BALANCING ON THE EDGE: THE UKRAINIAN BANKING SYSTEM UNDER STRESS

by

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Abstract

The importance of the banking system in the economy can be compared with the blood system's importance in human life. Any disturbance can hurt substantially not only banks but also the whole economy. A number of factors, which are connected with such disturbances, result in banks' illiquidity and insolvency. First this thesis discusses these factors. Then, this thesis includes the research on the influence of the recent financial stress in Ukraine on banking system of this country, and some other problems which characterized the Ukrainian banks' activity. Overall this thesis demonstrates that the recent financial stress had a massive impact on the Ukrainian banking system. Finally the thesis reveals that for 1999 the Ukrainian banks do not have the possibility to improve the quality of their assets and liabilities. In other words, the Ukrainian banking system is very close to crisis.

Table of context

1. Introduction

Since August 1998, the whole Ukrainian banking system has being in danger to become totally insolvent. This happened because the macro-economic situation worsened and the old questions of banking system were not solved. Macroeconomic problems include the devaluation of Ukrainian currency and the government restructuring of internal bonds (OVDP). Old questions to solve include the internal problems of banks: the small amount of capital, the low quality of assets (credits) and management, the low level of earnings and liquidity. All these points will be carefully discussed in this research. The thesis also presents the theoretical background of this problem. The main purpose of this research is to illustrate the influence of the financial stress of August-September 1998 on the Ukrainian banking system, and to assess the chance of a banking crisis occurring in 1999.

A crisis of the banking system merits special attention. When a banking crisis occurs, the whole economy gets a sharp shock. In a crisis banks stop providing all payments. Additionally banks are not likely to fulfill their obligation on deposits.

The first section of the thesis, except introduction, includes a literature review. The second section contains theoretical issues, concerning banks' illiquidity and insolvency. The third section includes the effect of the recent financial crisis on the banking system of Ukraine: the influence of the currency devaluation, the restructuring of government OVDP, and the changes in banks' deposit amounts. This section includes also the influence of credit quality on assets' liquidity and earnings' level, the possibility of banking crisis' occurrence in

Ukraine during 1999. Based on findings of this thesis the fourth section includes conclusions.

1.1 Review of literature

Since banking system crises occur in many countries, and usually they have massive impact on the whole economy, there are a number of economists who research banking insolvency. Most of these researches contain not only theoretical issues but also practical experience of different countries. They also pay special attention to experience of emergency countries which dealing with banking crises. To my mind some of these researches are especially important for my thesis.

Mishkin (1996) in his article starts the determination of crises' special characteristics from asymmetric information issue. "A financial crisis is a nonlinear disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to economic agents who have the most productive investment opportunities" (Mishkin, Frederic S. 1996, p.39). The author also emphasizes that financial system crisis influences the whole economy, which can not fulfill its functions. According to Mishkin, four categories of factors promote financial crises: increase in interest rate, increase in uncertainty, asset market effects on balance sheets, and banking panics.

Some of these factors, according to Mishkin, are especially important for developing countries. For example, currency devaluation occurs more often in developing countries, while currency appreciation occurs usually in developed countries (Ibid., p.42). Increases in interest rates, stock market crashes, depreciation or devaluation (when debt is denominated in foreign currencies) can cause a deterioration in nonfinancial firms' balance sheets that makes them less likely to pay back their loans (Ibid., p.43). As a result, banks will not receive their loans back and their state will be vulnerable. Currency devaluation also leads to banks' capital deterioration. Then banks may fail to meet capital standards. Mishkin emphasizes that banks must shrink their lending until they can raise new capital to meet the capital standards (Ibid.).

Theoretically, the first remedy against the disturbance of banking system is to provide deposit insurance. However, "…even in the absence of explicit deposit insurance governments stand ready to provide support to domestic banks when they face runs" (Ibid., p.34). Thus, according to Mishkin, banks that are provided with a safety net can (and do) take on greater risks than they otherwise would (Ibid.). Additionally, depositors have little reason to monitor the banks' activity if the safety net exists (Ibid.). Regulatory requirements are also important for avoiding banking system disturbance. For example, under the absence of a capital requirement, if bank has too little capital, Mishkin stresses that its incentives to engage in moral hazard and to take big risks increase dramatically.

Gerard Caprio Jr. and Daniela Klingebiel (1996) in their article discuss other leading indicators of banking crises. The first indicator is financial deepening: flat or falling ratio of the M2 to GDP shows that problems remain in the banking system. The second indicator is development of real credit: negative real credit growth may reflect a credit crunch while exploding credit growth (well in excess of twice real GDP growth and sustained for several years) may reflect distress borrowing from those in default. The third indicator concerns real deposit interest rates: high rate leads to distress in the banking system, while significantly negative real rates on a sustained basis often signify a credit crunch or government intervention. And finally, the fourth indicator is recurrent problems in the banking system after restructuring: unsustained recovery might have different causes, for example, "…banks did not stop lending to their borrowers in default or the government did not manage to bring fiscal, monetary, or external imbalances under control" (Caprio Jr., Gerard and Klingebiel, Daniela 1996, p.93-94).

In his article Patrick Honohan (1997) describes the contrast between epidemics of the macroeconomic and microeconomic varieties, and between these factors and syndrome of epidemic failure, typically associated with pervasive government involvement in the banking system. According to the author, except macroeconomic issues, all other factors are especially important in developing and transition economies.

Morris Goldstein and Philip Turnur (1996) in their article discuss the factors responsible for banking problems in developing countries and the policy options available for reducing the frequency and severity of these crises. Providing several examples from the emerging economies' experience, the authors highlight the following factors: macroeconomic volatility: external and domestic; lending booms, asset price,collapses and surges in capital inflows; increasing bank liabilities with large maturity/currency mismatches; inadequate preparation for financial liberalization; heavy government involvement and loose control of connected lending; weakness in the accounting, disclosure and legal framework; distorted incentives; exchange rate regimes.

Such a short review helps only to estimate the field of future research. The empirical part of this thesis includes research of an emerging market's experience: Ukraine. Taking into consideration this point, the theoretical part of this thesis includes factors which characterized emerging markets' economies in first turn.

2. The major characteristics of banking system crises

The banking system crisis occurs if a great number of banks are insolvent. A commercial bank is insolvent (or bankrupt) when the value of its assets have fallen below its liabilities' value. The main factors, which determine insolvency, are long-term problems with liquidity, and limits on equity capital increasing. The liquidity issue should be divided into two parts - assets quality and nature of liabilities. These characteristics are especially important for the transition economies and economies in the conditions of stress[1].

2.1. The assets quality

The following issues determine the influence of assets quality on liquidity.

Risk diversification: this issue means banks' ability to provide many types of loans to a number of customers (when you do not "put too many eggs in one basket"). However,

[1] Under stress I mean any external disturbance to banking system, which occur in the economy (for example financial crises).

under emergency market conditions risk diversification is usually impossible because of frequent macro-economic stresses, and poor financial performance of the majority of companies. As a result, banks' choice of credit policy is limited. Therefore, these problems with loans cause dreadful changes in the whole credit portfolio's quality. The direct effect of such limits in risk diversification is the fact that banks provide loans to well-known clients. This leads to another problem, so called "connected lending".

Connected lending: " Connected lending "refers to loans extended to banks' owners or managers and to their related businesses…" (Goldstein, Morris and Turnur, Philip 1996, p.20). Connected lending leads to "asymmetric information" (which means unequal distribution of information between insiders and outsiders). Both these issues' presence in bank's credit policy means a decrease credit efficiency and quality. And if they occur systematically, their negative influence on credit portfolio's quality increases dramatically. A special role in credit policy belongs to management quality.

Nevertheless banks can provide loans to different clients using collateral. Collateral covers the risk for the bank if clients can not return the loan. Therefore if banks use collateral for deciding information problems, then they in general can find resolution of connected lending and asymmetric information problems by using collateral.

Management quality: the absence of a formalized manual for banks' middle level management can lead to an incorrect assessment of a borrower's credit quality (mistakes in determination of clients ability to meet their loan obligations). There are many problems which middle level management meets in the process of loan provision: the absence of written policies on credit allocation; the absence of portfolio concentration limits; a cursory financial analysis of borrowers; an excessive reliance on collateral; infrequent customer contact; inadequate checks and balances in the credit process; the absence of loan supervision; a failure to improve collateral position as credit deteriorates; poor controls on loan documentation; excessive overdraft lending; incomplete credit files (McNaughton, Diana 1996, p.32). These factors combined with corruption among management lead to the low quality of credit portfolio.

Credit expansion: this can lead to decreasing credit quality, when middle level management stops paying attention to clients' financial condition. Credit growth is especially dangerous if its growth is higher than GDP growth (as far as that means that there is no possibility among clients to meet their loans' obligations).

Macro-economic factors have a separate influence on the assets' quality and their liquidity. Four such factors are: sharp decline in real exchange rate, fall in real GDP, unexpected inflation, and state policy, are discussed in turn.

Sharp decline in real exchange rate: this issue hurts banks' assets in several ways. First, under currency devaluation real value of banks' assets decreases especially when credits interest rates are unchanged in short run but deposits interest rates are increased. Second, banks in emerging market countries often lend in foreign currency. However clients usually earn their incomes in local currency. As a result, "… a large unhedged debtor position in foreign exchange not only makes banks and their customers more vulnerable but also makes it harder to deal with a banking crisis once it occurs…" (Goldstein, Morris and Turnur, Philip 1996, p.16). In this way, a sharp decline in real exchange rate decreases banks' liquidity.

Fall in real GDP: this issue means that the output level of most companies decreases and they will have problems with their loan obligations. Therefore, the quality of banks' credit portfolios will decrease and this will hurt banking liquidity.

Unexpected inflation: this issue leads to decrease of purchasing power. As a result, goods' sales also decreases. Then we have the same situation as previous one. The impact can be stronger if there are fixed interest rates on credits in short run.

State policy: this issue includes influence of government and influence of central bank. In transition economy, government can have influence on banking system through the influence on banking credit policy, through the support provided to insolvent banks, and through government stabilization policy. Such influence can be represented by the following situations: first, the allocation of credits to particular sectors; second, extend favorable loan discounting privileges to certain borrowers (Goldshtein, Morris and Turnur, Philip 1996, p.20). The general result of such policy is the increase of doubtful and bad credit in the banking system along with decreased efficiency of credit resource allocation. This happens because companies who get credits, usually can not get them under general conditions (their financial quality is low). Furthermore, the government can cover banks' losses and protect them from closure. As a result, "…banks tend to have lower incentives to innovate, to promptly identify problems loans at an early stage and to control costs" (Ibid., p.19).

Under the conditions of financial stress in a transition economy, the government and central bank may use commercial banks as "cash cows" to solve their budget problems and to stabilize the current situation. For example, government can "… require banks to hold government bonds at below market interest rates, impose high reserves requirements or taxes on banks…" (Ibid., p.20).

The central bank may also use commercial banks to stabilize currency market. For example, it can increase the level of required reserves, or may require deposit insurance savings be held only in cash, prohibiting the use of state securities for this purpose. All these factors certainly decrease banks' resources that are available for different activities.

2.2. Nature of liabilities

Emerging markets' commercial banks usually have a lot of problems with their liabilities. Some of this problems have strong effects on banking liquidity (deposit insurance, maturity mismatch, banks run, currency devaluation).

Deposit insurance: as it was discussed above, use of cash in deposit insurance has a direct effect on banks' liquidity level. Furthermore, Frederic S. Mishkin argues that even in the absence of explicit deposit insurance, governments stand ready to provide support to domestic banks when they face runs. Banks that are provided with a safety net can (and do) take on greater risks than they otherwise would. Depositors also have little reason to monitor the banks' activity under the safety net conditions (Mishkin, Frederic S. 1996, p.34). Again, greater risk in banking activity leads to deterioration of credit portfolio quality and eventually to banks' liquidity level decreasing.

Maturity mismatch: banks also may have problems with loans-deposits mismatch. Morris Goldstein and Philip Turnur argue that "… the risks of maturity mismatches are typically higher for banks in the emerging markets because they have less access to long-term sources of funding (on the liability side) and receive less assistance from securities markets in increasing liquidity and in spreading risk (on the asset side) than do banks in industrial world…" (Goldshtein, Morris and Turnur, Philip 1996, p.16). Under stress, clients usually start to withdraw their deposits, and banks' liquidity level decreases sharply.

Banks run: a run on bank can lead to two outcomes: either this bank's clients will transfer their money to other banks, or this bank's clients as well as other banks' clients lose their trust to the whole banking system. The second case is usual for transition economies where the most banks have the same characteristics. For this research, the second case is especially important. Under economic stress, individuals usually lose their trust in banks even sooner and start to withdraw their deposits. Commercial banks have special problems if their activities are characterized by maturity mismatch (as it was discussed above). In such circumstances banking liquidity level decreases immediately. This problem starts to be big if banks do not have enough resources for renewing clients' trust.

Sharp decline in real exchange rate: generally banks in emerging markets' can not find enough financial resources inside the country and borrow abroad in foreign currency (if foreign banks trust them). Usually they provide these resources to their borrowers in local currency. Then, under local currency devaluation local banks can not meet their obligations to foreign banks since their liquidity level decreases a lot.

2.3. Limits on equity increasing

Some of the problems that were discussed above transfer their influence from assets' quality decreasing into limits on equity capital increasing (especially if these problems exist in long run). First, banks' bad loans decrease interest earnings, which limit retained earnings growth. This problem starts to be especially urgent if banks do not have a profitable alternative to lending. Such a situation can occur if the general macro-economic situation in the country is very poor and there is a limited number of profitable industries. Second, central bank policy also may limit banks' equity increase by raising required reserves' level and deposits' insurance level.

Other problems are connected with banks' ability to earn profit. For example, if the stock market is underdeveloped, banks do not have the ability to make profits with stock operation (have limited possibility of stocks' disposition). Also banks may have problems with their investments for the same reason.

Therefore, all of these issues have massive impact on banking liquidity and possibility of equity earnings, and are leading indicators of banking crisis. The best way to avoid crisis is not allowed the discussed issues to occur. What does happen in reality, what does distress financial systems of Ukraine, which effect financial crisis has on banking system will be discussed in the next section.

3. The Influence of the Recent Financial Crisis in Ukraine on the Banking System

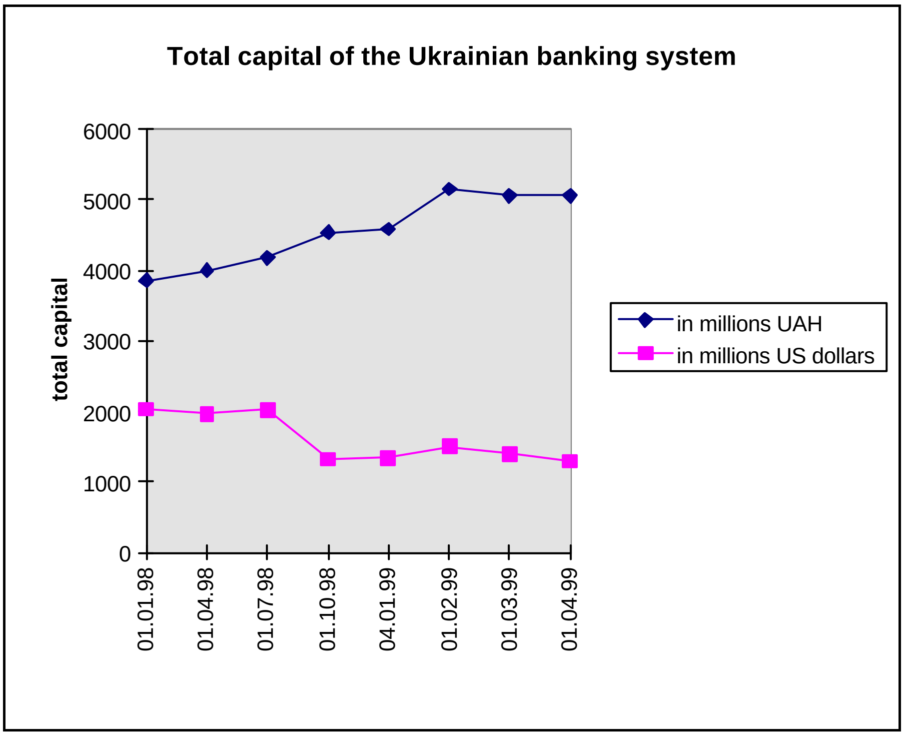
Several points can characterize the influence of the recent financial crisis in Ukraine on the banking system:

- a sharp decline in the real exchange rate;
- large scale state debt (OVDP) restructuring;
- the people's reaction to the financial situation in Ukraine and Russia (changes in

Beyond these problems during the recent stress, we can also identify other banking system problems: banks' credit portfolio quality and problems with banking activities' profitability. The next point of this discussion is why banking crisis did not occur during August-September 1998, the possibility of banking crisis in 1999, and the role of the NBU in current situation.

3.1. Sharp decline in the real exchange rate

A sharp decline in the real exchange rate can cause bank illiqiudity or even insolvency. Under such a devaluation of the national currency Ukrainian banks lost 34% of their capital in the beginning of October 1998 (Andronov, Oleg, Drobyazko, Anatoliy, and Sushko, Valeriy, 1998, p.60.).



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Also the banks met new problems with paid-in capital. According to the banking legislation their paid-in capital should be not less than 1 million EURO. If a bank wants to operate with foreign currency, its paid-in capital should be not less than 3 million EURO. Otherwise it will not get a license for such operations. But banks hold their paid-in capital in local currency. As a result of the recent devaluation small banks have problems with this requirement. Therefore the amount of total capital determined in UAH is increasing constantly. However this graph includes data in US dollars for better estimating the current situation, because in dollar terms total capital does not increase from August 1998. In this case dollar values reflect capital of banks in real terms. The NBU permitted the calculation of paid-in capital under a lower exchange rate (2.5 UAH/$). Nevertheless, fifty banks were very close to bankruptcy. Therefore there was the possibility of small banks' bankruptcy and mergers. In such case, a chain reaction could occur (through interbanks credits, despairing of clients trust to all banks).

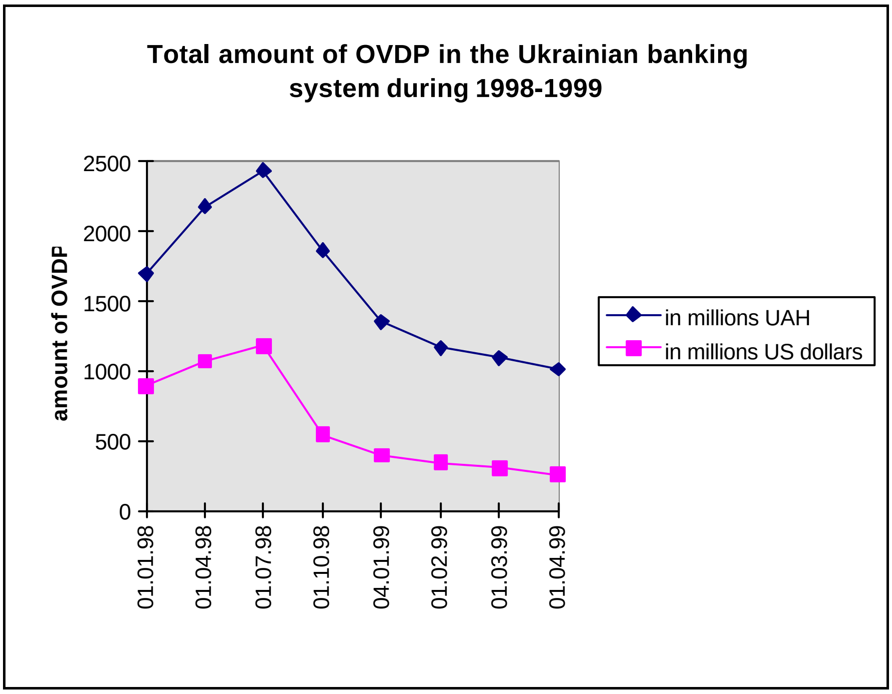
The NBU changed the situation at the last moment (March 31 was a deadline). It permitted small banks to continue increasing paid-in capital (up to 1 million EURO) and did not announce any bank as bankrupt according to this requirement. However existing problems of small banks are not resolved, because we can not expect that their paid-in and equity capital will be increasing continuously (after 1 million EURO limit) [2].

The high probability of further currency devaluation still exists. Then banks can meet new problems. Since foreign banks did not trust Ukrainians banks, they did not have large amount of foreign loans on August 1998 as Russian banks had. Thus this factor did not have influence on Ukrainian banks' liquidity. But before August 1998 the currency system was sufficiently liberalized. Banks provided some share of their credits in foreign currency (37.8% as of August 1, 1998 (Kovtun, Alla, September 19, 1998, p.1)). According to the experience of the emerging market economies this leads to negative results under currency devaluation. Clients start to have problems with their obligations (as far as clients get income in local currency). In addition, individuals have some amount of their deposits in foreign currency. Again, banks may face the same problems with their obligations.

[2] Small banks with small amount of paid-in capital (and equity capital also) can not work efficiently on the market. Because such banks can take less risk on their credit activity (as far as they should not take to much risk on deposit resources). But banks have very limited choice in low risk activities. Thus NBU should provide strict policy in this sphere (should support increasing their equity capital).

3.2. Large scale of state debt (OVDP) restructuring

Banks can easily resolve the problems discussed in section 3.1. if they have a high level of earnings. One of the most important assets for their earnings was OVDP holding. Under the pressure of financial disturbance, permanent debt increasing, overborrowing through state securities (the last OVDP sales were used for covering interest rate and principal value payments), and the behavior of nonresidents (they started to withdraw their capital from Ukraine) the government stopped their payments to commercial banks. In September, banks received the government's suggestions of their voluntary agreement for restructuring government OVDP obligations. Such restructuring means prolonging debt for different periods - some share of these OVDP will be paid during 1999, some share will be paid during the next three-five years. "During September banks lost 0.7 billion UAH of their liquid assets as a result of this restructurisation" (Andronov, Oleg, Drobyazko, Anatoliy, and Sushko, Valeriy, 1998, p.60.).



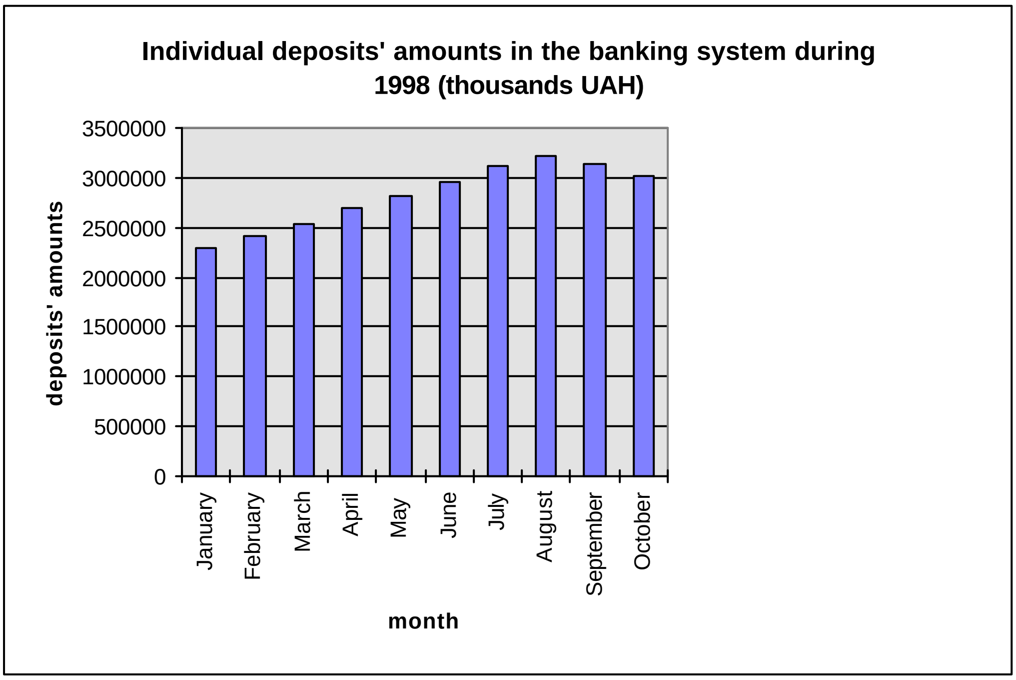
Source: data provided by HIID.

Government obligations for the following months were also restructured and some of their share were paid. “February payments also were restructured and would be paid during this year: 30% in May, 30% in July, 20% in August, and 20% in September. This restructuring leads to new problems: the converted bonds will yield 33% annually - the same as the bonds they replace - but expected inflation is over 20% for this year; and this time they were restructured without the banks’ agreement” (Bloom, Greg, February 11.1999, p.1). The Association of Commercial Banks insists that the recent restructuring is in fact a default by the government. Still banks do not have any guarantees that government will meet their obligations after restructuring.

In addition, the disappearance of the secondary OVDP market had a massive impact on banking liquidity level. Banks lost the possibility of selling OVDP at all.

3.3. Changes in the individual deposits’ amounts

The discussion of the last point of the influence of the financial crisis includes also the Russian experience. In Russia, the banking system was on the higher level of development (but also with greater problems - larger share of state securities in banking assets, large amount of foreign loans in banking system). More people saved their money in banks. They started to withdraw their money immediately, but unsuccessfully. In Ukraine the financial crisis also occurred, and the citizens carefully watched Russian events (Russian situation could have the effect of bank runs, as it explained in section 2.2.). Therefore we could expect that the Ukrainian citizens started withdrawing their deposits also (such situation can lead to a banking crisis). The amount of individual deposits did not decrease significantly.



Source: *Visnyk NBU* (Herald of National Bank of Ukraine), December 1998, p.45.

Such behavior of Ukrainian citizens can be explained by the provision of an insurance fund in September 1998 for individuals' deposits of not exceeding 500 UHA. Ukrainian citizens were limited in their buying of foreign currency. Possibly, they decided to hold their money in banks, because banks increased interest rates (during September - October up to 55–59% (Levada, Igor and Zarudnyy, Anton, November 6,1998, p.7)), and some share of the deposits was in foreign currency. Another positive factor in these conditions was temporary currency exchange rate stabilization by the NBU during October - January. The most important factor in this situation was that the Ukrainian citizens did not trust Ukrainian banks and did not hold all their money in banks (only some small share).

So, we can say that deposits' withdrawals did not hurt the banking system too much. *The main issues that influenced banking liquidity were local currency devaluation, restructuring of government OVDP payments, and the disappearance of the OVDP secondary market*.

3.4. The banking system's credit policy and credit risk

As it was emphasized, the Ukrainian citizens do not trust the Ukrainian banks. The Ukrainian banks are not very active in credits' activities. Information from the following table proves these statements.

country	demand deposits, % to GDP	term deposits, % to GDP	money in circulation, % to GDP	% of total credits to private sector
Ukraine	2.8	3.6	5	18
Russia	4.1	7.5	4.6	41
Poland	6.2	23.4	8.2	44
Greece	5.9	32.5	7.8	50
Turkey	2.4	12.1	2.4	72
Thailand	2.6	80.1	7.4	98

Source: *Ukraine on the Parting of the Ways.* ed. by A. Zinderberg and L. Hoffman. Kyiv: Feniks, 1998, p.226.

The Ukrainian banks have a lot of problems with their credits' quality. As it was discussed above, to decrease credit activity risk requires risk diversification. The general economic situation in Ukraine does not permit commercial banks to do this. It is possible to mention just few industries, which can be profitable (for example metallurgy, chemistry, especially gas and oil industries).

For understanding current banks' problems in their credit activity we should recall shortly the history of the Ukrainian banks' creation. During the Soviet period, in Ukraine there were five banks (actually branches of the Soviet Union banks) which dealt with specified industries of economy (for example, bank Ukraina specialized and specializes now in agricultural industry, Prominvestbank's main clients were and now are big plants). As far as at the end of 80s and at the beginning of 90s there was no stock market in Ukraine at all, banks which were organized during this period (banks of the second wave) usually belong to a limited number of shareholders (actually, most of them are so called "pocket" banks).

Actually, the government in Ukraine still has the ability to insist on credits for some industries. Some of these credits were given with government guarantees, and some without them. One popular way to provide such credits is as follows: the NBU provides loan to a bank according to the government decision, the bank provides loan to a company (companies). At some predetermined moment everybody should meet his credit obligations.

In general these companies were chosen according to some ideas (not to economic principals, for instance investment rate of returns). The bank should pay back the NBU. In such way the bank has bad loans in its credit portfolio. After August 1998 the possibility of repayments of such credits (even with state guarantees) disappeared, because the government started to have even more problems with its budget deficit. For example, every year (actually twice a year, in spring and autumn) the government provided loans to the agricultural industry. These loans were provided by bank Ukraina usually with government guarantees. During this autumn this bank was very close to the bankruptcy (by the way, Ukraina holds 10% of all individual deposits in the system - its insolvency de-jure would decrease the trust of Ukrainian citizens to banking system even more). The NBU's support cannot solve this problem. The most possible solution, according to newspaper articles, is its nationalization (Ryaboshapka, Svetlana November 21, 1998, p.7). Other big banks have the same problems with such loans (they only are not so severe as in bank Ukraina case). Therefore, the government policy has a strong negative impact on banks' credit quality.

The next issue is connected lending. Those banks whose shareholder are gas and oil traders (Ukrainskiy Creditinyi bank and bank Financy & Credit) actually did not have big problems during this period. Other not so lucky banks actually had problems. For example, "…20% of banking system loans are doubtful" (Zabska, Iryna November 1998, p.33). More importantly, the amount of doubtful and bad loans has been increasing during the whole year. Generally, banks prefer overdue loans and do not announce them doubtful or bad, because for overdue loans there is lower credit risk reserve rate:

Type of loans	March 1998	July 1998	October 1998	November 1998
overdue loans	1,077,095	1,189,216	1,379,695	1,401,708
doubtful loans	145,353	187,313	257,294	264,763
bad loans	84,981	164,152	223,860	231,306

Source: *Visnyk NBU* (Herald of National Bank of Ukraine), December 1998, p.45. (Numbers are million UAH)

It can be explained by problems with credit efficiency (connected lending), as far as banks usually provide loans to their shareholders or to enterprises, whose shares they hold. Then banks chose companies for whom they provide loans not by risk factor, for example, but by their relationship with a bank. Banks have problems with the collateral of their credits. Generally collateral is companies' equipment. As far as the current economic situation in Ukraine is pretty bad, banks can not find buyers for this collateral. The bankruptcy procedure takes too much time. Therefore collateral does not play the role that it is supposed to. So the actual quality of banking credits is even worse.

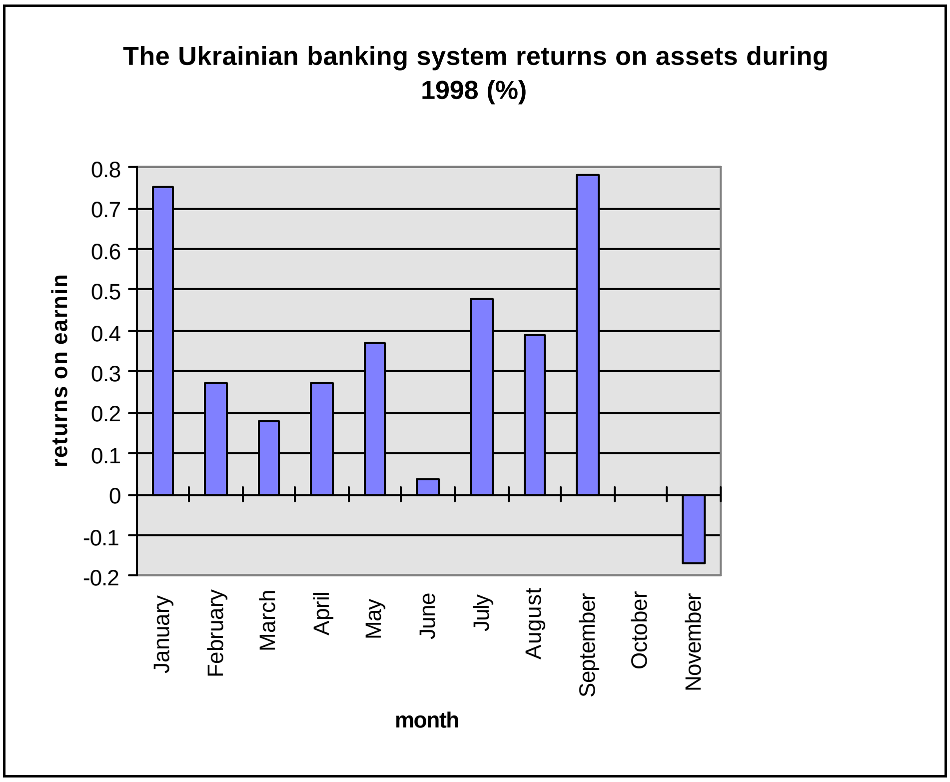
In addition to discussed issues, the problem of management quality should be highlighted. The first feature of the Ukrainian banking management is the lack of experience in risk assessment. So all the management problems which were discussed in part 2.1. are currently urgent for Ukraine. Such a situation is the result of low cooperation and competition level with foreign financial institutions. The second feature is a high level of corruption in credit policy (especially in regional banks' branches). Therefore, inefficient credit management, misallocation of credit resources, and high-risk concentration characterizes the Ukrainian banks.

We cannot expect any improvement in credit policy quality in the near term, nor credit expansion. As far as the financial state of most Ukrainian enterprises does not improve, and even worsens, we can assume that the possibility of bank insolvency increases sharply.

The Ukrainian banks also have problems with maturity mismatch. The main share of the Ukrainian banks credit portfolio belongs to short-term credits (the ratio of long run to short-run credits is from 0 to 30 % for different banks). But liabilities are even shorter-run: on July 1998 28% of liabilities belonged to companies' demand deposits, 21% - to interbank credits (Kovtun, Alla, September 19, 1998, p.7). Therefore the probability of banks meeting their obligations on liabilities is very low, especially under the stress.

3.5. The possibility of banking crisis in 1999

The main point of the previous analysis is to show that the crisis of banking system has not occurred yet. But the impact of the recent financial disturbance is very severe.



Source: *Visnyk NBU* (Herald of National Bank of Ukraine), December 1998, p.45.

Theoretically, the return on assets provides information on how efficiently a bank is being run because it indicates how much profits are generated on average by each dollar of assets (Mishkin 1998, p. 241). Such poor situation with returns on assets in the Ukrainian banking system predicts huge future problems with banking liquidity, problems with liabilities' obligations.

The first problem which banks can meet and already has been met in this situation is deposits' interest rate and principal payments. Exactly after the crisis, banks tried to interest clients in their services by increasing their deposits' interest rate. Now banks changed their policy to the opposite: they understand that they can not earn enough money for interest rate payments and they start to decrease deposits' interest rates. In other words, they are not interested in attracting new deposits.

The situation could be improved if banks have not had limits on expanding their activities. After August 1998, the NBU recommended to banks to limit their credit activity and prohibited providing credits in foreign currency. In spring 1999, the NBU canceled its limitations on credits in local currency. But as far as companies' financial quality is poor in general, banks are not eager to increase their credit activity themselves. Amount of interbanks credits decreased from 2943773 mln UAH in September 1998 to 2645229 mln UAH in November 1998 (Yushenko,Victor, November 1998, p.4). Also banks do not have and are not likely to have the possibility of selling their investment portfolio as there is no demand for assets. A main earning source for most banks are services which they provide, but they are pretty costly. Therefore the most safe types of their activity are deposits in the NBU (by which they get interest rate payments of 40-60% in UAH and 3-5% in foreign currency (Ibid., p.6).

As it was emphasized above, one reason for low credit efficiency is the poor economic situation. In Ukraine GDP is decreasing (GDP in February 1999 is less by 5.1% GDP in February 1998(Maskalevich, Ighor, February 6, 1999, p.7). It is really difficult to expect any GDP growth in this year. This year is a presidential election's year, and the government pressure on the banking sector should increase, especially in credit policy. The influence of the NBU's policy towards commercial banks is correlated with government's one in this sphere. For example "…in February 1999 the NBU proposed to banks to provide credits to the coal industry, which is an absolutely unprofitable one" (Mesenko, Olena, and Koshevyy, Dmytro, 1999, p.43).

Under the present circumstances, the NBU's policy is especially important. The NBU does not have enough financial resources to avoid currency devaluation and to support commercial banks. It is impossible to estimate the influence of permanent devaluation on banking system. However the Ukrainian government and the NBU decided to provide strict currency policy (strict control of currency devaluation). Banks have new problems under this policy.

Since September 1998 the NBU prohibited commercial banks from buying foreign currency freely (Yushenko,Victor, November 1998, p.3). For example, such a restriction, which was applies till May 5, is that banks can not buy foreign currency for their own needs. In other words, banks cannot buy foreign currency for solving some short-term problems like deposits' payment which are denominated in foreign currency.

Additionally the NBU imposed requirement on resident companies of 50% obligatory hard currency exchange at the NBU exchange rate (Ibid.). Trying to avoid obligatory sale of their hard currency revenues, exporters are not in a hurry to transfer their earnings into current accounts at the Ukrainian banks, weakening in this way the banks' liquidity position.

In February 1999, the NBU increased required reserves from 15 to 17%. Importantly, all these reserves should be on the NBU accounts', before this decision banks could hold some share of these reserves in cash. Banks hold deposit insurance only in cash, while before banks could use OVDP for this purpose. These new requirements decreased banks' liquidity substantially (and we should remember about other banks' problems with liquidity, which have not been decided yet). There is some information that even some largest banks can not meet their obligations with required reserves. The amount of banks' highly liquid assets increased: from 2445737 mln UAH in September 1998, to 3486649 mln UAH in November 1998 (Levada, Igor and Zarudnyy, Anton,November 6, 1998), because these reserves are included to the high liquid assets. If local currency continues to devalue during this year (that is possible), highly liquid assets will lose their value.

So, even with last the NBU decision about paid-in capital there is high possibility of banking system crisis. *And the main reasons of possible crisis would be connected with banks' credit policy (first of all lack of low risk earnings' possibilities), and the government and the NBU banking system's policy.*

4.Conclusions

To conclude, the Ukrainian banking system faces so many problems because it is generally underdeveloped: it does not collect financial resources in the economy, does not hold them as deposits, does not provide credits in normally accepted ways. This happens because Ukrainian citizens generally do not trust banking system. Additionally, small levels of equity capital makes banks unable to take too much risk and provide long-term loans. Banks are looking for highly profitable, short run possibilities for credits' activities, which are usually very risky. After the recent stress banks faced new problems: currency devaluation (sharp decline in paid- in and equity capital in denominated EURO, decline in liquidity connected with loans and clients' deposits in foreign currency and government OVDP restructuring, disappearance of the OVDP secondary market). However banks' clients also faced new problems after the stress: they have problems with credits' payments. Therefore, the quality of banks' credits decreased sharply (and it had not been perfect before crisis). Additionally, we can not expect improvements in macro-economic situation in Ukraine during 1999. Then, we also can predict that the government and the NBU will continue to use banks as "cash cows". If the NBU continues to use strict reserve requirements, banks' earnings in1999 are not likely to be higher than in 1998. Therefore, the possibility of a Ukrainian banking system crisis exists and will exist if banks do not find solutions for highlighted problems.

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