Figure 10: **Return on Equity in the banking sector (in %)**

However, this situation is not sustainable for different reasons. First of all, inflation rates are currently sloping downwards, from 60% in December 2014 to 10% in May 2016<sup>32</sup>. Moreover, the NBU has restricted lending regulations and has fixed financial stability measures to progressively lower interest rates (13.5% as of December 2019<sup>33</sup>).

<sup>29</sup>Cf; Figure 11: Ukraine 1 year Bond

<sup>30</sup>Confidential source from Ukrainian banking actors

<sup>31</sup>Cf. Figure 10: Return on Equity in the Banking sector

<sup>32</sup>Cf. Figure 7: Inflation Rate

<sup>33</sup><https://tradingeconomics.com/ukraine/interest-rate>



Source : [www.tradingeconomics.com](http://www.tradingeconomics.com) / NBU data

Figure 11: **Ukraine 1 year Bond (%)**

### The decrease of interest rates and its implications for the Ukrainian banking system

Interest rates have been systematically dropping since October 2018, from 18% to the current 13% of December 2019<sup>34</sup>. This should bring back into the market borrowers who were previously deterred by high rates and trigger a higher competition on deposits. Such a decrease should thus put an additional pressure on banks to increase lending to businesses and households.



Source : [www.investing.com](http://www.investing.com)

Figure 12: **NBU benchmark interest rates (%)**

<sup>34</sup>Cf. Figure 12: NBU benchmark interest rates

Therefore, banks are currently exploring new market opportunities and customers, such as Ukrainian and international companies, in order to preserve their profits.

### Different types of banks in the market

Three different types of banks can be distinguished in the Ukrainian ecosystem. First comes public banks, among which Privatbank (which was nationalized), have a rather low profitability. Their main activities consist of state financing and holding private individuals' deposits. The second kind is local banks, which account for a high number of banks but less than 20%<sup>35</sup> of total Ukrainian assets; they cannot be considered as actual competitors for the other major banks. Multinational banks compose the third type and have a considerable presence in Ukraine. Despite recent difficulties, the market still possesses a high potential; competition among these actors is fierce.

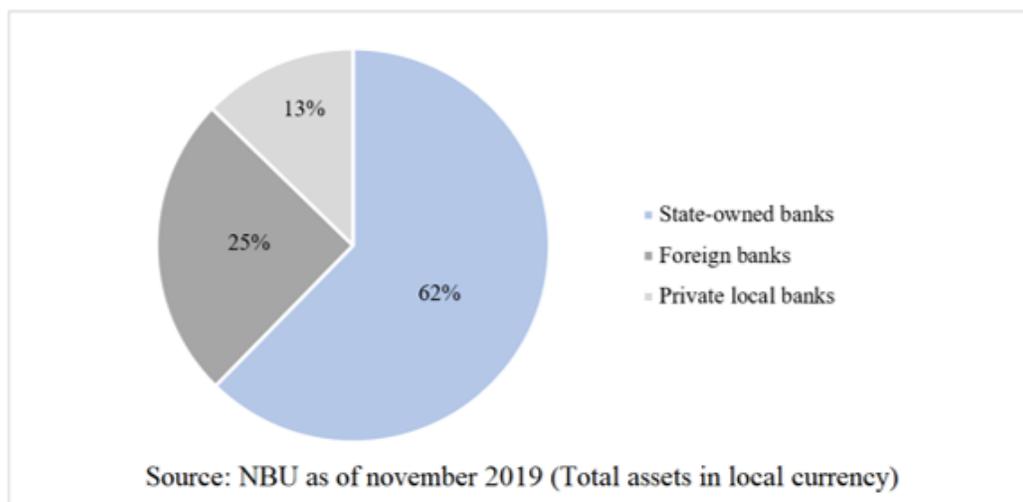


Figure 13: Share of assets in the banking sector

### The Ukrainian market

L'absence de comptes audites gênent les banques étrangères. Mais c'est surtout le système judiciaire qui nous freine.]

<sup>35</sup>Source: NBU as of november 2019 (Total assets in local currency)

In addition to the deficiencies of the judiciary system, the under-development of accounting management and processes has highly affected the Ukrainian economic environment: the important business cultural differences with western partners and the lack of education of managers are key challenges<sup>36</sup> for local companies. Besides, the lack of transparency in business activities (on shadow transactions for example) does not encourage companies to develop their accounting systems. Most companies are not complying with western regulations. As a result, international banks are not eager to collaborate with Ukrainian companies because of the judicial risk that this situation leads to.

In such a plagued environment, multinational firms and Ukrainian exporting companies (IT, agriculture, manufacturing,...) are among the only safe borrowers and become the banks' favorite customers. The competition is thus high in this market.

Local companies are another important market, characterized by a strong *information asymmetry*: the ability to understand and classify the clients' reliability requires real expertise from banks, that impacts on their market share. The Austrian bank Raiffeisen Aval, for instance, is one of the most profitable banks in the local companies sector because of its strong knowledge of the Ukrainian market<sup>37</sup>; the bank had the opportunity to build a long trust relationship with its customer base. To mitigate the information asymmetry problem, specific partnerships have emerged such as the partnership of Ukrsibbank with the private equity fund manager Horizon-Capital<sup>38</sup>. The latter's strong ability to spot profitable firms in Ukraine has enabled them to support Ukrsibbank in its research for bankable clients.

Finally, most banks try to diversify their offers, by looking towards new side markets (loans to premium clients, consumer loans...) to preserve their profits in this very competitive and technical market. These represent a substantial part of their current activities in Ukraine, 15-16% of Raiffeisen's portfolio for example<sup>37</sup>.

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<sup>36</sup>Cf. Appendix F: Interview with the UGCA, an Academy funded with the support of INSEAD and designed to teach better management practices to companies

<sup>37</sup>Cf. Appendix D: Interview with Raiffeisen

<sup>38</sup>Cf. Appendix D: Interview with Horizon-Capital

## **Four examples of major international banks<sup>39;40</sup> (*Field study*): key figures**

### **Ukrsibbank: focus on consumer loans and large international companies**

Ukrsibbank faced strong difficulties during the Maidan crisis. Since then, the French-owned bank has designed new internal policies to further limit loan risks. Its amount of deposits is high, financed mostly by small structures as SMEs and private individuals (the total amount of deposits from retail clients reached USD 660.28 in 2019 ), whereas its lending activity is still underdeveloped (USD 907.68 bn was the total amount of loans issued by the bank in 2019 for both corporate and retail clients). The bank is mostly used to lend to large international firms because their accounting processes are cleaner and the bank has built a good network of clients in this market (Ukrsibbank lent a total amount of USD 729.31 bn to corporate clients in 2019, which represents 80% of loans during this year).

Given the high competition in this market, the bank decided to extensively get into consumer lending (it was among the first banks in Ukraine to create such loans). The amount of these credits is low (it represents a USD 178.37 bn market in 2019), which leads to small annuities and encourages consumers to borrow them. Moreover, for the same reasons, the chances of being paid back are much higher than, for example, in the case of mortgages<sup>41</sup>. This side market is thus an important complementary source of income for Ukrsibbank.

For the next years, the French bank aims to increase its market share in premium and digital clients. The bank closed 177 branches in 5 years, in order to focus on larger cities and further invest in its digital platforms.

### **Raiffeisen: focus on clients' proximity**

Raiffeisen is one of the largest banks in Ukraine. The Austrian bank focuses on its large and loyal customer base, composed of more than 2.5 million clients, and an extensive local presence through a high number of agencies (more than 500 ) spread on the whole Ukrainian territory. The bank's main

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<sup>39</sup>Cf. Appendix D: Interviews with international banks

<sup>40</sup>Confidential sources from Ukrainian banking actors

<sup>41</sup>Cf. Appendix D: Interviews with international actors

focus was also to invest in the agriculture sector, which allowed it to face the crisis and to reach a 30% growth during this period. Its deposit-to-loan ratio is thus balanced thanks to a sustainable bucket of clients.

Raiffeisen is also active in the consumer loan market (15-16% of its portfolio), but it wishes to invest in the IT and mortgage sectors when market access barriers will be dismantled, in order to progressively reduce this activity.

### **Crédit Agricole: focus on the Agriculture sector**

Crédit Agricole is highly engaged in the agriculture sector, which is large and stable in Ukraine and has the peculiarity to focus on exports and international clients. The bank developed an expertise in this market and is now able to allow credits to a large number of clients; more than 8% of farms of more than 100ha are Crédit Agricole's clients. Thanks to these activities, it managed to maintain a lower NPL rate than other competitors (only 20% in 2014 with 9% interest rate compared to 5% with 3% interest rate in 2019<sup>42</sup>), which enabled it to preserve more stable profits during the crisis. Crédit Agricole has also targeted other channels (upstream and downstream) by slowly extending its client network. Its deposit-to-loan ratio (1.17 loan to deposit ratio for the local currency loans and 1.50 for the foreign currency ones) is balanced by the growing agriculture sector, which represents in total a USD 178.37 bn market in 2019

### **Alfa Bank: an expertise in the Ukrainian legal system**

Alfa Bank also uses deposits from small structures to finance credit to larger companies. It invests in consumer loans as a side market, but it is above all one of the most important banks in the secondary market<sup>43</sup>. The particularity of Alfa Bank is its ability in NPLs recovery (20% of nPLs after the crisis<sup>43</sup>). Instead of directly suing companies in the case of a non-payment, the bank hires external lawyers to find a compromise with the different actors. Alfa Bank is very familiar with the Ukrainian legal system and has an excellent knowledge of Ukrainian social peculiarities. It is also less threatened by international legal constraints since its headquarters are based on Moscow.

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<sup>42</sup>Cf. Appendix D, interview with Crédit Agricole

<sup>43</sup>Cf. Appendix D: Interviews with international actors

These represent unique competitive advantages that are extensively exploited by the bank.

## **New opportunities**

### **Local economic agents and bankability**

Most companies, as mentioned before, are not bankable in Ukraine and, given the high lending risks, interest rates are too high to enable healthy companies to borrow<sup>44</sup>. However, some of them have managed to adapt to this particular economic environment. Odessa's real estate company Prostransvo is an interesting example of such a firm: the risks of their real estate projects are carried by both Prostransvo and the buyers. In their system, the earlier one buys, the lower the cost of a house is, but the buyer takes the accommodation's construction risk. Other economic actors in the region have implemented several systems to replace the non-existent banks lending activity, such as Adis Auto, a car concessionary which car models differed depending on the consumption loans to which they were linked<sup>44</sup>.

### **Digital transformation: a growth opportunity for banks**

The banks' collection of information is impaired by the shadow economy (30-50% of Ukraine's GDP<sup>45</sup>) and corruption. However, the current rise of transaction transparency has developed the banking activity: payments through card transactions have almost increased sixfold in ten years<sup>46</sup>.

Moreover, the advent of governmental open data (for example, by implementing online public procurement systems) has helped to develop an agile and efficient public administration. For example, fines can nowadays be directly sent to companies through online systems, so that proofs can no longer be destroyed. This digitalization process has contributed to the fight against corruption. Increasing the quantity of available information through digital means could thus help to improve the bankability of private individuals and companies.

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<sup>44</sup>Cf. Appendix E: Interviews with local economic actors

<sup>45</sup>Cf. Appendix D: Interviews with Raiffeisen and UkrSibbank

<sup>46</sup>Cf. Figure 14: Number of credit card transactions

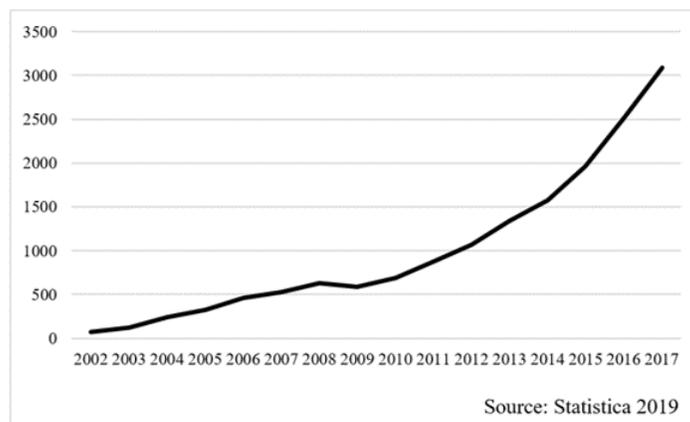


Figure 14: **Number of credit card transactions in Ukraine (in million per year)**

## IT: a sector to invest in ?

IT is a growing sector in Ukraine: the country has a great expertise (500 000 well-qualified new engineers per year<sup>47</sup>) and its cost of workforce is very low compared to other European countries (average Junior IT salary is three times higher in Ukraine than in Poland<sup>48</sup>). Moreover, the sector is boosted by its proximity to the European Union, an area with high demand for IT services, and little entry barriers. The rise of FinTechs in the country is emblematic of the tactical position of the sector<sup>49</sup>.

IT is also a strategic market for banks, both at a company and individual levels. Its connections with foreign markets provide stability and foreign currencies inflow (IT exports reached \$3.6 billion in 2017, 3.4% of GDP<sup>50</sup>). However, at present, the sector's demand in loans is quite low, mostly financed by foreign capitals (96% of total ICT investments in 2017<sup>51</sup>) and banks merely host deposits from employees.

A characteristic example of a leader of the Ukrainian IT world is the retailer Citrus, one of the recent success-symbols of the local Hi-Tech market. Such a company is not only a proof that this sector is raising, but also a new

<sup>47</sup>Cf. Appendix D: Interview with Horizon Capital

<sup>48</sup>IT Outsourcing Review: Ukraine

<sup>49</sup>*Fintech Nation: Ukraine*, from the Disruption Banking magazine

<sup>50</sup>Unit City Report

<sup>51</sup>AVentures

example of opportunity for banks. Its business model is based on a partnership with banks, through consumer loans that they themselves subsidize.<sup>52</sup>

## Part III

# Future Challenges

International partners are currently pushing the Ukrainian government to pursue the implementation of its structural reforms. The IMF has approved a new and shorter financial support in December 2018: a Stand-By Agreement of US\$3.9<sup>53</sup> putting an additional stress on the development and liberalization of the land market, the intensification of transparency measures and the rebuilding of the judiciary system. These measures are the main conditions on which are based the disbursement and reviews of its loans. In the past weeks, the IMF decided to unlock a new 5.5 US\$<sup>54</sup> billion which had been stalling due to the slow progress of reforms. On this occasion, Ms Georgieva, the Managing Director of the International Monetary Fund, underlined the urgency for Ukraine to "strengthen the rule of law, enhance the integrity of the judiciary, and reduce the role of vested interests in the economy"<sup>54</sup>. Besides, the convergence of the legal and judiciary system within the European Union is also one of the main conditions of the EU-Ukraine Association Agreements.

The restructuring of the Ukrainian banking system is characterized by a transition towards the rule of law, through the depersonalization of relations. The current effects of such a transformation can be observed in the light of two notable examples, the judiciary and the land-market reform, which may both have a considerable impact on the banking sector's evolution.

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<sup>52</sup>Cf Appendix E: Interview with Citrus

<sup>53</sup>International Monetary Fund Press Release No. 18/483

<sup>54</sup>International Monetary Fund Press Release No. 18/392

## Personal relationships and institutional transformation

The problem of corruption that we observe from our Western perspective is seen as a wound that cripples the Ukrainian society. Institutions are corrupted, especially judiciary authorities and, consequently, the system as a whole.

However, such a subjective point of view might not be appropriate to observe this phenomenon: corruption is first and foremost the sign that the Ukrainian society is built as a clan system. As some interviews with local actors<sup>55</sup> underlined, corruption is above all a culture, a natural system that reigns since the fall of the Soviet era, which was inherited from these times.

This situation can easily be analysed in the light of the theory of Social Orders developed by Douglass C. North, John Joseph Wallis and Barry R. Weingast in *Violence and Social Orders* (published in 2009). The structure of the society and the relationship between people and Law can be observed through the level of personalization of relations. The book opposes limited access orders with open access orders. The firsts are governed by power relations which structure the clan-based links between individuals. The seconds, conversely, are regulated by solid institutions that ensure their right to property. Similarly, the firsts are marked by the preponderance of *personal relations*, whereas the seconds by the *depersonalization of relations*.

Ukraine is a typical example of a country in transition from a Limited Access Order to an Open Access Order. Institutions, such as the National Bank of Ukraine, strive to fix legitimate playing rules. Law courts are progressively moving towards a structural reform in order to ensure the respect of these rules. Finally, relations are depersonalized in the administrative and banking systems, where digitisation has never been so strong. These changes in the system are supported by the pressure of international western partners, which inspire new local institutions through their well-established examples of Open Access Orders.

A symptomatic example of this transition is the decrease in the number of banks. Only a few of them were effectively closed by the NBU. Most of them decided to stop their activities on their own initiative because the new rules determined by the NBU and the new "transparency-oriented" environment

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<sup>55</sup>Cf. interviews with DeJuRE and UGCA

was not suitable anymore. *This change of rules is the real driving force of the banking environment transformation rather than the specific suppression of singular banks.*

Similarly, a paradigm shift can be noticed in the relationship of Ukrainians with administrative procedures and financial information flows. Both of these processes are easily tracked and controlled through digital systems, which explicit information and enable a transparent overview of transactions. This new depersonalized environment consequently makes shadow transactions impossible.

*The true challenge which persists in Ukraine is mainly societal. The country should aim to enable a transition from the current Limited Access Order structure to a state equipped with modern, transparent and reliable institutions capable to ensure a predictable and unbiased market for its economic actors.*

## The reform of the judiciary system<sup>56</sup>

Beyond the rebuilding of the NBU, the second major pillar of the structural reforms engaged by the Ukrainian administration since the Euromaidan revolution has been the transformation of its judiciary system. It is, indeed, still one of the less trusted in the world (10% public trust), with a user satisfaction of around 50%<sup>57</sup>. In 2013, a Transparency International Global Corruption Barometer report showed that 66% of the Ukrainian public considered the judiciary to be the most corrupt institution in the country<sup>58</sup>. Moreover, most institutions, which are supposed to ensure the correct functioning of the rule of law, still lack of efficiency. Very few judgments are actually executed: according to the Ministry of Justice, only 20% of courts decisions are really carried out<sup>59</sup>.

Corruption is the most important sore of the judiciary system, which lacks independence. In the earlier mentioned Transparency International

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<sup>56</sup>Other interesting figures, charts and tables in the website <https://voxukraine.org/en/we-need-a-balance-between-the-quality-and-independence-of-the-judicial-system/>

<sup>57</sup>Cf. Appendix F: Interview with the DeJuRe Foundation

<sup>58</sup><https://ukrainianweek.com/News/84111>

<sup>59</sup><https://razomforukraine.org/projects/policyreport/judiciary-system-and-reform/>

report<sup>60</sup>, it was showed that 74% of the Ukrainian public would not report an incident of corruption because 24% are afraid of the consequences and 63% believe that it would not make any difference. Court judges maintained a 99.5 percent conviction rate from 2005 till 2008, equal to the conviction rate of the Soviet Union<sup>61</sup>. Judges are directly influenced by politicians and most of them have not been renewed since the post-soviet eras. They have created a self-renewing "cast", whose objective is to preserve the advantages it benefits from corrupted methods<sup>62</sup>. The press often reports judges who own an unreasonable number of luxury cars, houses and goods. When they are held accountable for corruption practices, the commissions which are in charge of interrogating and judging them are composed of judges who turn a blind eye to the abuses of their colleagues.

Consequently, with the direct support of EU partners, a top-down reform is currently in progress<sup>62</sup>:

- **International support:** New selection methods were first implemented for the Supreme Court, thanks to the help of an international committee composed of English, Danish and other mainly European Judges. This committee was responsible for suggesting 12 possible new judges for the court to the Ukrainian authorities, which were in charge of selecting 6 final members.
- **Rationale of this method:** Besides allowing a simple and progressive rebuilding of the system, a top-down reform also enables to create a barrier to the current abuses of the judiciary system. If an ill-intentioned defendant wishes to win a lawsuit simply by systematically appealing a decision at each stage of the trial, the case will finally be appointed to the brand-new fair and incorruptible Supreme Court which will be appointed to hand down the final judgement. This dissuades economic actors to take profit in decision appeals.

Corruption has naturally an effect on the banking system. The recovery rate of loans in Ukraine is 10%, with only Indonesia having such a low rate<sup>62</sup>. 94% of the decisions are taken in favour of banks, but delays in the procedures are considerable<sup>62</sup>. Even if a court takes a decision, collecting back the

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<sup>60</sup><https://ukrainianweek.com/News/84111>

<sup>61</sup><https://www.kyivpost.com/article/content/ukraine-politics/jackpot-62564.html?cn-reloaded=1>

<sup>62</sup>Cf. Appendix F: Interview with the DeJuRe Foundation

collateral is often impossible and no legal way exists to enforce the court ruling. A reinforcement of judicial transparency is thus a crucial step for the rebirth of the Ukrainian banking system and the possibility to enable new lending activities.

## The land reform

In Ukraine, the land market is regulated by a Moratorium implemented in 2001, which bans the sale of arable lands. Over 41 million hectares of agricultural land subject to this moratorium<sup>63</sup>: 10.5 million hectares (25%)<sup>64</sup> of state and communal land, 27.7 million hectares (68%)<sup>65</sup> of citizens' private plots of land, that were allocated during the post-soviet era. Most of these lands are not operated by their owners and are managed by major Ukrainian holdings and oligarchs through a leasing system. As a consequence, land concentration is very high (large companies control 15.5 % of the lands), while the added-value by hectare of these lands is scarce (413 USD, compared to USD1,142 in Poland)<sup>66</sup> Following the pressure of international partners, the president Volodymyr Zelensky has decided the opening of land ownership, scheduled for October 2020<sup>67</sup>.

While international institutions believe that this measure could have a positive impact on the Ukrainian economy (2% increase of the GDP<sup>68</sup>, an additional investment of \$10 billion into agriculture<sup>69</sup>), such reform has caused strong reluctance among the public opinion. Ukrainians fear that these lands will be monopolised by large agricultural holdings and international investors. Consequently, to mitigate these risks, the government has planned to limit land ownership (respectively, no more than 35, 15 and 5 % at the communal,

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<sup>63</sup><https://en.ecoaction.org.ua/the-land-question.html>

<sup>64</sup>Information from the State Service of Ukraine for Geodesy (Surveying), Cartography, and Cadastre (StateGeoCadastre) (2017)

<sup>65</sup>Information from the State Service of Ukraine for Geodesy (Surveying), Cartography, and Cadastre (StateGeoCadastre) (2017)

<sup>66</sup><https://financialobserver.eu/cse-and-cis/ukraine-will-lift-the-ban-on-agricultural-land-trade/>

<sup>67</sup>Cf. Appendix D: Interview with UkrSibbank

<sup>68</sup>Cf. Appendix B: Interviews with the IMF and the World Bank

<sup>69</sup><https://www.atlanticcouncil.org/blogs/ukrainealert/ukraine-is-finally-ready-to-embrace-land-reform/>

oblast and national scale<sup>70</sup>). Another debate remains on the possibility to subsidize lending for small buyers, but the IMF is quite sceptical on this kind of measure. Therefore, the establishment of this land market liberalization is still fragile and concerns subsist on the respect of the reform calendar.

Nevertheless, the lift of the Moratorium may have a considerable impact on the banking sector. In a country where agriculture is one of the main activities, and which is considered as the breadbasket of Europe, arable lands could become a new important source of collaterals, which may boost lending activities.

## Conclusion

The crisis of the Ukrainian banking system is the result of a long accumulation of imbalances, together with a severe lack of banking regulations. These instabilities were suddenly unveiled by the recent geopolitical crises in the region. The restructuring of the Ukrainian banking economy led first and foremost by the NBU, progressively contained the systemic risk and induced banks towards a more stable and healthy state of equilibrium. However, in order for the Ukrainian economy to keep growing, several steps still remain to be reached, especially through the judiciary system and the land-market reforms.

Such progress was necessary for the banking system: the stabilisation of interest rates may lead to an increase of competition on deposits. Through this elasticity of loan demand, the entry of new bankable economic actors should finally be possible. It is therefore crucial in this context to grant a secure access to property for banks.

The NBU is the heart of the economic and institutional reforms which are taking place in Ukraine. The main challenge of the country's transformation is the ability of the central bank to finalize what has started. Will the NBU be able to keep monitoring and controlling inflation rates? How will it ensure stable interest rates?

Moreover, the link is fragile between Ukrainians and their institutions: Ukraine had the lowest level of confidence in government action in the world (9% according to a poll conducted in March 2019) and 91% Ukrainians believe

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<sup>70</sup>Cf. Appendix B: Interviews the IMF and the World Bank

that corruption is widespread in the government<sup>71</sup>. The longevity of Mr. Zelensky's presidency is at stake in a political environment characterized by frequent political changes.

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<sup>71</sup>Survey conducted by Gallup

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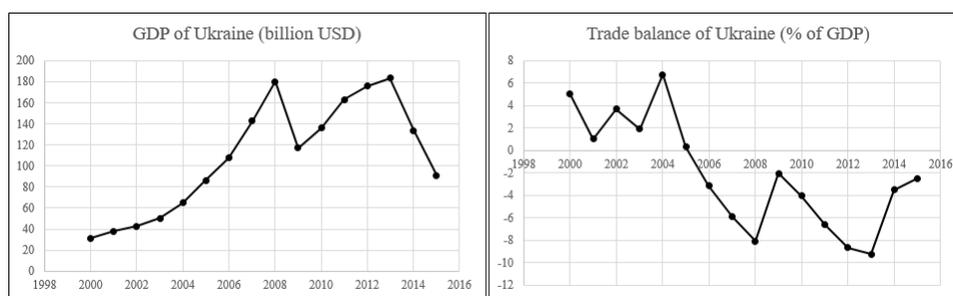
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# Appendix

# Appendix A: The origins of the Crisis

*Main source: lectures and documents of Dominique Menu, Country Head of BNP Paribas in Ukraine between 2004 and 2016.*

## 2005-2008: the initial euphoria



source : World Bank

Between 2005 and 2008, Ukrainian growth averaged 7 percent annually, mainly because of an increase on steel prices as well as a quite steady situation for gas. Ukraine was the 8th producer of steel in the World in 2007 (3.18% of total). In fact, steel and related products represented 50 % of Ukraine's exports between 2001 and 2008 (World Bank). Thus, the economy of the country highly depended on these prices. Despite this significant growth, this period of euphoria was not characterized by a high level of investments by public actors. Concerning the banking sector, fueled by both the necessity to modernize its economy and the population's thirst for consumption, Ukraine had seen its banking system taking off as the country's economy started to grow. Ukraine attracted foreign investors despite the lack of information and transparency in the companies' accounts<sup>72</sup>. For instance, it was difficult to assess the financial health of the companies since every actor did not apply the same accounting standards. Relations and loans

<sup>72</sup>How do the foreign banks analyze the requests of financing from Ukrainian banks on the international markets?, Dominique Menu, 2005

between companies where also unclear. During this period, big foreign banking groups such as BNP Paribas, Raiffeisen or Cr dit Agricole, massively invested to buy local banks. For instance, UkrSibbank, which was the fourth bank of the country, was bought in 2005 by BNP Paribas. This appetite for Ukrainian banks was due to the significant growth in the profits of Ukrainian banks at this time as well as the high potential for deposits: in 2006, less than 40% of the Ukrainian population had a bank account. Loans in US dollars were also commonly used for investments in real estate before 2008.

## **2008-2014: A drop in steel prices as well as eastern military conflicts weakened Ukrainian economy**

After 2008, the country's GDP sharply decreased because of a drop in steel prices. The loan to deposits ratio reached an historically 225% in 2009. In 2014, The Ukrainian economy was hit by the military conflict in eastern Ukraine which caused a decrease in industrial production and revenues in Donbass which disrupted the confidence in the overall Ukrainian economy. In fact, looking at exports destination, Russia was Ukraine's major trading partner through 2013 and it represented one fourth of Ukrainian exports.



Following the conflict in eastern Europe and disrupted relations with Russia, the GDP of Ukraine decreased by 6.6 percent in 2014 and by a further 9.8

percent in 2015. The deep recession and depreciation caused deposit removals from the banks, rising levels of non-performing loans and a large number of bank failures, reducing confidence in the economy.

## **After 2014: the restructuring of the banking sector**

An overvalued exchange rate, a substantial budget deficit, and sizable losses in the energy sector put Ukraine in an unsustainable situation, with a large and rising current account deficit and a rapid loss of foreign exchange reserves. The new government that took office in late February 2014 after intensive political turmoil took measures to secure macroeconomic and financial stability and to concentrate resources on critical spending needs. They saw their program as a historical break with the past of crony capitalism, pervasive corruption, and poor governance that weighed heavily on the economy. They believed that the political regime change had given them a mandate to launch bold and ambitious reform aimed at transforming Ukraine into a dynamic and competitive emerging market economy with transparent government and vibrant business environment. To face the banking sector crisis, radical reforms had to be taken. Requirements to banks' capital were increased up to UAH 500 million, internal financial monitoring was strengthened and measures for strengthening responsibility of bank's related parties were enforced. Consequently, between 2014 and 2015, 47 banks were declared insolvent, and 5000 employees were laid-off as regards the reduction of non-key functions.

# Appendix B: Restructuring the NBU

## The reconstruction of the NBU to tackle the systemic risks

Created in 1991, the NBU's missions did not change until the Maidan revolution and the triple crisis. A restructuring was much needed. The NBU employed in 2014 almost 12 000 employees. More than half of the employees were working on side businesses such a TV channel, making goodies... In 2014, the NBU decided to undergo massive changes and focus on its core business: controlling the banking system. At that time, the economy was seen as weak, with a lot of corruption. The banking system was losing money for more than 5 years and lacked of transparency. The NBU also lacked of an efficient decision-making system with no trust from the civil society. At the beginning of 2015, the NBU began to stream the organisation. New processes were implemented alongside the redefinition of its core missions. In January 2018, the NBU presented its strategy for the first time, setting out clear goals with accurate achievement criteria. The implementation of the Strategy covers seven areas of development, where six out of the seven goals are external and aimed at meeting the needs of financial ecosystem participants: low and stable inflation; stable, transparent, and effective banking system; resumption of lending; effective regulation of the financial sector; free flow of capital; financial inclusion. The seventh goal is to ensure the high institutional capacity of the central bank: The NBU plays now a crucial role in the Ukrainian's economy through the following areas: modern, open, independent, and effective central bank.

The NBU cooperates with the international community with the purpose of enhancing the stability of Ukraine's financial system. It is interacting with international institutions such as the IMF, the world bank or the European Bank for Reconstruction and Development in order to implement technical assistance projects for Ukraine's financial sector. The NBU tries to replicate the European Union central bank and improve it through the EU-Ukraine association agreement in order to be part of a global financial community. The NBU is gradually turning into an expertise hub, sharing its best practices

with other central banks.

## **Systemic risks identified by the NBU**

According to its national bank, Ukraine is facing many systemic risks. *Global economy* has been decelerating over the past year. Economic growth of most major trading partners of Ukraine has been slowing down for the past couple of years. Even if the national central bank of other countries planned to ease their monetary policies, this signal is not sufficient enough to reduce the risk of a slowing world-wide economy and support economic growth.

The second systemic risk is the *external demand*. Prices for Ukrainian export and import commodities, including energy or raw materials, were mostly declining except of iron. Ukraine being a big producer, its economy performance relies drastically on these prices. Thus, the result of Ukrainians companies is directly correlated to the variations in price and fear surges.

*Economic conditions* of Ukraine is qualified as a systemic risk by the NBU because of the weaker global economic activity. If steady domestic demand, underpinned by higher wages, social benefits and slowing inflation towards target rates fixed at 5%, current public account deficits are increasing. Fortunately, this gap is expected to decrease thanks to new trade terms such as lower energy prices according to the NBU. Besides a better productivity in the agricultural sector is expected which will have a trickle-down effect on the budget.

As of *public finance*, Ukraine is facing peak repayments on its external debt for the years to come. As Ukraine is facing some difficulties to raise funds on an international scale, a threat might emerge to finance its widening budget deficit or refinance the debt that was already contracted. Therefore, further cooperation with international institutions and especially the IMF is important in view of receiving preferential financing from its partner and have wider access to international capital markets.

*Foreign currency market* might introduce some instability especially because of the reforms that are being carried out. However, this risk is very limited so far thanks to a stable supply of foreign currency by exporters and remittances from labour migrants. Emitting domestic government bond is another way for Ukraine to have a source of foreign currency supply. As long as foreign currency is coming steadily, the hryvnia exchange rate will remain stable at about 26 hryvnia for 1\$ as it is the case for a couple of years.

## **Reforms and actions carried out by the NBU**

### **Restructuring of the NBU: transparency as an effective way to restore trust and efficiency in the institution**

In 2014, the National Bank of Ukraine received help from the IMF and from another national bank such as the national bank of Norway and Canada. Together, they decided that the NBU had to focus on core functions, and they the reforms to make the NBU a better version of the national bank of England. The transparency of the institution through an effective communication was one of the major pillars of this restructuring. Changing the rules, establishing new tools to manage the monetary policy and financial institution combined with an independent decision-making were the other pillars of the renewal of the NBU.

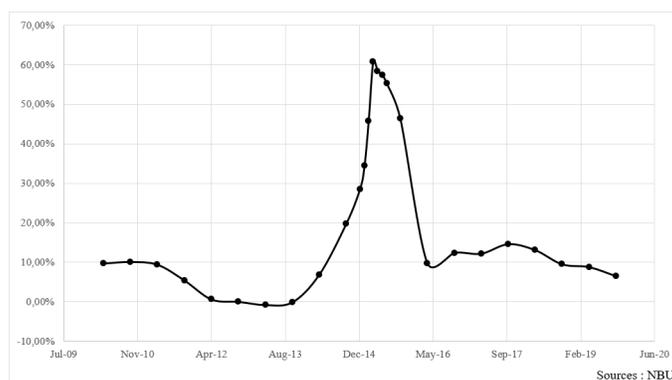
Its Communications strategy is to establish more trust in the institution and the banking system, to have enhanced impact of the its policy on the behaviour of its targeted audience, as well as less uncertainty in the economy through the disclosure of information. Thus, an effective communications policy is a key tool to carry out the NBU's mission of ensuring price and financial stability. The management of inflation expectations, which can be guided through effective communications, is an instrument that helps the central bank implement its mandate. The NBU, similar to other central banks, publishes regular reports, such as the Financial Stability Report and the Inflation Report, and hosts public events. It actively communicates with the Rada of Ukraine, ministries, agencies and other state authorities to create an efficient institution thanks to the reforms. Along with the large-scale reforms of the banking sector and the transformation of processes within the NBU, there is an increasing need for visuals to explains the reforms. Thus, the NBU took on a new visual identity in 2018.

On 13 March 2019, for the first time, the NBU received the prestigious International Central Banking Transparency Award for making strong progress in improving its transparency and advancing communication with stakeholders. The prize is awarded to the most successful central banks. Since its restructuring in 2014, the NBU has faced numerous problems including a malfunctioning banking system, high inflation rate and a conflict with Russia in east Ukraine. Under these conditions, the central bank could have been tempted to withhold information and make itself less transparent. But the NBU opted to do just the opposite. The NBU significantly expanded the

scope of the information it publishes, to make it accessible, intelligible and available in due time according to the Central Banking Awards.

### **Control of monetary policy and price stability thanks to classic monetary instrument**

Delivering price stability is the primary objective of the NBU. In order to achieve this, the NBU operates according to an inflation targeting framework. The NBU's monetary policy steers toward gradually bringing inflation down. NBU's monetary policy considers that the optimal target level of inflation is  $5\% \pm 1pp$ . It is slightly higher than in developed country. Thus, Ukraine prices will slowly reach European prices according to the Europe-Ukraine agreement. Starting at December 2019, the target of 5% will become a constant one to be revised only downwards, and only if the hryvnia exchange rate volatility and relative price volatility go down.



It might happen that for certain periods, inflation rates may deviate due to factors that are not controlled by the NBU such as the price of highly volatile primary goods. The focus of the NBU on ensuring price stability implies a floating exchange rate regime. Increasing and maintaining net international reserves at high level will be another priority because it can smooth sharp variations in the foreign exchange market. The main tool for the NBU to achieve its goals will be the key policy rate. It defines the rate to lend money from or by the NBU on the inter-banking market. Alongside the key policy rate, the NBU has other tools at its disposal. The corridor for overnight lending and deposit rates will be set alongside the key policy rate which is about 17% in 2019. This tools allows the national bank to have

a direct control of the short-term interest rates on the inter-banking credit market for either liquidity-absorbing or liquidity-providing operations, then limiting their fluctuations around the key policy rate.

Reserve requirements will be used to manage liquidity in the banking system, and to enhance the influence of a change in the key policy rate. It is of 6,5% for current accounts in national or foreign currency. For long-term deposit, the ratio is about 3%. Differentiated reserve requirements may be used in order to make liquidity regulation more effective, and to encourage banks to attract mainly deposits in hryvnia for longer periods. When it comes to short and long-term deposit rates applied by the banks on the market, there is already a 12-percentage point spread between foreign currency and hryvnia deposit which is explained by the lack of demand in foreign currency and promotes the deposit in hryvnia. However, there is only a 1 percentage point between short- and long-term deposit which is not incentive enough to support long-term deposits.

The NBU applies its monetary tools to support financial stability only in cases where systemic risk significantly affects the prospects of inflation and economic activity. With all these tools, the NBU will create a suitable environment to fulfil its financial stability objective which is a necessary condition to stable monetary mechanism.

### **Financial stability**

To ensure the smooth functioning of financial stability the NBU is putting in place a Macro-prudential policy which aims to prevent the build-up and materialization of systemic risks. Once again, the ultimate goal is to promote financial stability, defined as the state in which the financial system is able to properly perform its main functions. Financial inter-mediation, enabling payments and withstand crises are the main functions. The environment of a stable monetary policy: low and stable inflation, floating exchange rate, will help the NBU to fulfil its financial stability objective.

NBU's macro-prudential economy is made of principles that ensure its efficiency such as independence from pressures of the financial sector or other authorities to make sure long-term goals are prioritized over short-term and individual objectives. Transparency stipulating the rules to follow and presenting the instrument to implement in advance to be sure that any party of the financial sector will be aware in advance of any new implementation. Transparency is also important to informs in due time the audience of any

changes. A preventive approach to identify systemic risks before they happen and adopt an over-cautious behaviour. However, any risk has to be evaluated and dealt with a proportional response. Coordination is also required with the other entities of the NBU for efficiency purposes. Another principle of the NBU is to avoid any regulatory arbitrage, i.e. it is not possible to avoid restrictions by going in less regulated sectors. Last but not least principle is to take into account any specifics of the Ukrainian financial system such as the importance of the state through the ownership of banks. With all these principles the NBU has a few tools at its disposal to reach its goals:

- **Stress testing** plays a major role in the identification of systemic risks and their scenarios are built on assumptions of adverse macroeconomic and financial indicators (NPLs coverage ratio, Loan-to-deposit ratio ...) and are unlikely to happen. Their role is to answer the question "what would happen to banks if the worst scenario materialized". The stress test helps evaluate the impact of economic shocks on banks and assesses the related costs of such events for the banking system. The NBU is gathering all the information of the tests and it is able to underpin actions to be taken regarding a bank or recommendations for individual financial institutions or the use of the other macro-prudential instruments. Every top bank in Ukraine have to conduct such tests. For the remaining one, they are chosen randomly.
- **Capital Instruments** are numerous. The counter-cyclical capital buffer sets higher capital requirements or buffers during periods where credit thrive. However, the bank has the option of easing or releasing that buffer when systemic risks materialize. This tool helps to prevent losses in the banking sector and enhances the resilience of the banking system. For major banks that would present an adverse risk for the system, there is an additional capital buffer to cover losses to diminish the impact of a crisis. Another capital instrument named systemic risk buffer was introduced to cover long-term structural non-cyclical systemic risks such as high concentration. The capital conservation buffer aims to ensure a stock of capital in "normal" times above the minimum requirements to cover possible losses and prevent non-compliance with minimum capital adequacy requirements in the future. The leverage ratio, whose minimum is set at 3% by the Basel committee for Bank, is an extra safety measure against an excessive expansion of bank's

balance sheets when risk weightings do not reflect actual riskiness of operations.

- **Liquidity instruments** such as the liquidity coverage ratio is a ratio of the bank's liquid assets to the expected net cash outflows over a 30-day crisis period. The bank has to be above a threshold defined by the regulators that will help the financial institution to maintain the liquidity level needed to withstand a crisis. It is possible for the NBU to change the ratio requirements during a systemic liquidity crisis to allow banks to meet obligations to depositors in full. Another ratio is the net stable funding ratio and defines the minimum proportion of stable funding depending on the liquidity and residual maturity of a bank's assets. This ratio prevents the bank for making long-term lending and secure their position with short term funding rather than long-term one.

### **Dealing with the state-owned banks and their NPLs**

In 2019, the state-owned bank represented more than 66% of the NPLs gross loan portfolio mostly possessed by PrivatBank. The development and implementation of new approaches to get rid of the NPLs in order to reduce the pressure on the balance sheets of state-owned banks and the maximization of recovery value were among the main components of the strategy adopted by the council of the NBU. To speed up the process, the NBU appointed a new member to the supervisory boards to the following state-owned banks: Oschadbank, Ukreximbank and PrivatBank. They all have the specific mission to deal with the NPL in the most efficient way possible. Their assignment started in June 2019.

In order to boost clearing state-owned banks balance sheets, the NBU implemented a regulation of the management of non-performing exposures within the European practices which are based on the European central bank guidance. The implementation of the regulation's provisions is necessary for establishing an efficient system for non-performing exposure management. Banks will have to develop and implement a strategy and an action plan on non-performing exposure management.

Since 2008, the NBU forbid loans in dollar to reduce the risk of creation of new NPLs. Most of the NPLs are coming from loans in dollar. In 2008 the exchange rate was about 5 hryvnia for 1\$. But this rate increased drastically

at 8 to 1 and a couple of years later at 11 to 1. As a lot of interest rates were computed on the value of the dollar and not in hryvnia these coupons soared and customer were not able to pay back their loans creating NPLs.

## Results

Even if the reforms were carried a few years ago, it is already possible to observe some results:

- The inflation decreases from 60.9% in 2015 to 8.6% in 2019 through the new and effective monetary policy of inflation targeting reaching a minimum since the reform began. Anchoring inflation expectations at the targeted level and actual inflation meeting the medium-term target are the main success criteria of monetary policy. NBU is expected to reach its target at the end of 2020.
- The NBU succeeded to implement stable and transparent banking system. Not only the banking system is more transparent because it uses international standard such as Basel III, the NBU even won the Central Bank Transparency Awards thanks to its new communication policy. Annual assessment of banks, risk evaluation combined with a macro-prudential policy helped to create a stable banking system. The NBU forced the banks to disclose information such as their stakeholders or its stress test results. This enables the financial market to have an idea of the standards of the banks. As a result, Ukraine is now rated as B and it will most likely be revised upwards for the years to come.
- Abandoning the fixed exchange rate helped Ukraine to increase its international currency reserves from \$5.6 million in 2015 to \$20.6 billion in April 2019.
- The NBU has been transformed into a modern and efficient institution. Last year, the NBU converted to the new IFRS 9 standards and was one of the first national bank to do so. It has also launched successfully a paperless project aiming to expend financial services and give new banking opportunities to Ukrainians. This project also improves the control of the national bank over the transactions and the services that are performed.

- Cooperation with international partner such as IMF, world bank or EBRD, helped the NBU gained international recognition and being considered as an example for other national banks.

Thanks to all these reforms the banking system changed drastically and lead the way for further reforms in others such as the judiciary system.

# Interviews with the NBU and international actors

## Interview with the NBU

### General description

#### Hashtags

Restructuring; Banking system

#### Institution

Since the NBU was founded in 1991, the institution had to deal with several significant events over the past years, which marked Ukraine's economy, e.g. the introduction of Hryvnia in 1996, economic crisis in 2008 and the Maidan crisis in 2014. Following the Maidan crisis, the NBU has entered in a full reconstruction phase and redesigned its strategy over a new set of missions: ensuring price stability, ensuring financial stability and contributing to the economic growth of Ukraine. 3 types of structures are under the supervision of the National bank of Ukraine: commercial banks, payment systems and cash-in-transit companies.

#### Participants

Mikhailo Vidjakin (Deputy director of Strategy and Development Department /Head of Strategic Analysis and Planning Office)

## Relevant points of the discussion

### General statements

The NBU is composed of a board and a council:

- The board is composed of 5 Deputy Governors and a Governor who is elected for 7 years. The role of this board is to:
  - Define the strategic directions of the NBU
  - Take decisions on monetary policies, financial system, banking supervision, cash and payments
- The council is composed of 4 members appointed by the parliament and 4 by the president. The Governor being the ninth. The role of the council is to:
  - Elaborate the Monetary Policy Guidelines on the basis of the NBU Board proposals
  - Exercise control over the implementation of the monetary policy
  - Approve the budget of income and expenditures of the NBU for the following year
  - Oversee the activities of the internal audit
  - Appoint and dismiss the First Deputy and the Deputies of the NBU at the proposal of the NBU Governor

### Triple crisis during Maidan

The NBU's analysis of the Maidan crisis is based on three pillars:

- **Banking crisis:** Banks faced important bank runs during the maidan crises which leads to many bank failures (76 in about 2 years). Moreover, more and more non performing loans combined with a credit crunch lead banks to focus on their core activities to be able to recover from crisis.
- **Macro crisis:** Ukraine underwent a severe growth recession in addition to a surging inflation. This had a huge impact on Ukraine's budget which deficit was widening.

- **Crisis of balances:** Institutions lacked confidence from citizens, especially in the financial and judiciary sectors. Exchange rates raised significantly to reach its balance at about \$1 for 25 hryvnia. Besides, an unsustainable current account deficit led to a crisis in the balance of payment.

### **NBU restructuring - reasons**

After the Maidan crisis, 3 major reasons were given to justify the engaged reconstruction of the NBU:

- **A very weak local economy:** Characterized by a lot of bureaucracy and corruption leading to little faith in the institution therefore undermining its power. The country was also embedded in a war with Russia for Crimea and Donbass weakening even more the economy.
- **A shadow banking system:** A high number of banks (185) are present in the market with limited capitalization and market share (less than 5% for the last 80). Banks were very often owned by major industrial players to directly finance their corporate activity. These activities were carried out with little transparency, using client's savings without control, and many of them were also used to make money laundering. Then, when the NBU tightened the rules, a high proportion of banks could not keep up with the legislation anymore and were forced to close, which explains why only 76 banks are left now. The NBU assumes that this number will slightly decrease when the rules will be strengthened in the next years. Besides the banking sector is losing money for the previous five years.
- **Inefficiency of the central bank:** The NBU was formerly divided in 25 miniaturized central banks (one for each region). More than half of the employees had functions that were either useless or non-related to banking supervision. Ukrainians' confidence in this institution was extremely low compared to where it stays now. High hopes and expectations currently back the NBU.

### **NBU restructuring - facts**

- In 2014, the National Bank of Ukraine received help from the IMF. Together, they decided to focus on core functions, based on the example

of the national bank of England. The NBU used to perform diversified activities such as creation of TV content or production of furniture. New core functions are: bank supervision, monetary stability, market operations, payments and cash monitoring, finance and administration, governor functions (=communication, administration. . .).

- NBU reconstruction went along with a simplification of the hierarchy to settle an horizontal organization: the previous 11 hierarchic levels became 4. This simplification lead to a reduction of headcount from 12 000 in 2014 to 5 000 in 2019.
- According to the NBU, the main success of the reform is its independence. For example, until 2016 NBU's employees were public servants, they have now a special status.
- Amongst all of its monetary policies, the NBU decided to fix for the first time an inflation rate target. This rate was set at 5% and was supposed to be reached at the end of 2019. Real inflation in 2019 will probably be around 7-8% but the NBU is rather confident that their target will be achieved in 2020.

### **NBU concerns on shadow economy**

- In the shadow banking system, banks can realise "arbitrage". Some banks are giving up their licenses to enter a different type of market with less regulations such as the non-banking financial market. These markets are composed with new structures such as pawnshops, micro-credit institutions. . .
- Based on NBU, the average salary in Ukraine is about 300\$ even if it might be slightly higher in reality, due to shadow economy. The institution noticed that I.T. professionals and farmers are fleeing the country because they can get better salaries in neighboring countries such as Poland, which is part of the European Union.

# Interview with the International Monetary Fund

## General description

### Hashtags

Land reform; Institutional Reform; Corruption; International loans

### Institution

The International Monetary Fund is one of the main international funding institutions present in Ukraine. In order to ensure the country's financial stability and support its post-2014 economic recovery, the Fund signed a Memorandum of Understanding with the Ukrainian government in March 2015 agreeing on an Extended Fund Facility worth \$17.5 billion, which implied a series of conditions to be respected, including an extensive institutional reform. The aid of the IMF was re-confirmed through a Stand-By Arrangement (SBA) of \$3.9 billion, signed at the end of 2018.

### Participants

Igor Schpak, Senior Economist

## Relevant points of the discussion

### General statements

- The crisis of 2014-15 costed 38% of the Ukrainian GDP. The Memorandum of Understanding is a central document which lists all the conditions of the agreement between Ukraine and the IMF, as well as the way they implemented reforms are assessed.

### Land reform

- The opening of the land market is supposed to start next January, if the Parliament supports the initiative.
- Currently, most of land spots are owned by public institutions. An illustrative example of the peculiar Ukrainian situation is the Ukrainian

Academy of Agrarian Sciences, which owns 5 million hectares of the most productive Ukrainian soil.

- Two reasons have led to hold the moratorium for such a long time. The first are "populist" opinions, for example the fear to see the Ukrainians' lands stolen by foreign companies. The second reason is that the moratorium gave space for vested interests, inhibiting reforms and actions from politicians.
- The IMF expects the GDP to increase of 2% if the land market is opened. Indeed, arable lands could become new collaterals that would reinvigorate the lending market. It would also boost agriculture because investments would be made in newly-owned lands
- Some restrictions will be applied on the land market opening. For example, buyers will need to be residents and restrictions on property concentration will be applied over three tiers: at the communal, regional and national scale, with, respectively, no more than 50, 15 and 5% of lands owned by the same buyer.
- Currently, the government also discusses the possibility to help small farmers by compensating their high-interests bank loans. The IMF has a neutral opinion on this policy.

## **Corruption**

- Concerning the fight to corruption, despite the creation of the NABU (National Anti-Corruption Bureau), Ukraine urgently needs a special anti-corruption court, which started being active only since last month.

## **Institutional reforms**

- Besides a reform of the economic system, the IMF requested in the case of Ukraine a reform of its institutional system as well as measures allowing to reduce corruption.
- The IMF is very satisfied with the reform of the NBU, which completely changed since 2014-15.
- Now reforms have to continue, for example one of the main concerns is the excessive public share in the banking sector.

# **Interview with the World Bank**

## **General description**

### **Hashtags**

### **Institution**

The World Bank is an international institution which supports Ukraine in developing its economy and growth. The organisation provides technical assistance, operations support and advice but also funds the Ukrainian government since 2014 through the Developing Policy Loan. The DPL which consists of a \$3.5 billions loan, aims to finance Ukraine in exchange of laws and policies elaboration. The World Bank also invests in operations and infrastructures in the country.

### **Participants**

Vahe Vardanyan, Lead Financial Sector Specialist

## **Relevant points of the discussion**

### **General statements**

- 85% of the banking system is concentrated in 30 banks.
- 90% of the assets belong to banks.
- Raiffeisen is the major bank in the agriculture sector.
- The World Bank especially worked in the settlement of the Deposit Guarantee Fund but other institutions also need support (enforcement or judiciary systems).

### **Reforms in the banking sector**

Two sets of reforms are led in Ukraine to specifically develop:

- Banks independence. Many banks were state-owned and used by politicians. Privatisation helped to develop bank's own governance but new reforms are needed, especially to improve corporate governance.

- Loans. If Ukraine wants to reach Poland's economy and growth with the actual loan rate, it needs 15 years. Huge investment are necessary: the loan-to-GDP ratio is at 32% which is very low compared to neighboring countries. However, institutions weakness and unhealthy loan demands prevent banks from lending. As a consequence, big companies are responsible of the 3-4% corporate growth of banks; the high growth of SMEs is not enough to urge banks to lend.

Changes on NBU are impressive and the institution needs further development, which can be complicated by the action of lobbies. As an example, NBU wants to higher the level of capital required for the banks in order to force their merger but lobbies block the new policy.

Moreover, NBU has to tackle a new issue: previous banks invest in non financial markets which are less regulated.

### **Land reform**

- Agriculture sector in Ukraine is well-developed because leasing price of fields is low and margins are high.
- A solution to further develop the economy is the land reform. The aim is to open the land market of Ukraine. According to some specialists, it will boost lending market and farms productivity. The reform will deeply transforms the agriculture sector. One particularity of Ukraine's land market is that most of lands are state-owned.
- This reform raises problems on different scales:
  - Small farmers. The law needs to ensure that small farmers will have access to the new market, especially because most of them are not banked. However, 85% of smaller farmers currently own their land.
  - Medium farmers (100-500ha of fields). They currently lease their fields or own a small part (around 30%).
  - Big farmers. They are already bankable, borrow and get cash flows in foreign currency.
- To support these farmers, different solutions exist but they all need huge amount of subsidies:

- Subsidize 50% of the credit risk through the Partial Credit Guarantee Instrument. The World Bank used this alternative in a neighboring country in a context of land market opening.
- Lower interest rate, difference with the real interest rate will be paid by the state.
- The price of the land is expected to be 1500 dollars per hectare.
- The opening of the land market may also lead to a liquidity crisis in hryvnia. Some solutions can be:
  - Lend in foreign currencies. Many banks cannot lend in foreign currency due to internal policies.
  - Get more hryvnia bonds through international market.
  - Increase total amount of hryvnia in the country but the NBU fixed a certain target of inflation.

## **Interview with the EBRD**

### **General description**

#### **Hashtags**

#### **Institution**

The European Bank for Reconstruction and Development is an European institution which supports Ukrainian economy development in contribution with other key players such as the IMF and the World Bank but also the US Aid, European Commission, Canada or Switzerland. In 2014, the Bank invested in equity (loans) and in the capital market. Since the crisis, the EBRD supports policy maker through advice and technical assistance in developing institution frameworks. The institution supported the reforms of the NBU but also developed and supported the strategy of the Guarantee Fund, Ministry of Finance, Parliament and Parliament Committees.

#### **Participants**

Alexander Pavlov, Deputy Head of Ukraine, Financial Institutions

## **Relevant points of the discussion**

### **General statements**

- The lack of accounting is a huge problem in Ukraine. Companies are not used to this exercise and they fear that their transparency will make them more liable to be sued.
- Micro financing exists, especially to bridge the gap between two months salaries.
- FinTech sector misses regulation.
- Many Ukrainians are not bankable because they do not want to or they do not possess enough documents to prove they are.

### **EBRD support**

The EBRD supports Ukraine at different levels:

- Adviser. The EBRD discusses with institutions and provides advice and feedback on reforms.
- Policy advocacy. The EBRD educates Ukrainian institutions.
- Technical assistance. The Bank funds long term consultants from Lazard, KPMG, Rothschild. These experts operate in institutions and can, for example, support the elaboration of budget during two years.

Different reforms are pushed and supported by the EBRD:

- 2015: Debt restructuring by elaborating a legal process to help banks to deal with their bad loans (NPLs).
- 2016: Set of reforms on state-owned banks.
- Investment in banks through loans to make profit and share risks with them in some investments.
- Deposit Guarantee Fund strategy elaboration and technical support.
- Development of the NBU (public communication, monetary policy and PMO creation).
- Settlement of capital market.

## **Focus on State-owned banks NPL reforms**

- The EBRD supported the reforms on state-owned banks through:
  - Policy engagement. The institution prepared a proper governance for some banks to overcome the lack of supervisory board. In some cases, the bank was supervised by the CEO who was very engaged in politics towards his friendships.
  - Memorandum of Understanding (MoU) signed with banks for changes. The objective was to transform banks management and prevent the State of being involved in these organisations.

Because of the link between politics and banks, the law raised strong oppositions and waited 3 years to be voted by the Parliament.

- The EBRD designed a mechanism (law) to process bad loans: the law only applied to new banks and not to state owned banks because the new Parliament changed the law terms so it became not as efficient as it should be. As a matter of facts, 70% of the NPLs are owned by people who used to work in the Parliament.

## **The high number of banks**

Few solutions can be raised to lower the number of banks:

- The NBU can change policies to force small banks to close softly. However, if banks are profitable, the NBU cannot do anything against these banks except suggesting them to close in 3 years step by step.
- Banks can merge. Most of the time, these transformations happen only between two banks owned by the same person. In that case, the merger takes 3 years.

# **Interview with the Delegation of the European Union**

## **General description**

### **Hashtags**

EU; Financial Aid; Association Agreement

### **Institution**

The Delegation of the European Union was opened in 1993 in Kiev and is the official diplomatic representation institution of the EU in Ukraine. Its main role consists in reinforcing political and economic relations between both EU and Ukraine. In 2014, a Association Agreement, including a Deep and Comprehensive Free Trade Area (DCFTA), was signed, also containing several financing initiatives from the European Union. The role of the Delegation facilitate the implementation of these agreements and to monitor the progress of the EU's funding programs.

### **Participants**

- Simone Raudino, Sector Manager for Economy, Trade and International Financial Cooperation

## **Relevant points of the discussion**

### **General statements**

- The EU delegation collaborates with all the other international institutions in Ukraine, especially IFIs and funding organizations such as the International Monetary Fund and the World Bank.
- Ukraine has a very low loan to GDP ratio (around 60%) compared with the European Union (150-160%), which justifies the possibility to provide financial support through lending.

### **Focus on: Financial support and Association Agreement**

- Moreover, the EU has progressively been moving towards new financial instruments, instead of only providing grants as it was classically done before. Very often, the EU is not the direct implementor of these financing programs, since funds are provided to institutions such as BERD.
- The EU funding mix for Ukraine consists of 200 million euros managed locally (mostly lending) and 100 million euros of grants which are part of a regional EU program. The EBRD plays a central role in the funding strategy.
- The split is as follows: roughly 50% of these total 300 million euros go to IFIs (*blending*) and private companies, 40% go to more traditional institutions (UN, NGOs, think tanks) and 10% are direct state budget support. Loans are in Euros, Dollars and local currency.
- Concerning the conditionality, it is roughly the same as the IMF and the World Bank (governance, anti-corruption) but with additional elements such as a stress on direct economic impact and energy efficiency.
- Large efforts have to be done on building capacity on the receiving side. Very often, the EU is ready to provide funds but is blocked by the incorrect management of this funding by local actors.

# Appendix C: Recovery of Non-Performing Loans

## The Deposit Guarantee Fund

### The institution

The Deposit Guarantee Fund was established in 1998 with the purpose of protecting the rights and legitimate interests of bank depositors.<sup>73</sup> Its major objective is to ensure the functioning of the household deposits guarantee system as well as the resolution of failed banks. Its role and importance for the stability of the financial system increased significantly over the last 4 years, mainly because of the banking sector reform driven by the National Bank of Ukraine.

### An important role in the post-crisis management

The Deposit Guarantee Fund received \$25 billion of non-performing loans after the 2014-2015 crisis. 20% of this amount concerned cars while the remaining part was related to real-estate which represented \$20 billion. 40% of these mortgage loans had no collateral and were not valuable. The rest were related to stakeholders in bad shape (located in Crimea, Donbass, ...) who cannot pay loans because of the devaluation. Consequently, they became insolvent.

Moreover, the court decisions were extremely difficult to enforce because of the weakness of the legal system. For instance, the Guarantee Fund had decided to sell flats and houses attached to the loans but it was impossible for them to visit those accommodations so they were unable to auction it. In this context, the aim was to enforce the decisions through private contractors who would be more influential in courts than public institutions.

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<sup>73</sup>for more information, read the summary about the discussion with the Deposit Guarantee Fund

## **A first solution to recover these NPLs**

The Guarantee fund targeted a recovery rate of 10 cents per US dollar on the loans principal. To reach this objective, they firstly decided to create a transparent sales process and so, they made a secondary market for loans. In was a local market in which they wanted to create a demand for bad loans and increase the involvement of international actors. They applied a particular disclosure procedure: banks had to prepare forms and to send them to the Fund. However, the bidding process did not work well because with 35 platforms, it was too hard to find good offers and so, the loans were badly allocated. Moreover, there was also an issue of moral hazard: some buyers had a particularly good idea of the performance of certain loans as they were also borrowers. For all these reasons, this first solution led to bad results.

## **How do they proceed today?**

After this failure, the Guarantee fund decided to change its strategy. Helped by KPMG, Lazard and supported by the EBRD, they created a structure in which brokers were remunerated for bringing the auction winner. However, they still had to find a way to gather \$2 billion from the selling of the loans. They fixed a reserve price of 20% of the book value and 15% of the loans were bought on individual basis with only one restriction: the buyer cannot be the borrower (to avoid moral hazard). The aim was also to create a competitive market which attracts foreign investors and loans which have not been sold during the auction were pooled with better assets to be more attractive for investors. To do so, they used the emission of US treasury bill for the sale of distress assets. As of today, they have attr\$1 billion by selling 40% of their non-performing loans. They still have \$1 billion to recover in order to achieve their initial objective but the remaining loans are those of lowest quality.

## **Interview with the Deposit Guarantee Fund**

### **General description**

#### **Hashtags**

NPLs; Guarantee fund; Corruption

## **Institution**

The Deposit Guarantee Fund was established in 1998 with the purpose of protecting the rights and legitimate interests of bank depositors. The major objective of the Guarantee fund is to ensure the functioning of the household deposits guarantee system as well as the resolution of failed banks. Its role and importance for the stability of the financial system has increased significantly over the last 4 years, mainly because of the banking sector reform, driven by the National Bank of Ukraine (the NBU), which has culminated in the removal of more than half the banks from the market. Between 2014 and 2017, 96 banks were resolved, accounting for 31% of total banking assets.

## **Participant**

Taras Yeleiko, director of consolidated asset sales department

## **Relevant points of the discussion**

### **The Ukrainian crisis of 2014-2015**

After the revolution following the crisis of 2014-2015, Ukrainian government was changed. Afterwards, they lost Crimea as well as a huge amount of production facilities, steel plants and mines. At this time, the crisis on commodity market pushed countries as Brazil, Argentina and Poland to devalue their money. Ukraine followed this stream. Before the crisis, 1 US dollar was valued at 8 hryvnias and a few months latter, the new rate became 1 dollar to 27 hryvnias. The country's GDP decreased by 20% in hryvnias and 50% in US dollars. Afterwards, the government decided to sort out all the issues of the banking system. Indeed, no supervision was done in this sector before the crisis happened.

### **The reconstruction of the banking sector and the role of the DGF**

The new government discovered that more than half of Ukrainian banks were insolvent (96 banks). It thus started to deep dive into each bank and decided that if a bank was declared insolvent for more than five years, it would be liquidated. The Deposit Guarantee Fund played an important role in the post-crisis management.

They received \$25 billion of non-performing loans to be recovered. 20% of these concerned cars while the remaining loans were related to real-estate and amounted to \$20 billion. 40% of these mortgage loans had no collateral and were not valuable. The rest were related to stakeholders in bad situation (located in Crimea, Donbass, ...) who could not pay back loans because of the devaluation and became consequently insolvent.

## **Corruption**

Court decisions were extremely difficult to enforce against debtors because of the weakness of the legal system. For instance, the Guarantee fund decided to sell flats and houses attached to the loans but it was impossible for them to visit those accommodations so they were unable to auction them. In this context, the aim was to sell these loans to new private creditors who could have much more influence over court decisions.

## **How the DGF initially managed to recover non-performing loans**

The Guarantee fund targeted a recovery rate of 10 cents per US dollar on the loans' principal.

- First, the Guarantee fund gathered information on all the bad loans. The institution sent forms to be filled by banks and gathered legal documents on owners and loans. The sale of the loans was then validated.
- To reach its objective, the Guarantee Fund decided to create a transparent sales process and so, created a secondary market for loans. The loans were sold on 35 different bidden platforms at the minimum price, 20% of the initial price. However, the loans were very often bought by the borrowers or their relatives. For this reason, the Guarantee fund decided to find an other way to sell the loans.
- The Fund wanted to create a demand for bad loans and increase the involvement of international actors. The institution investigated in the best loans, reached out investors and managed to sell some of them.
- After this failure, the Guarantee fund decided to change its strategy, helped by Lazard, KPMG and the BERD.

### **The new and current solution**

The Guarantee fund, supported by international specialists, created a structure in which brokers were remunerated for bringing the auction winner.

However, they had to find a way to gather \$2 billion from the sale of the loans. They fixed a reserve price of 20% of the book value and 15% of the loans were bought on individual basis with only one restriction: the buyer could not be the borrower (to avoid moral hazard). The aim was also to create a competitive market which could attract foreign investors. Loans which had not been sold during the auction were thus pooled with better assets to be more attractive for investors. To do so, they used the emission of US treasury bill for the sale of distress assets.

As of today, they have attracted two big foreign assets and seven auctions have been conducted. They have recovered \$1 billion by selling 40% of their non-performing loans. They still have \$1 billion to recover to achieve their initial objective but the remaining loans are those of lowest quality.

# Appendix D: Interviews with international banks

## Interview with Ukrsibbank

### General description

#### Hashtags

Land reform; NPLs; Interest rates; Black market

#### Institution

Ukrsibbank was founded in 1990 in Kharkov, one of the biggest cities in Ukraine. It became a branch of BNP Paribas in 2006. In 2009, the EBRD also invested in Ukrsibbank. It is a well-diversified bank focusing on premium retail with 270 agencies, large corporate and SMEs. As Ukrsibbank is well performing, BNP Paribas is confident in the evolution of the Ukrainian market. The bank will probably increase the funding envelope of its branch even if Ukraine is ranked 140 out 160 on the risk index.

#### Participants

Philippe Dumel (CEO)

### Relevant points of the discussion

#### Business of Ukrsibbank

The business of Ukrsibbank is well-diversified and divided into three main categories:

- *Large corporate*: The branch focuses on multi-corporate companies because Ukrsibbank can benefit from the BNP Paribas network. For these companies, the loan risk is shared with the holding which provides guarantees and is often located in countries where the economy is more stable and risks are lower than in Ukraine. In this segment, the

loan-to-deposit ratio is unbalanced toward the loans because companies tend to borrow money to finance their activities. The competition between banks is really high for the multinational companies sector and the margins are extremely low. Therefore the bank needs to focus on side businesses to develop its profits such as consumption loans, guarantee letters.

- **SMEs:** In this market, Small and Medium Enterprises make a lot of deposits. These deposits are used to finance loans of the large corporate business. In the UE, SMEs usually do not make such amount of deposits and contract heavy debts.
- *Private customers:* Thanks to this business, Ukrsibbank regulates the loan-to-deposit ratio because private individuals make a lot of deposits and almost no loans (except consumption loans). The bank does not provide any mortgage so far because it is too risky and the cost is simply too high for the customers. Indeed, the interest is about 20%. Ukrsibbank is also specialized in the niche market of premium services. Overall, the retail segment of the branch accounted for 1.3M customers. Besides, Ukrainians are tech enthusiasts and the bank invests more and more in digital solutions (digital payments, app...). As a result, many agencies have been closed (177 in 5 years); the bank had agencies in 135 cities in Ukraine few years ago, this number decreased to 80 now. By focusing its business in the biggest cities, BNP Paribas concentrates its activity where more premium customers stay.

## **Interest rates**

The credit market is evolving:

- As of October 2019, interest rates stand between 16% and 20% depending on the amount and the duration of the loans. They are expected to decrease to 9% within a couple of years.
- Because of the high value of interest rates, SMEs rather finance themselves instead of taking loans. Indeed, they could also borrow money in foreign currency at a lower interest rate, but they would then bear alone the burden of the change risk.

- So far, banks do not approve foreign currency loans because the associated risk is too high. Reforms in the judiciary system or in the cadastre are needed to increase bank loans. As long as the legal system is considered untrustable by banks - and customers to a slightly lesser extend -, the credit market will not grow. For example, even if a court rules out in favour of a bank, loopholes can be used by the defendant to prevent the bank from collecting the principal. One of these is the declaration of a kid in the apartment in case of a mortgage loan which makes it impossible for the bank to recover its loan.
- For this reason, banks only lend to the biggest companies for which audits are available to evaluate whether or not a company is able to pay the coupons. Banks also try to lower interest rates and thus annuities to increase their chance of being paid back.

### **Non-Performing Loans (NPLs)**

- Consumption loans are widespread in Ukraine. In all shops, some employees are dedicated to sell such loans and even encourage customers to buy some. The process is very fast and convenient because there is almost no background check. Consequently, consumption loans present high risks of becoming non-performing.
- If a loan becomes non-performing, the concerned bank tries to collect the annuities during three months. Once this delay is due, banks pool all their bad loans into a single financial product that they sell. Some companies buy these products and are specialized on recovering them.
- Ukrsibbank does not have any NPL from the Maidan crisis anymore except some mortgage in foreign currency. A moratorium prevents the bank to exercise its power and carry on further actions on this regard.

### **Land reform**

- The land reform law should be voted at the Parliament in the next months and is supposed to be enforced in October 2020. It will highly impact Ukraine's economy. According to the current form (October 2019) of the law, only Ukrainian citizens or companies will be able to buy lands. The market opening should boost demands which may

exceed offers. Prices will rise but only the richest farmers might be able to purchase lands. However, as the state still owns a vast majority of the lands, it will be the first seller and thus prevent the increase in prices.

- This reform has to be carried out carefully, because a liquidity crisis remains possible. In fact, loans can be taken in foreign currencies rather than in hryvnias and land owners can keep the received money (in cash or converted in foreign currency) instead of investing in the economy.

## **Corruption**

Shadow economy in Ukraine is supposedly extremely important, reaching around 35% to 40% of the GDP. Since blurred financial documents do not reflect real activities and many transactions are done in cash, banks would like to be protected, especially in the loan market, but such a protection is hard to establish.

## **Institutional reforms**

For which concerns the high number of banks in Ukraine (76 in October 2019), figures are expected to decrease a bit in the next years. In fact, the National Bank of Ukraine will probably strengthen rules on financial market especially on capitalisation of banks. Then, less capitalized banks will have no option to either surrender their licenses or to merge. However, such a high number of banks is not a real issue in the banking market because most of banks own a limited fraction of it. There is little systemic risk for the market.

# **Interview with Raiffeisen**

## **General description**

### **Hashtags**

Land reform; Interest rates; Black market; Institutional reform

## **Institution**

Raiffeisen Bank is a commercial bank in Ukraine. The bank was created in 1992. Since 2006, it is a subsidiary of the Austrian Raiffeisen Bank International. In 2015, the European Bank for Reconstruction and Development (EBRD) acquired a 30% stake in Raiffeisen Bank, increasing its capital. The bank operates more than 500 agencies across the country and offers banking services to individuals and corporate clients. As of 2018 it is the largest bank with foreign capital in Ukraine.

## **Participants**

Gerard Boesch (CEO)

## **Relevant points of the discussion**

### **General information about Ukraine's economy and Raiffeisen bank**

There are remaining risks in the Ukrainian market, even if reforms were carried out in the monetary or in the judiciary systems. Some of them were successful, such as the NBU, or less successful, such as the AMCU redesign.

The key risk, as of today, remains in the judiciary system, since there is no rule of law and no judge's impartiality, which is leading to biased daily behaviors and investments. Moreover, the real agenda of the parliament is not clearly known, which raises concerns in the financial market.

However, Ukraine economy has a lot of potential, especially:

- High quality of workers
- Low cost of workforce (at some point it was even cheaper than in China and by far lower than in Europe)

Some facts about Raiffeisen bank and its business:

- The bank has 2.5 M customers with about 3 billion € in assets and wants to increase its portfolio in number of client as well as in value. There are almost 500 branches all over Ukraine. The bank's strategy plans to keep all of them because many clients are farmers and need to have access to subsidiaries close to their working place. In each regional center, which are usually the main cities of the region, some

specialists are appointed to frequently visit the smaller local branches to meet with clients when they have specific needs.

- Raiffeisen bank is risk adverse; it doesn't get involved in any bribe nor works with any corporate that doesn't show a transparent behavior.
- Raiffeisen bank is a highly profitable bank, with 40% to 60% return on equity, but struggles to find new investors. The bank was not able to gain any new major client in the past 7/8 years. As Raiffensen bank is seen as very stable, it was less hurt by the crisis both in 2008 and during the Maidan revolutions. The bank even made benefits during the crisis with 30% growth in those years.
- Its core business area is the agriculture sector. Historically, the bank has always been present in this sector. It remained an important actor even during the recent crises and further developed its businesses. In fact, since nutrition is a basic need in a nation, the sector did not take a big hit during the recent political shifts.
- Saving rates are about 7-8% even for short term deposit and can reach up to 18% for 6 months deposits.
- 15 to 16% of Raiffeisen portfolio are consumer loans. This business, which is not the preferred activity of Raiffeisen, relies on the law of big numbers: the largest amount of customers is targeted, the more risk are decreased and profits are made.
- IT sector is a strong activity across Ukraine. Unfortunately for the bank, the companies working in IT do not need loans. However, Raiffeisen is very interested in these employees because they have a big purchasing power and they usually have a lot of money to invest.

### **Focus on: Interest rates**

*Interest rates* are about 20% right now and are expected to decrease to about 9% in a couple of years if everything goes as planned by the NBU. The threshold for banks to grant loans is about 10%, meaning that the lending market will develop fast once the target is reached. Currently, there is little demand for loans, but it is supposed to be elastic with the interest rate.

- There is not a single bank in Ukraine that is offering mortgages. Two reasons can be given to explain this phenomenon. First of all, there is no demand because the price is simply too high for households to buy such loans. Secondly, the risk of these products are also very high - given the weakness of the rule of law in Ukraine - for the banks, which are then reluctant to offer mortgages. The bank can be prevented to collect the collateral even if the loan is not paid back. This is possible, for example; when the customer registers a child in the apartment. There can also be a risk for the customer: every construction project needs pre-financing but there are high chances for the construction to remain unfinished forever.
- As Raiffeisen wants to be a leader in the mortgage market, the bank is preparing new specific products to Ukraine when the interest rates will reach the threshold of 9-10%. They are also developing digital solutions that are dear to Ukrainians.
- The bank wishes to lend money in foreign currency where there is less risk and less fluctuation, but it is forbidden since October 2008.
- To grant loans the bank is conducting due diligences using mainly the big four companies to be sure they respect European standards. Only major Ukrainian companies can afford to be audited with such extent because they are used to respect international standards for their businesses and have enough money to afford it. It is more difficult for smaller companies to respect all these conditions because they can't afford the audit and usually have less transparent accounting, often due to historical reasons.

### **Customer Loans**

Consumer loans market has been the most profitable market in the Ukrainian banking sector, even during the 2014 crisis, because the buffer was so big that it was always possible for the bank to issue such loans. Its interest rates can reach value as high as 50% depending on the household. When a product is bought, customers only look at the monthly payment, and most of the time customers do not default. There are no caps enforced by the NBU or the government for the consumption credit interests, it is therefore a massive source of income for the bank. However, this will most likely change in the

future. At least, the bank will be compelled to communicate the interest rates which are hidden nowadays.

The banks conduct some tests to grant the loans to the customer. Red flags can come from two sides: his behavior and his financial position. If there is no mortgage because no one can pass the financial test, it is not the case for consumption loans. To assess customers behavior banks are tracking people and buy data on him. It used to be very generic assessment, but they are now building more efficient test (for example, bad grade are accumulated by customers who use their cards to buy products in alcohol stores).

*Companies such as Citrus are able to propose interest rate of 0% when everybody on the market is offering 50% or more* because Citrus doubles the price of the product. It is then possible for them to offer such high prices because the products that are proposed have a huge pricing power such as new technologies and gadgets. As consumers do not look at the price but only see that the interest rate is 0%, the company uses a marketing strategy to sell its products.

### **Focus on: Land reform**

- There is some uncertainty because the final version of the law is unknown. The banks hope that the land will be able to be used as collaterals for loans.
- As there is no ownership of the land but only renewable contract with no assurance of being reconduct, there are only limited investments from agro-companies. So far, the investments made are on mobile products such as tractors. Such strategy also limits the yields of the lands because it is exploited for short-term purposes and no projections are made for the following years, leading to over-exploitation.
- After the reform a 30-40% increase of production is expected.
- Two solutions are proposed for the land reform: partial guaranties or interest subsidize. In any case, an infrastructure is needed to oversee the sale and way more precision is required, otherwise it will hard for the banks to issue loans. One remaining key question is who is going to take the risk for all these loans if there is no judiciary insurances.

### **Focus on: Corruption**

Shadow economy represents about 50% of GDP. To reduce this percentage, the banking systems has developed new payment methods with for instance mobile phone payment with apple pay or its e-watch with Garmin. By law it is not possible to refuse digital payment even for small amounts such as train tickets (8 hryvnia). Therefore, less and less transactions are done in cash and it easier to track the money. However, the cash culture remains strong in Ukraine, for example some banks are still paying part of their wages in cash or Agro-companies are paying landlords in cash.

### **Focus on: Institutional reforms**

The NBU's reform was a success because it became independent to pursue its monetary policy. Another reasons for its success are the cleaning up and the new management of the banking system. The closures of 100 banks in about 2 years, or the privatization of PrivatBank are good examples of the success of this institution. As investments from the World bank, the IMF, the European Union are crucial to Ukraine's development, the NBU is likely to stay independent and to continue to enforce its monetary policy.

## **Interview with Crédit Agricole**

### **General description**

#### **Hashtags**

Land reform; NPLs; Corruption

#### **Institution**

Crédit Agricole invested in Ukraine in 1993 and is the only bank to own 100% of its capital, even during and after the Maidan crisis. It has 150 agencies across Ukraine, but it is now mainly developing a digital banking system. It has 500 000 active clients with 380 000 individual customers and 120 000 companies. Its core business is the agriculture.

## **Participants**

- Jean-Paul Piotrowsky, CEO
- Olena Kozłowska, assistant to the CEO

## **Relevant points of the discussion**

### **Some figures about Ukraine's economy**

- EU association agreement was signed in June 14. 40% of the exports are towards Europe. It is very strategic for Europe because there are high quality workers at very low costs (lower than Poland for instance).
- The Government aims to reach 5% growth next year and 7% for the years to come in order to reach 40% cumulated growth for the next 5 years.
- The potential of the local market is very high, especially in the agriculture and the I.T. sector. Indeed, Ukraine strives to become a European I.T. hub and even compete on an international scale.
- A lot of startups are developed but they are rapidly sold when their products are successful.
- There is an overwhelming lack of infrastructures especially of railways and roads in the country.

### **Focus on: Crédit Agricole**

- During the Maidan crisis, business in Agriculture compensated the losses in other sectors. In fact, business was almost interrupted with Russia, but the new emerging markets such as Middle East and China have raised.
- Agriculture is a core business for Crédit Agricole. It has 8% of the market share regarding farms over 100ha. As it is a growing industry, especially with the reforms to come, the bank is not looking to gain market share but only to encourage the development of the market and grow alongside it.

- Crédit Agricole puts in place a value chain business. As the bank works with big multi-national companies, Crédit Agricole tries to catch these clients, which also have business partners and customers that could be attracted by Credit Agricole's products. Through this model, it trickles all the way down to small private customers.

### **Focus on: NPL**

To avoid NPLs (only 20% in 2014 with 9% interest rate compared to 5% with 3% interest rate in 2019) the bank established partnerships with its clients and offered them to restructure their debts, which allowed them to avoid insolvency. However, for the remaining NPLs, it is always problem to collect the collateral mainly because of the judiciary system. The bank urges thus the need of a reform of the judiciary system.

### **Focus on: Land reform**

- The moratorium withdrawal should and will be done within a few weeks (end of October) but needs to be correctly designed. Right now, the jurisdiction's framework is not clear and the cadastre will be an issue.
- The land reform could greatly impact Ukraine economy, triggering a 2-3% growth of the GDP.
- Some calculations estimate this market to require \$4 billion/year financing in the first years. In fact, the estimated amount of land is 24 million ha and about 10% will be sold the first year. The initial estimated unit-price is 1 100 hryvnia/ha at the opening and is supposed to increase by 50% before finding a balance at 1 650 hryvnia/ha.
- As most people own between 2 to 3 ha of lands and the biggest farms can reach 200 000ha, but consist of only 10% of the total lands, a lot of transactions are bound to happen. Some of them are already prepared by the major agrocompanies with small land owners. A precise ownership delimitation and a strict judiciary system to enforce the rules combined with an efficient cadastre are crucial steps of the land market opening.

- So far the new law is expected to introduce caps on the size of the land that someone can own in one region (15%), and overall in Ukraine (0,5%).

### **Focus on: Corruption**

Regarding the black economy, Crédit Agricole estimates that there are about 40 000 companies in Ukraine that are not bankable because they are not transparent enough. Given its risk-averse policy, the bank will not work with them as long as they are not fully transparent.

## **Interview with Alfa-Bank**

### **General description**

#### **Hashtags**

NPLs; Ukrainian judiciary system

#### **Institution**

Alfa-Bank Ukraine is a major Ukrainian commercial bank with international capital. The bank was founded in 1992. Since 2001, it has been operating under the brand Alfa-Bank Ukraine. The bank was presented during the meeting as one of the most sustainable and reliable banks in Ukraine, holding leading positions in all segments of the banking market. It is among the top 10 financial institutions in the country in terms of assets according to the data of the National Bank of Ukraine. Alfa-Bank is particularly active in Russia (where the group Alfa-Bank has his headquarters) and Ukraine.

#### **Participant**

Oleksiy Blinov, Head of Analytical Department. He is in charge of macroeconomics research for top management and corporate businesses.

## Relevant points of the discussion

### Alfa-Bank's business model

- The key source of funding of the bank comes from households, through their deposits, which are used as a source to finance companies.
- They are number one in the secondary market (financial market in which previously issued financial instruments such as stock, bonds, options, and futures are bought and sold).

### Focus on: Non-performing loans and how to make profits on them

- Alfa-Bank has been more active in retail lending (fast growing sector with high yields). They have produced consumption loans with which households were buying televisions, cars, houses or mobile phones. But it is not possible to only focus on households to significantly grow. Therefore, the bank started to build relations with companies. However, one of the major issues in Ukraine is the big amount of non-performing loans (NPLs). It mostly concerned state-owned banks in which the level of NPLs reached 50% of their loans portfolio. Alfa-Bank managed to reduce this ratio to 20%. The firm has a pretty good reputation in loan recovery, one of their main activities being to buy problematic portfolios and restructure them to finally make them profitable.
- One of the main questions of the public opinion on Alfa-Bank concerned their remarkable efficiency in court, explaining their ability to earn money from bad portfolios. They have particularly invested in that capacity compared to other commercial banks. In contrast to their competitors, Alfa-Bank tried to adapt to the particular "rule of law" in Ukraine. As an international group, which had already experienced these practices in Russia, it could easily deal with these NPL recovery situations. The bank has a very strong legal team on which it has heavily invested. Alfa-Bank also has particularly strong relations between their management teams and their shareholders, who were thus able to transfer their knowledge on "eastern countries" to the bank's managers and stressed on the importance to have an efficient risk management team.

- **Regarding loan recovery**, Alfa-Banks uses particular techniques which distinguish them from other European banks operating in Ukraine. For instance, in case of default of the loan, other banks sue the client at the court to get compensation, but there is a risk that the borrower corrupts the judge and makes them lose the trial. Conversely, Alfa-Bank hires external lawyers in order to enter in relation with partners of the borrower to negotiate directly and find a solution avoiding the court. They have a rather aggressive way of dealing and they are prepared to “go at war” with this kind of clients.
- Alfa-Bank decided not to go into construction sector because even though it is a fast-growing field, the collateral is very important and it is too hard to go after the client in case of default. This year, the bank has decided to dismantle their unit dedicated to real-estate.

#### **Focus on: Alfa-Bank’s client**

- The bank is mainly targeting big companies with a turnover of more than 1 billion Hryvnia. SMEs are not a very important client because they are closer to retail lending than corporate.
- Concerning the evolution of their loan policy, Alfa-Banks goes where the economy goes, as one of the biggest banks of the country. The GDP forecast for next year is a 3% growth, new foreign investors are thus not expected to come. However, some new markets seem to be rising:
  - This year was a particular attraction for green energy sectors appeared, such as machinery and infrastructure development. There have been regulatory changes in favour of the solar energy and biomass developments.
  - In the IT sector, there are several big names that are outsourcing from Ukraine with international partners, the problem is that the money earned in this context is not profitable to Ukraine.
  - Agriculture is also a growth market in Ukraine.

#### **Focus on: Ukrainian demography and workforce**

Ukrainian demographic context raises the problem of the workforce. They are about to open the borders and the workforce is expected leave Ukraine

for surrounding countries with highest wages. In that way, Ukraine will have to balance its wages with those of other European countries and will thus lose this competitive advantage. A solution may be to accept more migrants in the country.

### **Focus on: Shadow economy and Quantitative figures**

In quantitative research in particular, it starts from one question: how can we explain discrepancies between data? For instance, how can we explain that with an average wage of 9 000 Hryvnias per month, people can afford a car in Ukraine? The answer comes mainly from the fact that shadows incomes form a significant part of the GDP. Their main statistic sources come from the statistic service but they can also buy unofficial databases.

# Appendix E: Banks' opportunities

## The digitalization

As the rest of the world, one big challenge for Ukraine is the digital transformation which will foster transparency and, specifically for banks, bankability of structures (individuals or companies) which are not yet.

### Transparency

Transparency is the result of the fight against shadow economy and corruption. As a matter of facts, shadow economy represents between 30% and 50% of Ukraine's GDP. Transparency enables banks to collect information on these markets and so develop further their business. It is possible through different channels:

- **Transactions.** Number and speed of transactions are increased through the development of card payment, supported by the government. In Ukraine, it is forbidden to refuse a card payment even on small amounts such as train tickets for example. A new transaction-control system has also been designed 3 years ago, including a new experimental payment-tracking and market-study system. However, improvements are still needed because cash culture remains strong in Ukraine. Some banks even pay part of their wages in cash.
- **Open data, especially on a governmental side.** Information tends to develop in Ukraine. Citizens are more and more aware of measures taken by the government and open data is increased. The land ownership is now available for some zones, which enables the banks to clearly identify the cadastre.
- **Digital administration.** It limits the human factor which is a mean to decrease corruption. For example, fines can be directly sent to companies through online systems, so that proofs can no longer be destroyed in case of corruption.

## Bankability

The increasing quantity of information supports the development of individuals and companies bankability.

- **Lower interest rates.** The more information a bank has on a potential borrower, the lower the interest rate will be. Indeed, information decreases risk associated to a non-payment. The actual high interest rates (up to 20%), and so annuities, do not encourage clients to get a credit. Associated with NBU's new policies, digitalization could increase the number of bankable structures.
- **Accounting.** Most of the time, banks lack information on individuals or companies. Crédit Agricole estimates that 40 000 companies are not bankable because they lack transparency and accounting. Digitalization, especially thanks to the increasing number of digital transactions, fosters the development of a clean and trustable accounting. On an individual scale, information on a client's transactions can speed up the credit process. For example, PrivatBank implemented a system which allows its clients to apply for a credit by directly paying with their credit card in some retail shops.
- **Collateral** Diminution of corruption and open data (especially on cadastre) decrease risk associated with the defective judiciary system. Banks will thus invests in new markets which they do not trust at the moment.

## Interviews with local economic actors

### Interview with Horizon Capital

#### General description

#### Hashtags

#### Institution

Horizon capital is the biggest equity fund in Ukraine. It was originally a government fund created 25 years ago by the US government after the collapse

of Soviet Union. Since its creation, the fund has invested \$850 million in Ukraine mostly with good returns. Horizon Capital is composed of 4 smaller funds: venture capital, growth fund (for mature companies), bailout and distressed.

## **Participants**

Vasile Tofane, Partner

## **Relevant points of the discussion**

### **General statements**

- Horizon Capital is a better alternative for companies than banks because it is an easier process than bank and because the Fund offers support in different fields (recruitment, strategy, debt restructuring ...). Horizon Capital makes bankable the companies it invests in.
- Opportunities are huge in Ukraine: prices are low, labor market is huge (around 40 million Ukrainians) and the administration is well-developed.
- Ukraine is an interesting market for such fund. Currently Horizon Capital is studying more than 100 companies, 20 of them are part of active discussions, 2-3 in due diligence. Their due-diligence to deal ratio is more than 50%.

### **Crisis and their answer**

- After the crisis in 2014, the economy of Ukraine was very weak: high inflation, decreasing importations and increasing importations, low GDP growth, high exchange rates with foreign currency, high public debt.
- The NBU was not independent and over-budget; the judiciary system was highly corrupted. However, a lot of work have been done since 2013.
- Concerning Horizon Capital, in 2013 they were ready to launch a new fundraising campaign. After the crisis in 2015, they decided to invest only in exporting companies. The fund received foreign exchange and

the hryvnia was so devalued that it was still interesting for Horizon Capital to invest in the Ukrainian market. The returns in 2018 were good.

## Strategies

- Sectors to invest in:
  - Agriculture because it is a sector which exports a lot.
  - IT. Ukraine produces 500 000 well-qualified but cheap engineers per year. Large IT private universities, companies trainings and demands from outside can explain this high number and certify the engineer degree.
  - Light manufacturing. Ukraine's labor market is cheap compared to other European countries as Romania and Czech Republic which benefit from the European Union.
  - Furniture and automotive factories. These sectors especially grow in Ukraine.

Horizon Capital do not invest in sectors where penetration of oligarchs or politicians is important (metal sector for example).

- The due diligence preformed by Horizon Capital is a classic one: financial, legal, operations, environmental and social analyses.
- Investment strategy: the Fund mostly invests in 5 to 10 years old companies, with a fast growth, composed of one or two entrepreneurs and not located in the Donbass region. Horizon Capital invests money but also supports companies on technical issues (people, products, prices etc...). Ideally, it will just invest money and exclusively in foreign currencies.
- Exit strategy: Horizon Capital can operate an IPO or sell to a strategic investor, a financial investor or the shareholders. The market is not always easy in Ukraine and exit strategy is essential. For example, the Fund just bought a factory in Crimea when the US government prohibited any business in the region. It managed to sell its shares.

- Judiciary strategy: Horizon Capital tries to base its agreements on the English Law. Most of the time, trials are avoided by both party because of the high price of such process.
- Competition strategy. 2,5 funds exist in Ukraine and the other 1,5 are specialized in buyouts or real estate. So, the major concern is oligarchs and minigarchs.

## **Interview with Prostranstvo, a developer in Odessa**

### **General description**

#### **Hashtags**

Odessa; Real-estate; Non-bank Financial Products

#### **Institution**

Prostranstvo is a real-estate developer based in Odessa which has been operating in the construction field for 15-20 years. The company develops projects from the beginning until the sale. The firm is specialized in apartments construction (2 million sqm built so far) but it has also developed shopping centers and entertainment spaces (AquaPark for example). Concerning apartment business, the company has a turnover of \$4-5 million per month, \$8-9 million for all businesses. Prostranstvo's main shareholders are individuals from Odessa who decide together for the entire company.

#### **Participants**

- Zhanna Kiseleva, chief architect
- Evgenia Selezneva, head of the urban cluster
- Andrey Semenov, customer service department
- Alexander Sokolovsky, finance department

## Relevant points of the discussion

### Business process

The process' steps are:

1. **Land acquisition:** This first step is difficult to achieve in Odessa because the historic center is out of the land market and some lands are inoperable. Moreover, land owners are not ready to sell and Prostranstvo needs then to negotiate the land.
2. **Project development:** Concept and drawings.
3. **Permit application:** Receiving a construction permit is a long process, up to two years, except if the applicant is willing to pay more.
4. **Marketing campaign:** To promote the project, advertisements are distributed on the Internet, billboard or directly to clients.
5. **Construction and sale**

### Financing process

- Business process is financed by Prostranstvo's own funds.
- From 2-3 months until the end of the construction, apartments are sold. At the beginning of the sale period, the apartments are sold at a discount rate which evolves throughout the construction period. Prostranstvo can support its clients in their purchases by acting as a bank: some clients are able to pay 100% at the beginning, but others can pay only 50% at the beginning and Prostranstvo's enables them to reimburse the rest at the end of the construction with a 10% of interest rate.
- The firm wants to develop a leasing company to increase the number of clients. Apartments will be leased for 5 years for example.

### Risk management

Three types of risks can be identified:

- **Risk in land acquisition:** Land owners sometimes show fake certificates and Prostranstvo then needs to sue them. At the present time, open data shared on the owners and the company's experience lower the number of these situations.
- **Risk in construction period:** If commercials do not sell enough before the end of the construction, Prostranstvo has to stop the construction. The company's strategy is to sell small apartments to ensure this situation never happens. For small amounts of money (around \$1 million), the company can also get mortgages from banks and manage the construction risks. Consequently, during building process, risk is owned by investors and buyers and not developers.
- **Political risks:** Politician can create scandals. For example one of them has told to the medias that the company did not have a permit. However, Prostranstvo has showed their permit and the politician finally decided not to sue the company.

### **Bank investment - the need for more bank loans**

The possibility for Prostranstvo to get bank loans would enable the firm to sell its apartments at the end of their construction at the maximum price. It would therefore significantly increase revenues. Investment would also be expanded to other markets, for example in the retail sector.

## **Interview with the Odessa City Council**

### **General description**

#### **Hashtags**

Odessa; Institutions; Non-bank Financial Products; Decentralization reforms

#### **Institution**

Odessa is one of the top 3 cities in Ukraine. It has experienced a substantial economic growth, which is explained by the presence of the biggest ports in Ukraine, an important IT sector and the development of tourism (especially after the annexation of Crimea). For these reasons, Odessa is connected to

the rest of the world and is thus an important point of circulation of foreign currency in the country. The decentralisation policy of the government and the investments received from development banks (World Bank, EBRD,...) recently gave more autonomy to the city council, which lead new development projects for Odessa.

### **Participants**

- Svetlana Bedrega, head of the department of finance
- Sergey Tetyukhin, head of the department of economic development

### **Relevant points of the discussion**

#### **Tax and Black market**

- Black market represents an important part of Odessa's economy. A modernization of the tax system can tackle this phenomena to some extent.
- For example, in order to foster the entrepreneurial sector, the government decided to fix the tax on outsourcing a private entrepreneur to 5%, whereas hiring an employee is associated to a 30% tax. Many companies decided to hire entrepreneurs and declare these as subcontracts because of this low taxation rate. Hence, the development of entrepreneur sector is linked to the fight against black market. A balanced entrepreneur tax rate could solve both black market and entrepreneurship development issues.

#### **Digital transformation and fight against corruption**

- Opening to international market, especially to the European Union, urges Ukraine to develop automated systems. Some examples of automation measures could be:
  - The adoption of Iban system in the banking sector
  - The development of new transaction-control systems: 3 years ago a new experimental payment-tracking and market-study system has been designed

- Automation can enable to fight corruption, by limiting the human factor. Some example are listed below:
  - Creation of an administrative quarter in Odessa, where all the administrative papers are initiated and done. This speeded all the process from application to distribution, which used to be accelerated only for citizens who were willing to pay.
  - Sending fines directly to companies through online systems, so that proofs can no longer be destroyed in case of corruption.
  - Development of transactions made through credit cards, which develops transparent businesses and helps to eradicate shadow payments.

### **Municipality credit for renovation**

- Buildings are in a deplorable state in Odessa and need to be renovated for both aesthetic and energetic reasons. City council decided to contribute financially to the city restoration through a renovation credit which is allocated in the following way:
  - Inhabitants who want to renovate common parts of their building can apply for a credit by choosing between one of four state-owned banks.
  - Members of the council verify the renovation works and validate the application to the City Council.
  - City council sends up to 35% of the total amount required for the renovation to the chosen bank.
  - The bank sends the credit to inhabitants.
- To finance the other part of the renovation, banks can provide loans with different interest rates depending on the guarantees provided by the inhabitants:
  - If State guarantee and City guarantee are submitted, interest rate is the official rate from the NBU.
  - If only one of these guarantees is submitted, NBU's interest rate is incremented by 2%.
  - If no guarantee is submitted, interest rate is incremented by 5%.

# **Interview with Adis Auto, a car dealer in Odessa**

## **General description**

### **Hashtags**

Odessa; Automotive; Non-bank Financial Products

### **Institution**

Adis Auto is a car dealer which gathers cars from 4 different companies (Peugeot, Subaru, Mitsubishi and Seat). The company's main activities are:

- Leasing (restricted to companies).
- Sale (mainly to individuals).
- Reparation (especially since more and more people buy second-hand cars, which need to be repaired).

### **Participants**

- Dmitry Khlyvtsov, sales director

## **Relevant points of the discussion**

### **Stock financing**

Financing the process of stock acquisition is different between the 4 car makers.

- For Peugeot:
  - If cars are purchased to be used as tests, the car dealership pays directly the total amount to the car maker. Adis Auto can use its own funds or an overdraft.
  - If cars are sold to clients, the car maker pays once a credit is contracted between the client and a partner bank. Partner banks and the car maker work together to make good car-credit offers where interest rates are adapted to client's guarantee.

- For Subaru, the process is different: the car maker needs to receive 20-30% of the car's value before launching the production. The client has to pay before the car reception.

### **Ukraine's crisis in the car industry**

- A short history of new cars sales:
  - 2008: 700 000 cars
  - 2009: 120 000 cars
  - 2013: 220 000 cars (best year after the crisis)
  - 2014: 50 000 cars (worst year since the 90s)
- Car market is now stable, around 700 000 cars (including new and second-hand cars) are sold per year . When new cars are too expensive for Ukrainians (in case of a crisis), second-hand cars are bought instead.
- Adis Auto withstood the first crisis (2008) because its business started in 2006 and, at that time, they had not borrowed money yet.

### **Car sales and credit**

- Compared to the average salary in Ukraine, new cars are very expensive. Few people can afford such purchases.
- Even if some citizens can afford new cars (for example in the IT sector), most of the time buyers use bank credits to finance their acquisitions. They often pay cash a small portion of the car's price and directly apply for a credit to a bank, through partnerships, to repay the remaining amount.
- To increase car sales, car companies collaborate with banks. A car can be bought with a 10% interest rate instead of 18% if a loan is contracted with a bank associated with the car company: Peugeot cars, for example, can be bought through a partnership with Credit Agricole.
- To get a loan, a stable work situation (job in navy, IT or multinational company) and a clean banking background are required. Open data on banking history speeds this process which can last only 3 hours.

- This system increases new car sales. For example, more than 90% of Peugeot sales are linked to bank credits. Interest rates for new car purchase can be very low (up to 0% sometimes) compared to second-hand interest rates which are around 21%.

## **Interview with Citrus, a network of electronic stores in Ukraine**

### **General description**

#### **Hashtags**

Odessa; Retail; Non-bank Financial Products

#### **Institution**

Citrus is a network of 55 electronic stores across Ukraine, which is born in Odessa. The company recently launched an online platform which accounts for around 20-30% of total sales. In the stores, activities are diversified as follows:

- Sale of electronic devices (small market)
- Sale of accessories (cables, protectors, batteries,...)
- Insurance
- Item personalising
- Training on the usage of electronic devices

#### **Participants**

- Alexander Mazurik, commercial director
- Lilia Nikolenko, lending manager

## Relevant points of the discussion

### Purchases financing

- Items are less and less purchased cash (20% of all payments). Citrus clients use consumer credit for 4 to 25 months with an interest rate of 0-0,1%.
- Banks interest rate is around 18% so Citrus needs to bridge the gap between these two interest rates. For this reason, the price of an item is higher than in other countries to include the interest rates difference. The maximum length of a loan is highly linked to the margin done on a specific item.
- Consumer credit market started to develop after the 2014 crisis.

### Consumer credit

- Citrus (and many other consumer products sellers) has developed partnerships with banks in order to quickly offer loans contracts, in stores, with dedicated Citrus agents, through the following process:
  - The client first chooses among the different possible partner banks.
  - Citrus agents then evaluates the risk associated to this person, thus acting as in-store brokers for the partner banks.
  - After this first check, the evaluation realized by Citrus agents is transmitted to the partner bank, which verifies if the client is not on its "black list". If the bank has any suspects on the client, it informs Citrus, otherwise the bank validates the credit.
  - If the credit is validated, the client can purchase the item and all the loan's administrative tasks are directly performed by Citrus and the bank after the purchase.
- With this consumer credit system, both Citrus and banks take some risks. For this reason, auto-control of risk assessment carried out by both parties is essential.
- Historically, banks used to send their own agents in-store but then, credit evaluation has been delegated to Citrus agents through these partnerships. Ukrsibbank was the first bank to sign such delegations.

- A new type of consumer credit appeared a few years ago. Instead of getting a loan from one random bank, clients can get a credit from their own bank thanks to their credit card. The client directly asks for a credit authorization on the payment terminal and, if the credit is accepted by the bank, the payment is carried out. PrivatBank was the first bank to develop these system and other banks develop these types of payment so far, which are very efficient to speed up the payment process.

# Appendix F: Interviews on Future Challenges

## Interview with the Center for Economic Strategy & DeJuRe

### General description

#### Hashtags

Judicial sector reform; Corruption; Education

#### Institution

- The Center for Economic Strategy is an apolitical Ukrainian NGO, focused on economic policies research. It is a platform allowing to gather experts and organisations, in order to elaborate new economic reforms for Ukraine. It focuses on five main axes: strategy of state banks, privatization, medium-term budget planning, simplification of currency exchange operations, sharing participation for the development of Kyiv's infrastructure, currency liberalization.
- DeJuRe stands for "DEMOCRACY, JUSTICE, REFORMS" and is an NGO oriented towards the reform of the Ukrainian judicial system, promoting the rule of law and anti-corruption systems. Given the strong links between the rule of law and the efficiency of the banking system, the organization closely works in collaboration with the CES.

#### Participants

- Maria Repko, deputy director of the CES
- Mykhailo Zhernakov, director of DeJuRe

## Relevant points of the discussion

### General statements

- The reform of institutional bodies is ongoing and some progress has been made: a law on restoring trust in the judiciary (april 2014, Porochenko government) has been voted by the Rada, NBU's management was re-structured, the Anti-Corruption Court was recently created, the NABU anti-corruption authority was created and the Patrol Police was re-formed.
- However, a lot of efforts are still needed and the success of the reforms cannot be taken for granted. The judiciary system is still one of the less trusted in the world (10% public trust), with a user satisfaction of 50%. Several institutions, which are supposed to ensure the correct functioning of the rule of law, still lack of efficiency.

### Corruption

- Corruption is the most important sore of the judiciary system, which completely lacks independence. Judges are directly influenced by politicians and most of them have not been renewed since the post-soviet eras.
- Judges have created a self-renewing "cast", which objective is to preserve the advantages it benefits from corrupted methods. The press reports very often judges who own an unreasonable number of luxury cars, houses and goods. When they are held accountable for corruption practices, the commissions which are in charge of interrogating and judging them are composed of judges which close an eye on the abuses of their colleagues. If we compare their belongings to their salaries, frequently amounts do not add up.
- Corruption appears very early, since university, were many law professors can be corrupted in return for high grades or diplomas. Not all Universities and professors are concerned, but these are frequent practices.
- Corruption has naturally an effect on the banking system. The recovery rate of loans in Ukraine is 10%, with only Indonesia having a such low

rate. 94% of the decisions are taken in favour of banks, but delays in the procedures are enormous and even in a court takes a decision, it is very often impossible to collect back the collateral and there is no legal way to enforce the court ruling.

- Corruption is a mentality in Ukraine since it was the only way for people to get basic goods in the Soviet Union. This mentality should decrease if the government is able to provide necessary goods to citizens, especially medication.

### **Institutional reforms**

- The judicial reform needs to be implemented through the replacement of judges and the restructuring of existing institutions. The most important tool of this reconstruction is the implementation of new methods for judges selection.
- A top down reform
  - New selection methods were first implemented for the Supreme Court, thanks to the help of an international committee composed of English, Danish and other mainly European Judges. This committee was responsible for suggesting 12 possible new judges of the court to the Ukrainian authorities, which were in charge of selecting 6 final members of the court.
  - Besides allowing a simple and progressive rebuilding of the system, a top-down reform enables also to create a barrier to the current abuses of the judiciary system. If an ill-intentioned defendant wishes to win a lawsuit simply by systematically appealing a decision at each stage of the trial, the case will finally be appointed to the brand-new fair and incorruptible Supreme Court that will be appointed to hand down the final judgement. This dissuades therefore to take profit of decision appeals.
- Finally, high wages are crucial to enable judges' impartiality. Progress has been made to tackle this issue wages, and some judges' wages even increased from 2k to 8k/month, but such measures have to go further.

# Interview with Vox Ukraine

## General description

### Hashtags

Institutional Reforms; Land reform; Corruption; Banking sector

### Institution

Vox Ukraine is one of the most influential economic think tanks in Ukraine. Its goal is to elaborate news, with a strong analytical and quantitative point of view. Some of Vox members are well-known experts of the Ukrainian economic scene and have sometimes become important members of the Ukrainian government (e.g. Tymofiy Mylovanov, the current Minister of Economic Development, Trade and Agriculture).

### Participants

- Ilona Sologub, scientific director and C.E.O. of Vox Ukraine
- Yulia Mincheva, VoxConnector Editor

## Relevant points of the discussion

### General statements

- A general introduction on the current economic and political context was first given by the speakers.
- The outline explained the general political system of Ukraine (e.g. the electoral system of the Parliament, whose members are elected half on a list and half on the basis of local districts).
- The participants also highlighted the current will (also pushed and backed by international institutions such as the IMF) to reform the system: the NBU became independent in 2015.

## **Banks privatizations**

- 56% of banks are nationalized in Ukraine, especially since PrivatBank case (more than 50% of the market share).
- A plan to privatize the banking sector is supposed to be drafted in 2022-2025.

## **Land reform**

- 7 million land plots were distributed in the early 1990s from previous Kolkhozes, so far this market has never been liberalized.
- The land reform will be achieved with no rush, because the price of lands is expected to rise after the opening of the market, even if it will stay lower than in most European countries.

## **Corruption and Transparency**

- In order to escape from the inefficiency of the judicial system, a tendency of suing outside of Ukraine has been noticed.
- The year 2016 was a milestone for the Ukrainian judicial system: the independence of judges was reinforced and judges salaries were raised. However, some strong doubts persist, since a system that becomes more independent necessarily needs also to be already cleaned. It is therefore a difficult transition with a lot of congestions.

## **Institutional reforms**

- The organization has developed a specific quantitative Index, iMoRe (Index for Monitoring Reforms), which measures the elaboration of reforms of the Ukrainian institutional, economic and banking system.
- In a nutshell, the methodology consists in asking to a series of experts to rate the current status of reforms on a scale from -5 to 5 and then calculating the median of these rates. It is therefore a subjective index that depends on the own judgement of the experts.
- Current reforms were made possible by Oligarchs because many of them agreed and adapted to them. These measures have not impacted on

their personal wealth so far. The new reformist context was indirectly caught by them as an opportunity to reinforce their credibility and clean their image.

## **Interview with the Anti-Monopoly Committee of Ukraine**

### **General description**

#### **Hashtags**

Economic competition; Monopoly

#### **Institution**

Anti-Monopoly Committee of Ukraine (AMCU) is a state authority, established in 1993, which aim is to protect competition in the Ukrainian economy. The committee is directed by a chairman with nine state commissioners and its activities are under the control of the President of Ukraine. The AMCU is composed of a central body in Kiev, where 660 employees are working, as well as 26 regional offices. It supervises the activities of enterprises of all types of ownership in Ukraine, state and local authorities, or foreign entrepreneurs.

#### **Participant**

Igor Soldatenko, Head of the European Integration, International Cooperation and Communications Department

### **Relevant points of the discussion**

#### **Major function of the committee**

Its major function is to control the compliance with the legislation on competition, established in Ukraine. It includes the control over mergers and monopolies in order to promote a fair competition in the economy, in accordance with the law “On Protection of Economic Competition” enforced in 2002. This law defines legal grounds for maintenance and protection of economic competition and for limitation of monopoly in economic activities.

It aims to ensure efficient functioning of the economy of Ukraine on the basis of developing competitive relations.

Furthermore, the AMCU has to monitor public procurements as well as state aids, accordingly to its functions.

### **Focus on the main challenges**

In the particular context of the Ukrainian economic development, the AMCU has to face challenges such as a further harmonization with the European laws about competition which ensures that companies do not create cartels and monopolies which would damage the interests of the society.

Besides, as part of the EU-UA association agreement, several measures are going to be enforced such as vertical restraints regulation, fines guidelines and technology transfer regulation.

Two additional objectives of the Committee are the improvement of the quality of its decisions as well as ensuring legal certainty.

Finally, digitization is also a big challenge for the AMCU as the monitoring ways have to evolve along with the industrial landscape. The most profitable companies have changed during the last 10 years and the development of IT forces the regulators to adapt their tools.

### **Infringements**

- The AMCU deals with several types of infringements threatening fair competition. For example, in 2017, \$12.6 million were paid as fines in Ukraine because of an infringement of these laws. The Committee points out two main kinds of infringements which are the anti competitive actions of the state bodies in one hand, and the bid rigging on the other hand. The latter refers to an illegal practice in which competing parties collude to choose the winner of a bidding process while others submit noncompetitive bids. However, the list of infringements threatening competition is wide and non-exhaustive, including abuse of dominance, anti competitive concerned actions, anti competitive actions of public authorities, unfair competition; mergers/concerned actions without the AMCU's permit, non-provision of information to the Committee.
- To face these various infringements, the AMCU uses adapted tools. They can either fine the company up to a certain percentage of its

turnover of the previous year, but they can also decide to force the separation of the company in order to ensure more competition in the sector. One of the main concerns of the AMCU towards its anti-monopoly policy is to treat companies with the same concern, whatever the size or the economic sector: this is the competition neutrality.

- It was also pointed out that half of their decisions were going on appeal and afterwards, two-third was finally compliant with their initial decision.

### **Main industry sectors**

The priority industry sectors for the AMCU in 2017 were the pharmaceutical, fuel and energy, and telecommunications, as well as transport and consumer goods areas.

The AMCU investigated 317 cases of anticompetitive concerted practices while the biggest combined fine for this type of violation reached approximately EUR 41 million in the fuel industry and EUR 4.1 million in the pharmaceutical area.

In the banking sector, they noted an increase of the Herfindal index between 2014 and 2018, disclosing an increase in the concentration of the market due to the action of the NBU. The number of unfair business practices cases investigated by the AMC in 2017 totaled to 256.

## **Interview with the Embassy of the French Republic**

### **General description**

#### **Institution**

The French Embassy in Kiev is one of the most important vectors of the diplomatic relations between Ukraine and the French Republic, which were established 25 years ago, after the fall of the Soviet Union. Its several services ensure a complete collaboration with the Ukrainian government and the representation of the French economic actors on the Ukrainian territory. Our discussion was mainly lead by the economic service of the embassy, which aims to foster the local establishment of economic and industrial relations

with France and closely monitors the current evolution of the Ukrainian institutional, political and industrial systems.

## **Participants**

Vincent Pringault, head of the Economic Service

Flaurent Dauba, deputy head of the Economic Service

Alix de Gassard

## **Relevant points of the discussion**

### **General statements**

- Since Maidan's events in 2014-2015, Ukraine is undergoing a deep shift in its ideological, both at a national and international scale, by building new links with the EU, reforming its institutions and adopting a free-market approach on its national economy.
- The arrival of Volodymyr Zelensky at the head of the State in May 2019 was a new significant event of Ukrainian politics.
- Its electoral strategy was highly disruptive, leveraging new communication means and methods (e.g. social networks, TV shows).
- The new government has showed determination to intensify the reforms' path and to renew the management of Ukrainian institutions, by building a team of new, young and highly qualified ministers.
- However, the influence of oligarchs such as Ilhor Kolomoisky on Ukrainian political and economic affairs is still to be closely monitored.
- In conclusion, Ukrainian has showed signs of change, but the stability of this transformation still remains unsure.

# **Interview with the Ukrainian Corporate Government Academy**

## **General description**

### **Hashtags**

History of Ukraine; oligarchs; corruption; education

### **Institution**

The Ukrainian Corporate Government Academy (UCGA) is an independent, non-profit, governmental association which aim is to promote best practices of corporate governance in Ukraine. To reach this objective, the academy has built relations with people from key investments banks, consulting and international financial institutions. Above all, it recently signed a memorandum with the French business school INSEAD (Institut européen d'administration des affaires) which gave them the opportunity to present certain courses of the French business school in order to train members of companies' boards, in line with the academy's objectives.

### **Participants**

- Adomas Audickas, President, former Lithuanian deputy minister of Economy and Innovation.
- Taras Ivanyshyn, Executive Manager.

## **Relevant points of the discussion**

### **Historical context of Ukraine**

To understand the current economic situation of the country, it is first important to analyse the historical context. Ukraine has a certain legacy after the soviet era: after the end of USSR, there were 3 000 state-owned companies and 1 100 of them had revenues below \$1 billion per year. In this context, Ukraine decided to privatize most of its companies in the 90's.

## **The evolution of Ukraine's governance philosophy**

- Nowadays, state-owned companies create 10% of the GDP. The biggest companies of the country are in the gas sector and Ukraine is the second country in Europe in term of gas reserves. The gas activity represents 3% of the country's GDP. But Ukraine is also developing and exploiting other sources of energy such as hydro power.
- However, this evolution in the country's economy took place in parallel with an evolution in its governance philosophy. When Ukraine was part of the USSR, there was theoretically a culture of "equality", through the communist ideology. But in reality, the model was built on a true hierarchical structure. Companies' boards were not really used and decisions came from the very top. People were not thinking about the reasons of their tasks because they did not have to take any decisions. The idea was the following: letting people take decisions and giving more independence to the boards would encourage the members of a company to start working for their own interest without thinking about the company's interest. At this time, it barely took half a year to approve a budget. Today, the aim is to give more flexibility to the boards, but it is a long process to reform the institutions. Moreover, more flexibility can also imply mistakes in the decisions. In this context, the role of UCGA is to release recommendations; five programs have been developed, focusing on policy and education. The organization is not dealing with enforcement; they train members of supervisory boards.

## **Focus on the oligarchs' influence**

Oligarchs in Ukraine only have influence over politics, not on companies directly. There are two kinds of oligarchs: the true business men and those who steal money from companies. Ilhor Kolomoisky, one of the most powerful entrepreneurs in Ukraine and one of the most present oligarch of the current political scene, likes to "play the game of life", he enjoys power and is very influential. Concerning the land reform, there is a risk that oligarchs get all the lands available.

## **Corruption**

In Ukraine, the system is not liberal and regulations are quite tough, which makes business difficult. Corruption is ubiquitous and the current system can be compared to a football game without a referee, or with a corrupt referee. The main point is to have a referee doing his job properly because without that, business will be too difficult and nobody would want to invest in such a context.

However, it is slowly evolving. It is important to point out that corruption is not in the Ukrainian culture or genes; the problem is that the current system is suitable for this kind of activity. In Ukraine, the judiciary system is much easier to corrupt than in France, for instance, and the energy of people is going to wrong activities. They need to replace people, to change the referee.

It would need more or less ten years to change the situation significantly. In Lithuania, the economic environment changed: the GDP grew as the wages and the corruption disappeared little by little. The economic environment is strongly linked to corruption.

## **International relations**

Concerning the relations between UE and Ukraine, Maidan pushed Ukraine to choose only one path: Russia is no longer an option.

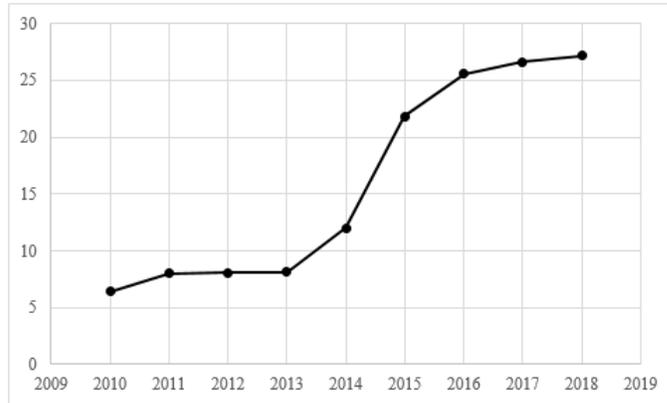
## **Relations between supervisory and management boards**

Supervisory boards of companies have a huge influence because they appoint management boards. Shareholders and managers do not often have the same objectives: managers want to lower the objectives to make them easier to reach, but the supervisory board can challenge them.

## **UCGA funding**

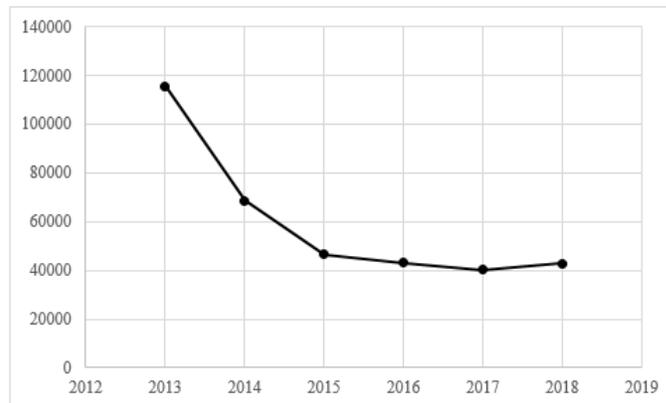
The UCGA is funded by the payments of people for the courses they follow, the academy is auto-financed for the educational activities. For which concerns policy design however, the organization is sponsored by UK and US embassy but not by UE, since they had difficulties in convincing the EBRD that their business was efficient.

# Appendix G: The Ukrainian economy, few figures



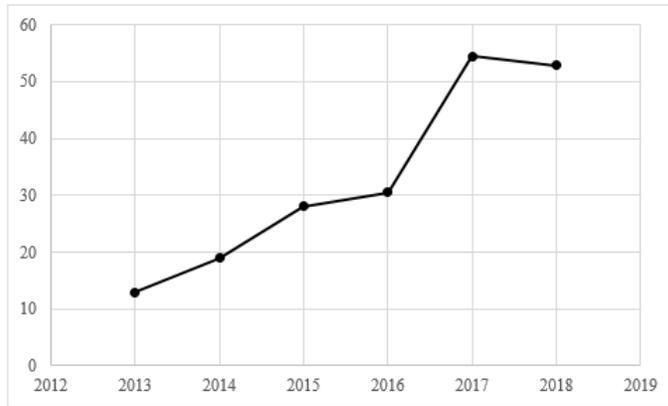
Source : NBU data

Figure : Hryvnia exchange rate variation (for 1 USD)



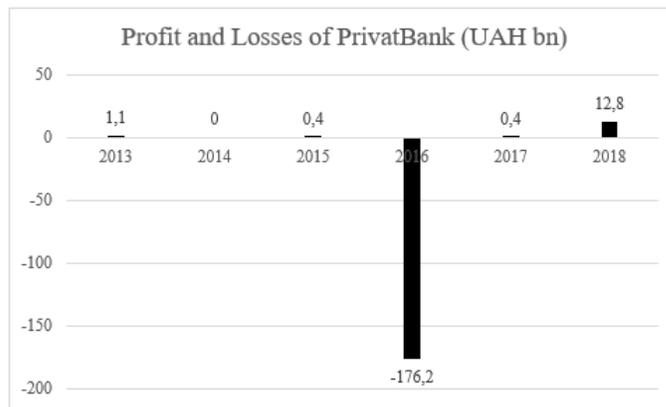
Source : NBU data

Figure : Total assets in the banking sector (mEUR)



Source : NBU data

Figure : Amount of non-performing loans (% of the total loan amount)



Source : PrivatBank annual reports

Figure : PrivatBank profit and losses (UAH bn)

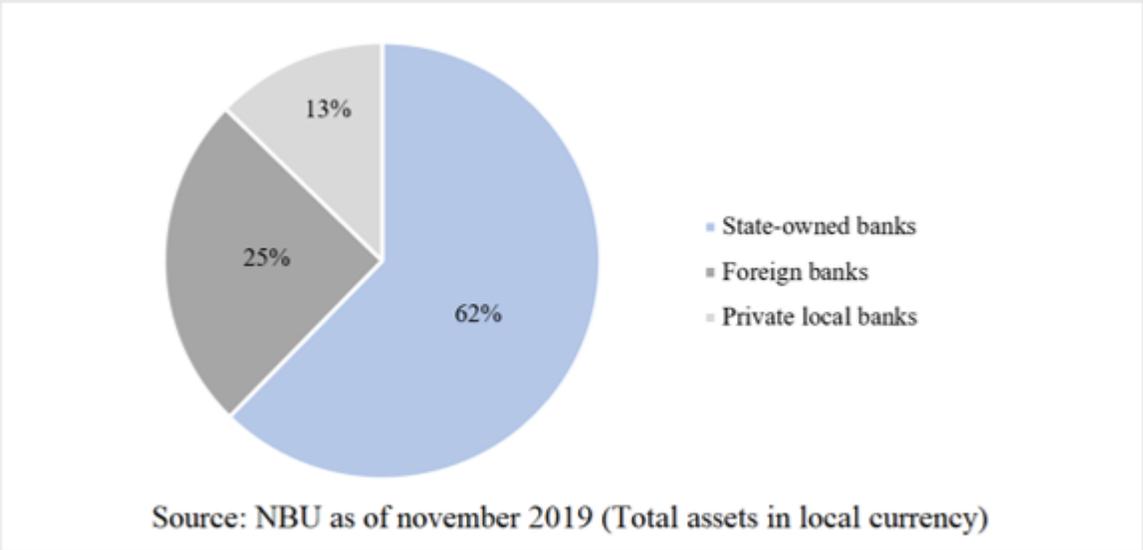


Figure : Market share of banking sector assets

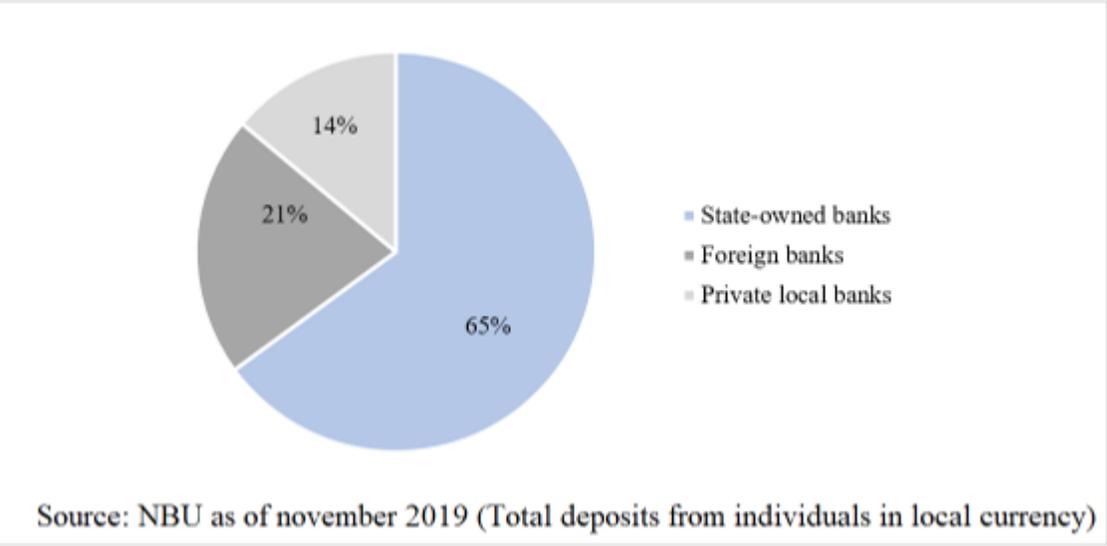


Figure : Market share of banking sector deposits

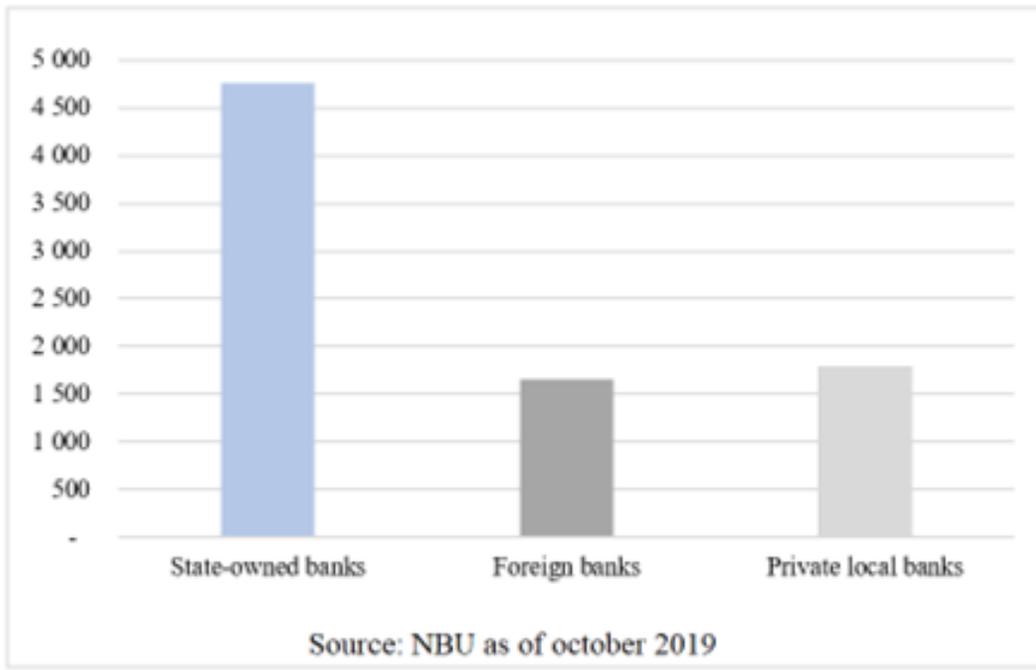


Figure : Number of operating departments across Ukraine

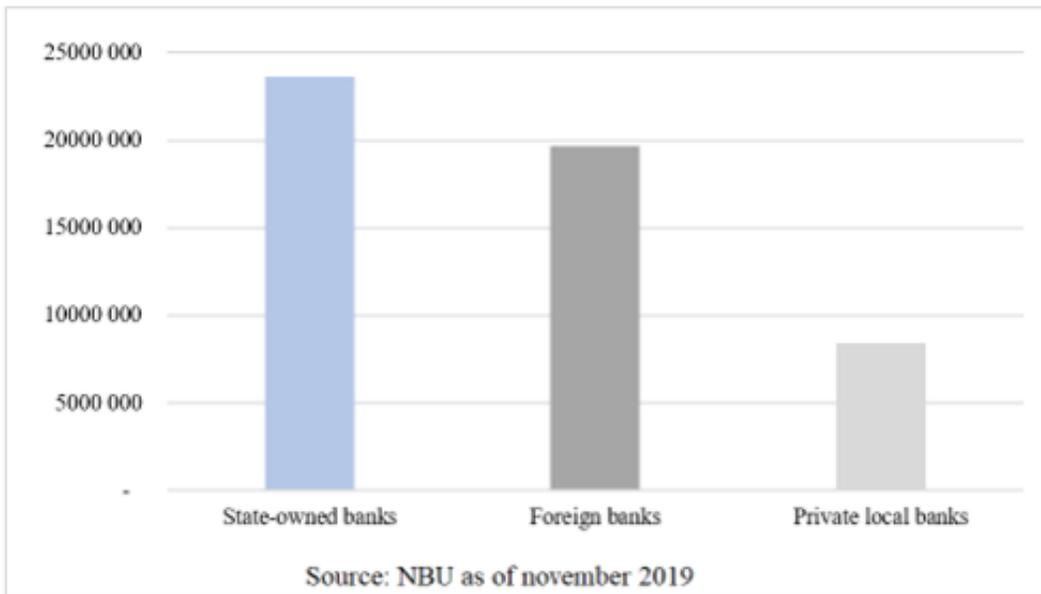
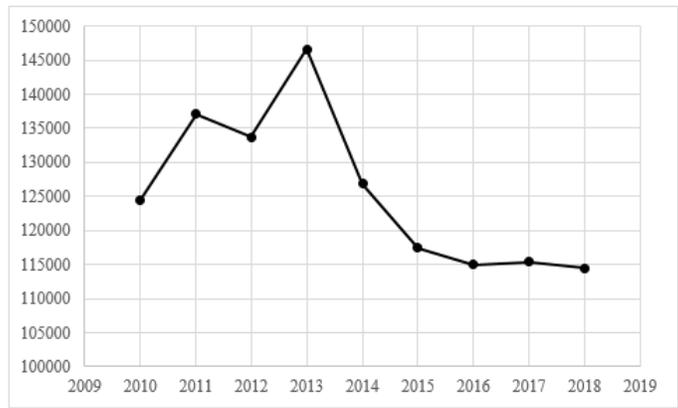
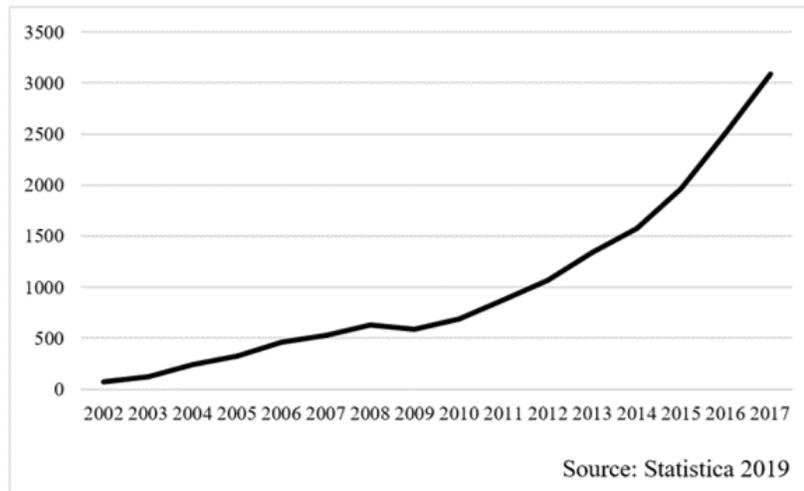


Figure : Assets due from the NBU (in thousands UAH)



source : World Bank

Figure : External debt of the banking sector (mUSD)



Source: Statistica 2019

Figure : Number of payment card transactions in Ukraine (in million)

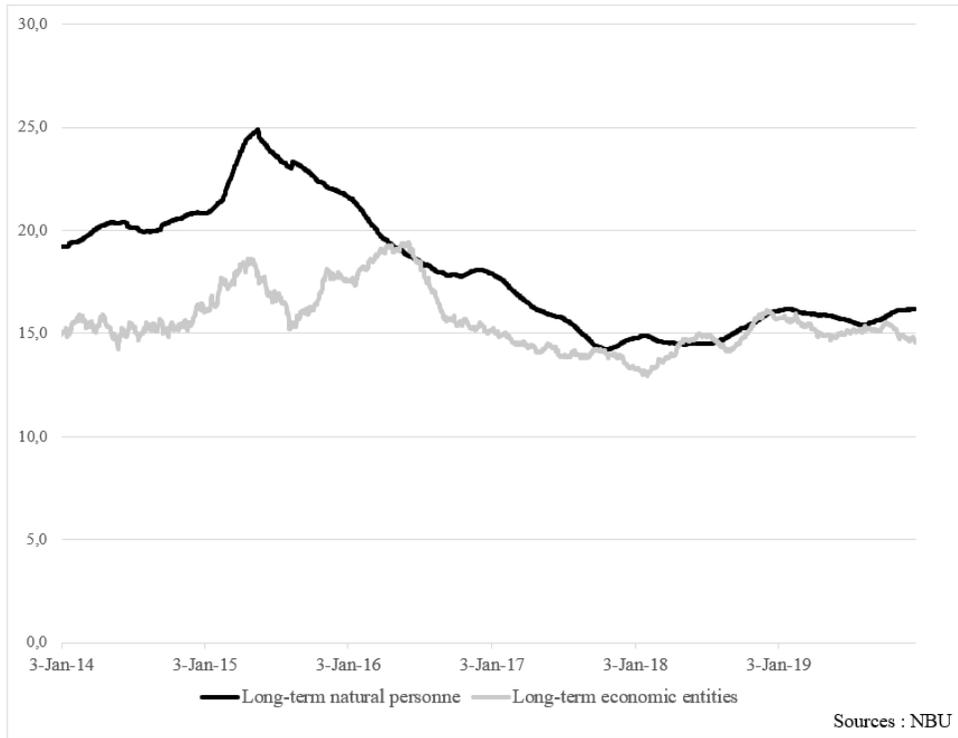


Figure : Long-term deposit rates evolution

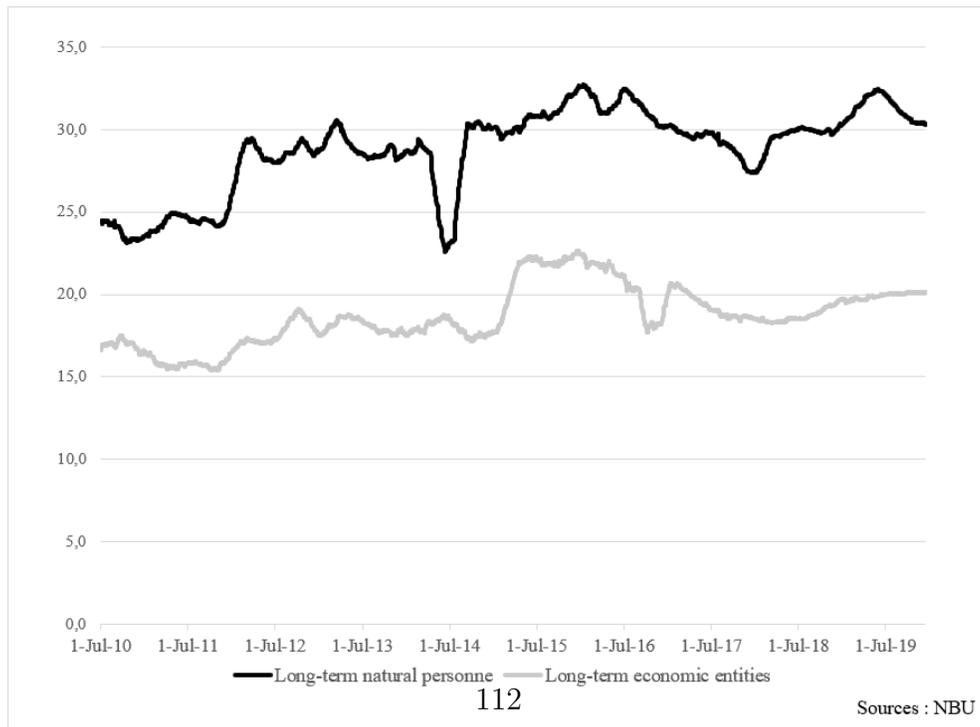


Figure : Long-term loans rates evolution

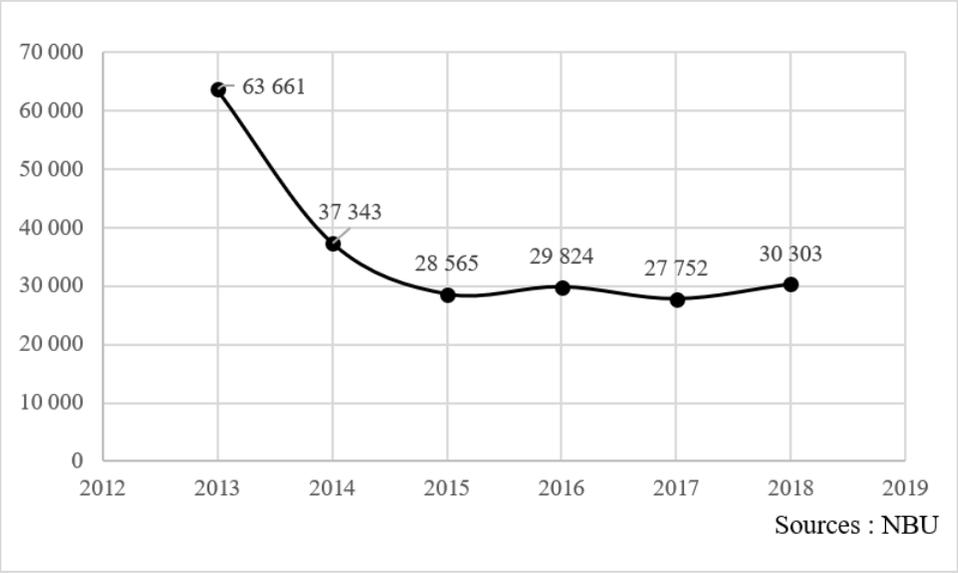


Figure : Total deposits (in mEUR)

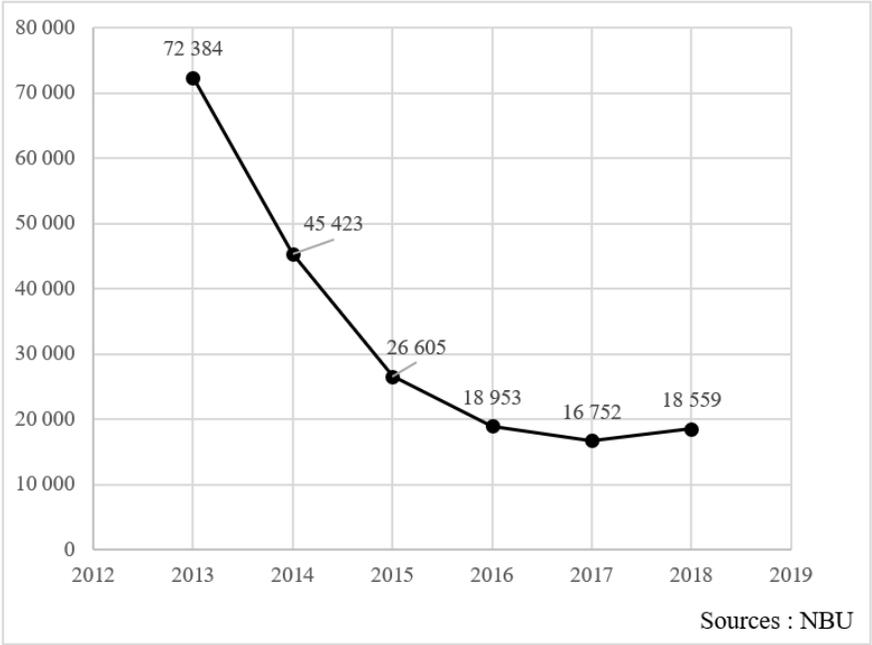
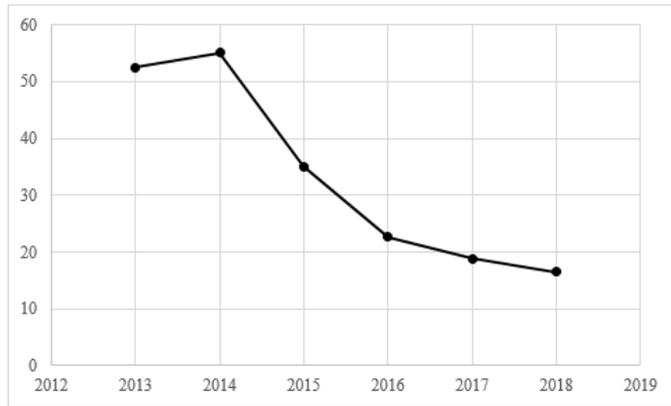
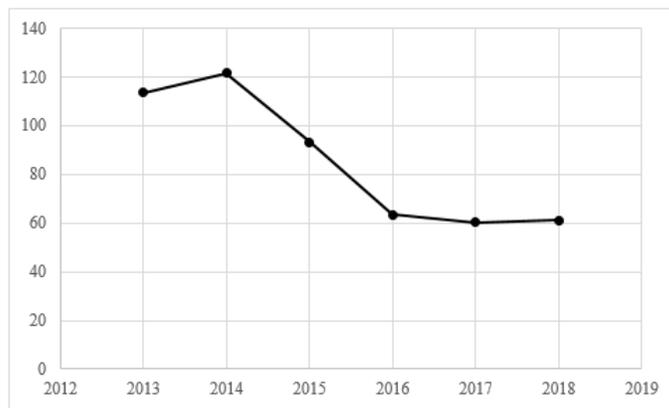


Figure : Total loans (in mEUR)



Source : NBU data

Figure : Loan-to-GDP ratio (%)



Source : NBU data

Figure : Loans-to-deposit ratio (%)

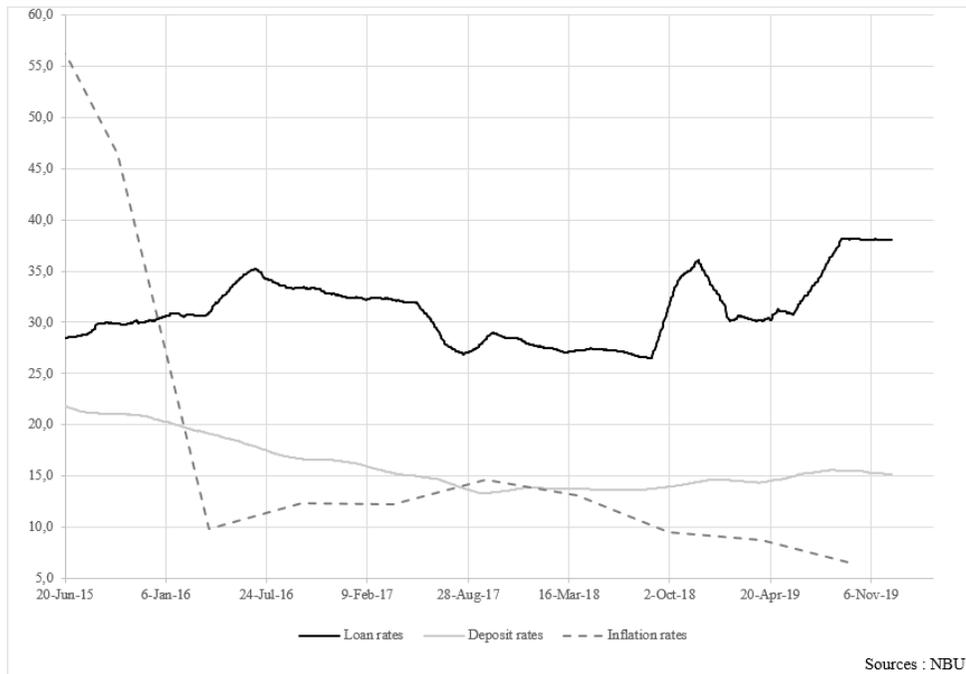


Figure : Loans and deposit rates versus inflation rate

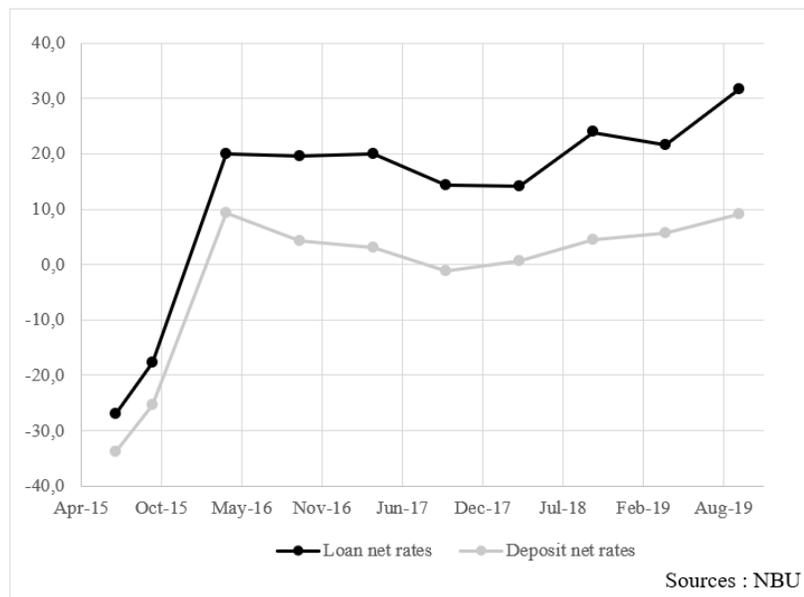
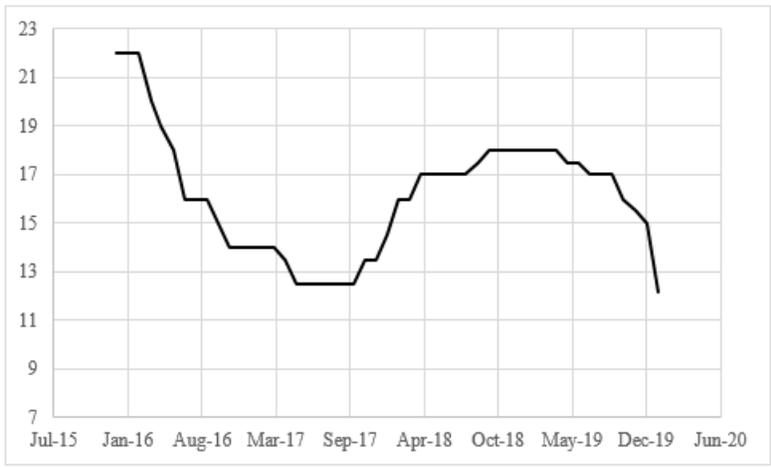


Figure : Loan and deposit net rates



Source : [www.investing.com](http://www.investing.com)

Figure : NBU benchmark interest rates (%)



Source : [www.tradingeconomics.com](http://www.tradingeconomics.com) / NBU data

Figure : Ukraine 1 year Bond (%)

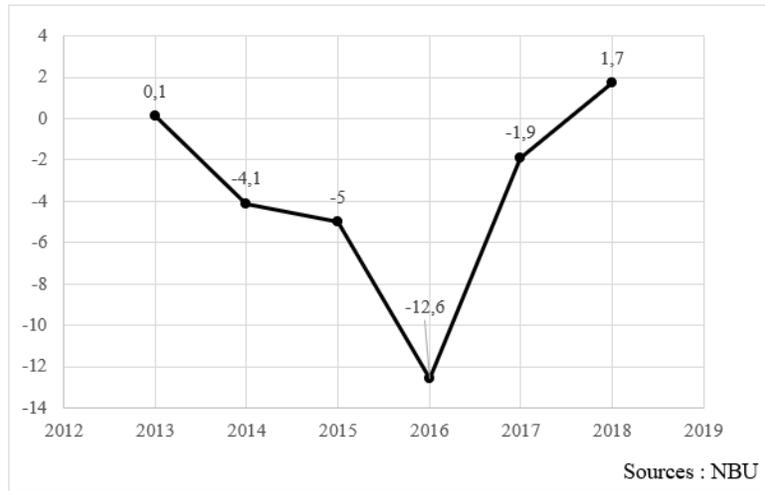


Figure : Returns on Assets for the banking sector

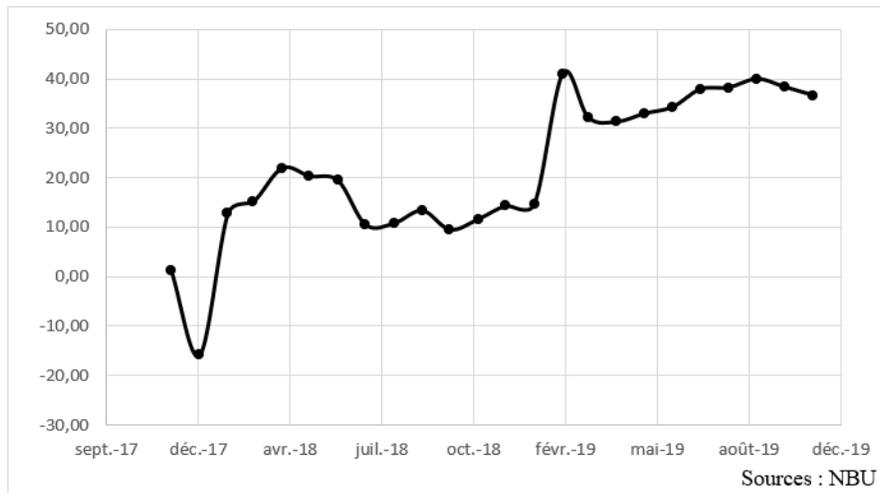


Figure : Return on Equity for the banking sector (in %)

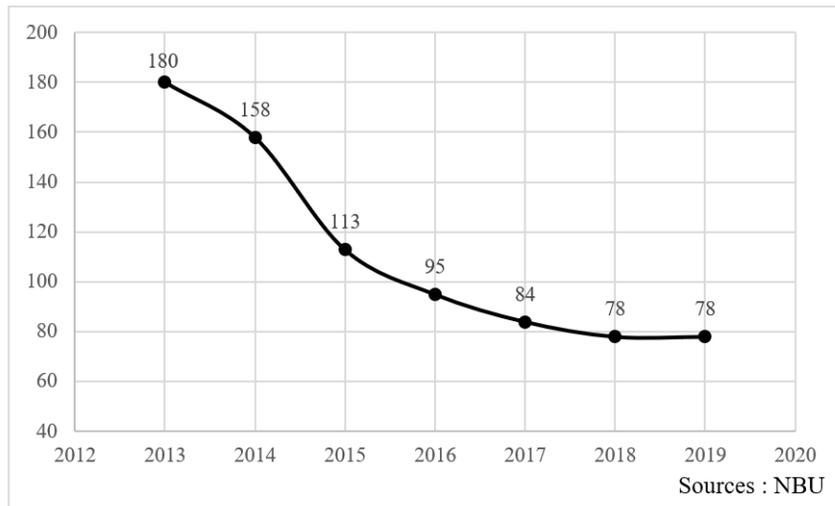


Figure : Number of banks

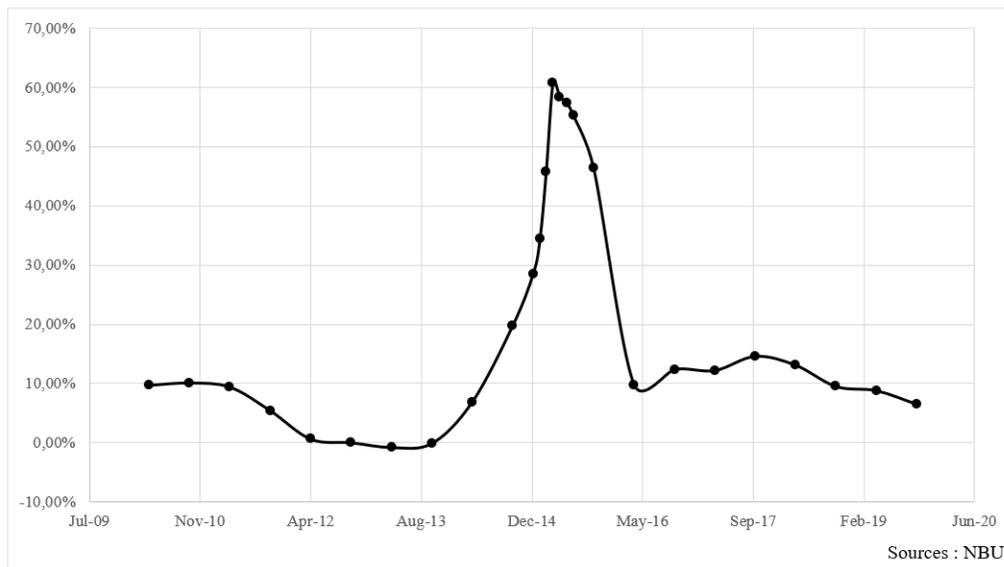


Figure : Inflation rate