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Credit Crunch in Ukraine: Facts, Causes and How to Restart Lending

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Executive Summary

The provision of bank credits to the private sector has slumped in Ukraine. As of February 2010, outstanding loans to the private sector were in real terms 15% lower than one year before. The picture is much worse if we focus on new loans only. The total amount of new loans provided in 2009 was on average in real terms almost 40% lower than the respective amount in 2008. The decline is particularly strong in the household and SME sectors.

Without doubt, this dramatic decline can partly be explained by demand factors. The appetite of companies and households for new loans is not particularly strong in a depressed economy with significant problems for debt repayment. But as it looks, also supply factors play a major role in the decline in lending. Banks seem to have tightened their lending standards to a large extent, making it very difficult for creditworthy companies to obtain loans. Thus, Ukraine seems to be facing a sizeable credit crunch.

The causes for this credit crunch are multiple: Dwindling capital as a result of higher non-performing loans, lack of refinancing in the form of deposits and of foreign loans, as well as a crowding out by state borrowings to bridge the growing gap between public revenues and expenditures. The effect of the limited access to finance is very strong, especially during the current depressed situation. Companies need funds to finance working capital and investment; this is an important precondition for economy recovery.

But what to do about the credit crunch? In our view, there is no quick fix to the problem. In particular, any schemes involving credits of the central bank to companies are doomed to fail and to create inflationary pressures. Thus, the Resolution No. 47 (long term loans via NBU) is definitely not the solution to the problem, but might aggravate it. The role of the NBU is to establish monetary stability and increase confidence in the hryvnia and in the banking sector, a task it cannot achieve in case of government interference and directed lending.

Nevertheless, there are several measures, which can contribute to an alleviation of the problem in the short-term. First, banks with insufficient capital should be forced to be recapitalised, in order to restart lending. Second, banks should be allowed to provide loans in foreign currency to all economic agents, since otherwise they cannot secure long-term funding. Third, the state budget deficit needs to be reduced dramatically and its financing secured though foreign lending, for e.g. in the form of Eurobonds. To sum up, the credit crunch can be combated effectively through the use of market compatible measures in the fields of banking regulation, monetary and fiscal policy.

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1. Introduction

Currently, one of the most hotly discussed topics is the alleged worsening in access to finance by many companies, a claim made by many policy makers and the business community. This discussion about a credit crunch takes place simultaneously in many countries all over the world, including transition countries like Ukraine but also developed countries such as Germany.

Why is this discussion so crucially important? It is a well-established fact that economies suffering from a credit crunch find it very hard to obtain the necessary sources for investment and experience as a result severe obstacles for economic growth. The topic is especially important in the context of the international financial crisis, as a functioning banking sector is essential for any sustained economic recovery. This is especially relevant to Ukraine, where financial intermediation is not very diversified and where due to the absence of developed capital markets no real alternatives to banking intermediation exist.

While the negative economic effects of a credit crunch are relatively straightforward to derive, a thorough discussion reveals that a credit crunch is actually quite a complex phenomenon, which includes several components. This paper contributes to the comprehensive discussion about a credit crunch in Ukraine in several ways. After a precise definition of what exactly a credit crunch constitutes, we provide a quantitative assessment for Ukraine in chapter 2. Here, we discuss the possible extent of a credit crunch, including its sectoral pattern. In chapter 3, we proceed by identifying the underlying causes, as this provides the natural starting point for improving the situation. Based on this analysis, chapter 4 develops our main policy recommendations for regulators and policy makers on ways to combat the credit crunch.

2. Credit crunch in Ukraine: The facts

2.1 Definition of credit crunch

Before starting the quantitative analysis, it is necessary to define a situation where a credit crunch exists. Throughout the paper, we will use the following definition:

A credit crunch is a significant worsening of access by the real sector (or parts of it) to credit, due to a general reduction in the availability of credit and/or a sudden tightening of lending standards or conditions by the banking sector for reasons other than the worsening of creditworthiness of the borrowers. The main causes for this are developments in the banking sector (i.e. the supply side), as opposed to problems in the real sector (i.e. demand side).

Above definition highlights the crucial fact that the causes must firmly lie in banking sector, i.e. in the supply side of credit market, and not the demand side! Only when banks suddenly stop (or considerably slow down) lending, a "supply restraint" in form a credit crunch develops. This could be explained by a counterexample: If many companies in an economy have been hardly hit by negative events (such as a severe economic downturn) and lose their creditworthiness as a result, banks will tighten credit standards and restrict access to credit. However, this would not constitute a credit crunch in the sense of the definition above.

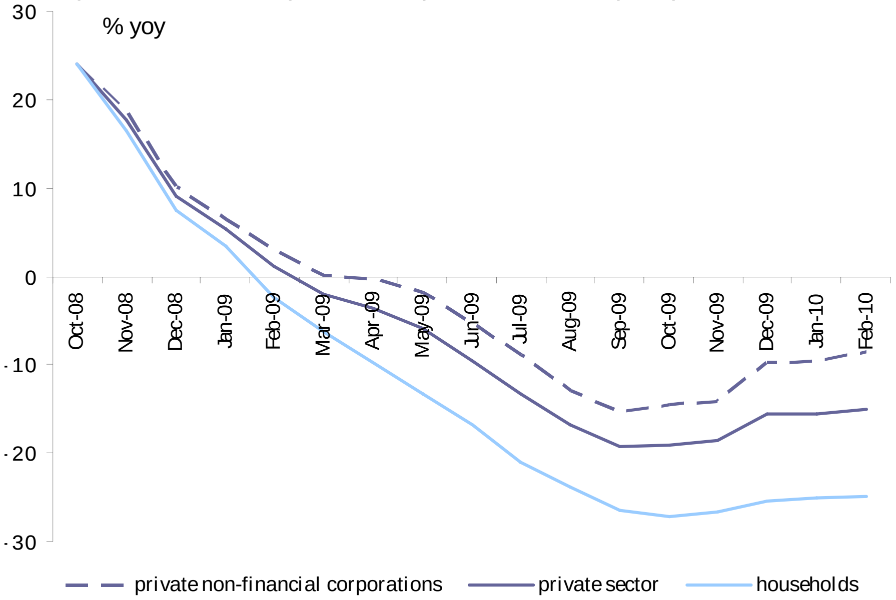
An illustration of the complexities in defining a credit crunch from an empirical point of view shows the current discussion in a number of countries: Many corporations from the real sector complain about a worsened access to finance, which constitutes in their views a credit crunch. At the same time, the banking sector firmly states that there are no signs of a general credit crunch. These contradictory statements show that there are obviously very different views respectively definitions of what exactly represents a credit crunch. At the same time, it reminds us of the importance of a clear-cut definition, which serves as a theoretical framework for assessing the situation from a quantitative point of view.

2.2. Recent lending developments in Ukraine

The starting point of our quantitative analysis is the 4th quarter 2008, when after the failure of Lehman brothers the international financial crisis hit swiftly and strongly many emerging markets, including Ukraine. A very important indicator is the development of loans to the private sector, as the exclusion of loans to the public sector, or to state-owned enterprises gives a better picture of the underlying situation.

Figure 1:

Change in outstanding loans to private sector (real)



Source: NBU, own calculations
Note: Lending to the private sector consists of loans to private (non-financial) corporations and loans to households. Lending to state-owned enterprises like Naftogaz etc. is not included.

A strong and continuous decline in the change of the real, i.e. inflation-adjusted loan stock can be observed, and only in the 4th quarter 2009 some bottom of the fall was eventually reached. Especially hit hard are household loans, which currently decline at a record pace.

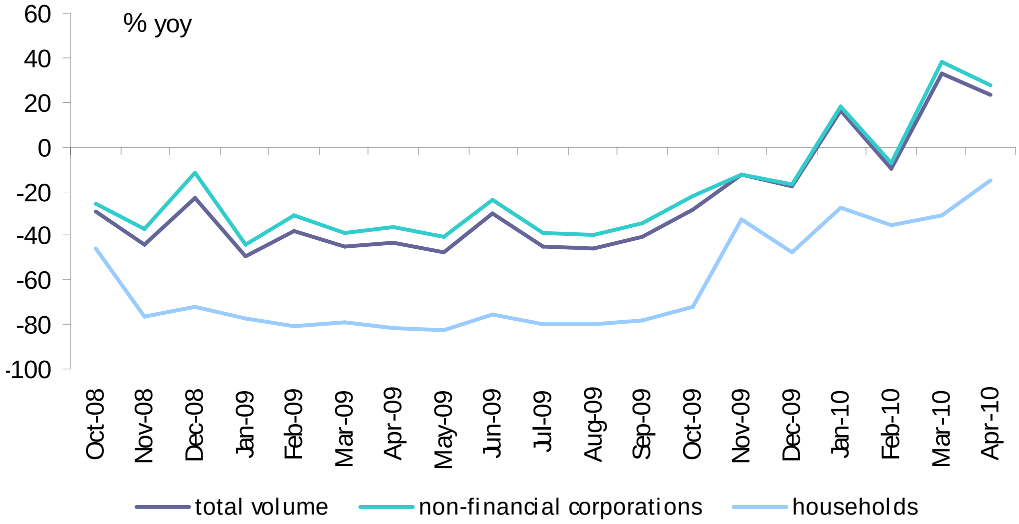
However, the extremely high real growth of credit extension in the past, which was clearly running at unsustainable levels, should not be considered isolated from the question of whether these developments constitute a credit crunch: Often, a sustained period of “loose and cheap credit” – the opposite of a credit crunch – precedes a later credit crunch.

While Figure 1 shows the overall developments in the total stock of loans to the private sector, Figure 2 focuses on monthly new loans to corporations (both from the public and private sector[1]) and households:

[1] Due to data availability it was not possible to exclude loans to public corporations.

Figure 2:

Dynamics of new loans issued (real)



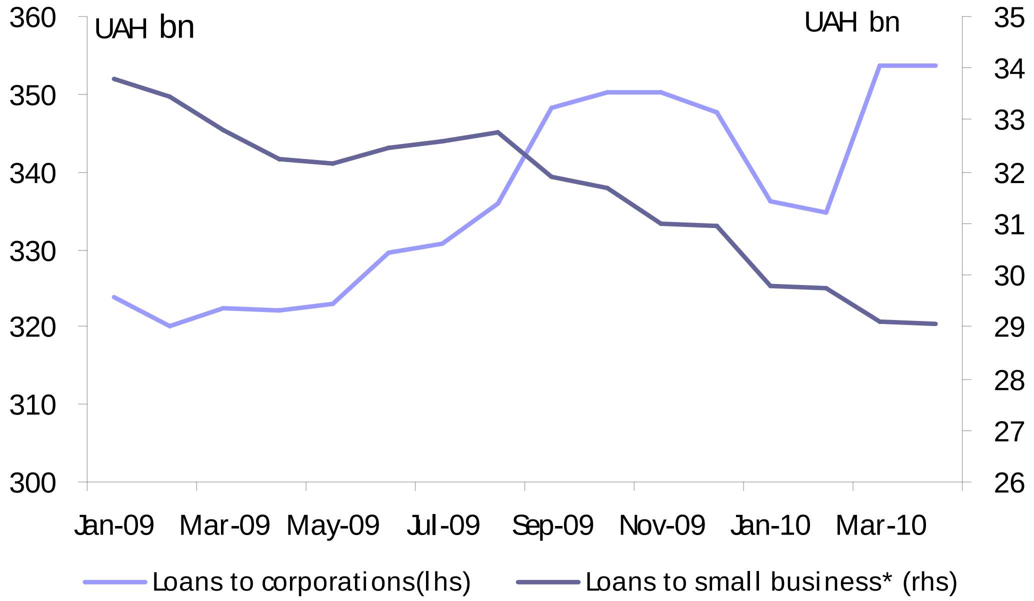
Source: NBU, own calculations

Figure 2 confirms the depressed state of financial intermediation in Ukraine during the recent crisis, as until the end of 2009, new lending activity was declining in real terms in comparison to the previous year. While recently some pick-up in lending has been recorded, clear signs of a revival of credit activity are still lacking.

A further sectoral differentiation of corporate loans reveals an interesting pattern, as Figure 3 demonstrates, which shows the development of the nominal loan stock to both the overall corporate sector and small and medium-seized enpterprises (SME):

Figure 3:

Development of total corporate and SME loan stock



Source: NBU

Figure 3 reveals that the access of SME to loans is especially worrying. While corporate loans in general in nominal terms were relatively stable or even slightly upward-trending over 2009, loans to SME recorded a continuous steep decline. This is a major economic problem for such companies, which are highly dependent on bank credit.

Conclusion 1: The results from the quantitative analysis presented above are two-fold: First, a strong decline in real lending to all major client groups (corporates, households) is an established fact during the crisis in Ukraine. Second, within the corporate sector, SME seem to be most hardly hit.

2.3. Credit crunch in Ukraine?

The quantitative analysis shown above brings us to the central question: What are the reasons for the strong real decline in of credit extension? Is it supply or demand, or a mix of both factors? In view of the discussion in the first section of this chapter, can the situation be described as a credit crunch, or is this a purely demand-caused decline in lending?

It is difficult to assess this question from loan statistics alone, as they show the joint influence of both supply and demand factors at the same time. Thus, further analytical instruments are necessary. However, while we have some information from the demand side, which point towards the existence of a credit crunch (e.g. enterprise surveys), there are practically no analytical tools available focusing on the supply side. Thus, from a strictly methodological point of view, it is not possible to state with major confidence that there is a credit crunch in Ukraine, and how large it is. This is a very serious analytical problem[2]!

Conclusion 2: Ukraine needs analytical tools to assess the supply side of the credit market, such as bank lending surveys, which are a major source of information by central banks in both developed and developing markets (e.g. Deutsche Bundesbank, ECB, Federal Reserve, National Bank of Poland, Hungarian National Bank). The NBU should install such tools as soon as possible.

There are signs that demand factors as well as supply factors play an important role in Ukraine. Even if it was the case that demand factors constitute the restricting elements for credit growth (which is not what our extensive discussions with bankers are telling us. On the contrary, these talks suggest that the supply side is the binding factor, i.e. that there is a credit crunch) it is of highest importance to identify the supply side restrictions because they could become a limiting factor once credit demand picked up again. Therefore the next chapter will focus on various supply factors where we identify problems.

Conclusion 3: Even though a thorough analysis is not possible due to the lack of analytical tools, there is wide evidence that the supply side of the credit market is the binding factor. Thus, we maintain for the rest of the paper the hypothesis that there is a credit crunch in Ukraine.

3. Causes for the credit crunch in Ukraine

In the following, we concentrate on four major reasons for the currently observed credit crunch in Ukraine. These reasons concentrate on supply-side restrictions by banks.

Cause 1: Dwindling own capital due to increase in non-performing loans (NPLs)

The steep economic downturn in Ukraine is reflected in a sharp deterioration in bank asset quality. While the officially published NPL-ratio[3] has risen continuously since the start of the crisis and amounts to 10.7% (as of June 1, 2010), estimates based on international accounting standards are substantially higher. The IMF, a number of rating agencies and investment banks estimate that the NPL-ratio is somewhere between 25-35% according to international standards.

Taking these NPL numbers rather than the official ones as a more representative picture of the true situation, this would point to the fact that there is still pressure on a significant

[2] The Annex gives an overview of bank lending surveys, which are the main analytical tool in this respect for a number of central banks around the world.

[3] Defined as non-performing loans in relation to the total loan book.

number of banks' capitalisation, as provisions need to be increased further and thus there is no strong base for a restart in lending.

For a considerable number of banks, the situation is even more serious, as they struggle for survival, or are in the process of being wound down. Given that the banking crisis has hit only some two years ago, there are currently some 25 banks that are either under temporary administration or under liquidation. These banks have currently totally other priorities than extending loans. The only target for those credit institutions which are under temporary administration is to survive and this means that they do all what they can to get access to liquidity. Extension of loans would be counterproductive for these banks as much needed liquidity would be given away.

Cause 2: Lack of external refinancing

Before the crisis, the rapidly growing banking sector relied increasingly on external funding in form of foreign loans (and to a lesser extent Eurobonds), which were cheap and abundant. This picture has changed dramatically since the onset of the crisis: Today, those foreign loans taken up in the past have to be repaid, or are in the process of being restructured, or are being rolled-over. At the same time, there are hardly any new external loans/Eurobonds, as access to international capital markets is still blocked (as it is for many western banks too).

This process of "deleveraging" by the banking sector is reflected in official external debt statistics. After reaching an all-time high of USD 42.1 bn in October 2008, the external debt has steadily declined to currently USD 29.4 bn in April 2010 (-30%). The speed of decline in short-term debt (-63%) was considerably higher than that of long-term debt (-16%) during the same period.

While these numbers are quite straightforward to interpret, some differentiation is nevertheless needed. Banks which are controlled by local owners are usually required to repay maturing external liabilities, and are often forced to restructure[4] them in case they do not have (or they are not willing to provide) the necessary funds. Banks which are controlled by foreign owners usually roll-over[5] maturing debt with the help of their parent institutions. There is also an increase in support by international and bilateral financial institutions (EBRD, KfW) for selected banks.

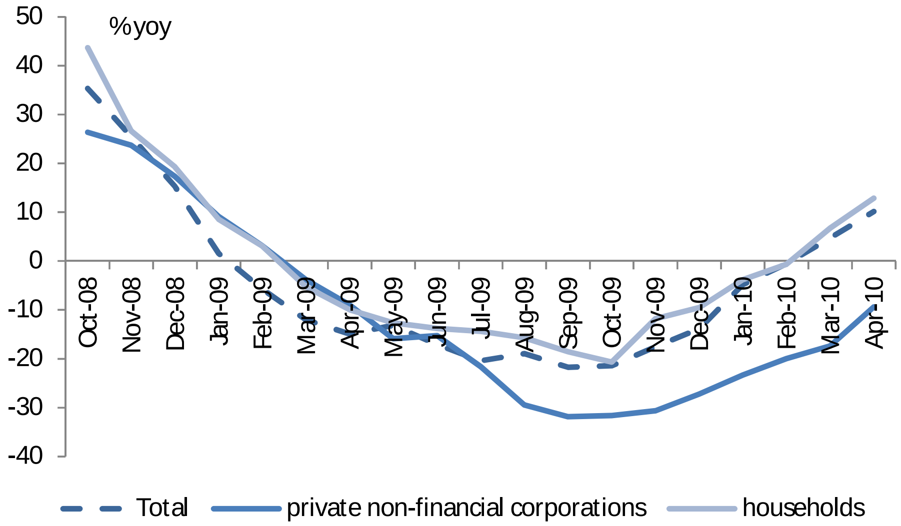
Cause 3: Lack of refinancing in form of deposits

[4] Examples are the well-know cases of FUIB, Finance & Credit, VAB and Nadra, among others.
[5] Raiffeisen Bank Aval, BNP Ukrsibbank, Bank Forum and others.

When the crisis hit Ukraine, it led almost immediately to a massive decline in trust in the banking sector by the population and the need to withdraw deposits to survive the economic downturn. Thus, total deposits (both by households and corporations in foreign and local currency) declined rapidly, as Figure 4 shows:

Figure 4:

Change in outstanding total deposits (nominal)



Source: NBU, own calculations
Note: Adjusted for exchange-rate changes

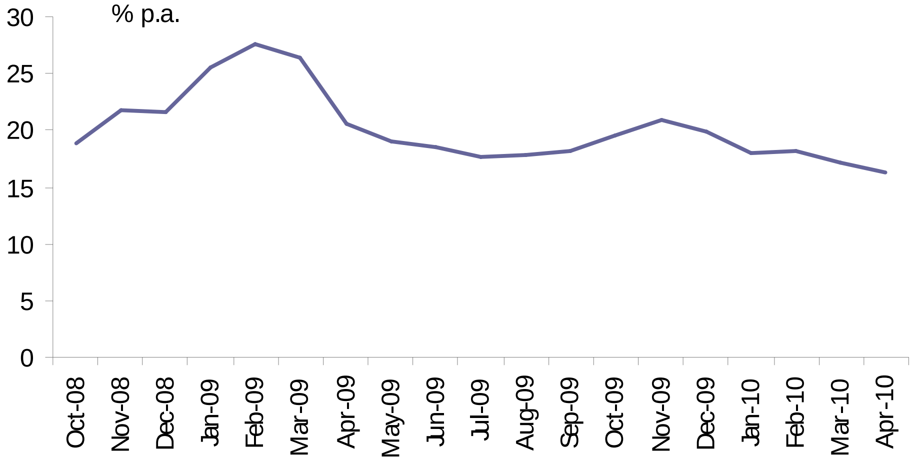
As Figure 4 demonstrates, some stabilisation in deposit funding has been reached, with a small growth in deposits more recently.

However, these developments do not constitute a solid basis for a renewal of crediting. Due to the crisis, there is a lack of incentives to attract longer term, stable deposits in local currency, which implies that banks have also problems to provide loans in local currency. While people might be currently willing to make longer term deposits in foreign currency (USD/EUR) only, the problem for the banks is that they cannot use such deposits as a basis for providing loans to corporations (e.g. SME) and households.[6] As a result of these problems, loan interest rates in local currency are quite expensive on average, as Figure 5 shows:

[6] This is due to the "anti-crisis legislation" (Anti-Crisis law No. 1533 from November 2009), which practically bans foreign currency loans to corporations without regular foreign currency revenues and households.

Figure 5:

Interest rates on corporate loans (in local currency)



Source: NBU

<u>Cause 4: Crowding out by state debt issuance</u>

During 2009 - early 2010, immense fiscal pressures coupled with a lack of access to external markets have led to sovereign issuance at record-high yield-levels on the domestic government bond market. Only more recently there has been a decline in issuance yields from more than 20-25% to the current level of 13-14% for government bonds.

Domestic banks are the main investors in these bonds, as they are a (relatively) safe and liquid alternative to crediting. Thus, the government is in active competition with other private sector borrowers, e.g. real sector enterprises, for a limited amount of funds.

4. Proposals to combat the credit crunch in Ukraine

Based on the quantitative analysis and the identified causes for the credit crunch, we provide a number of policy recommendations on how to restart lending. Since there is unfortunately no "silver bullet" in resolving this complex situation, we have structured our recommendations in several fields:

<u>4.1 Banking supervision</u>

The dramatic deterioration in asset quality during the crisis has led to the situation where in a number institutions the level of own capital is insufficient for resuming lending. Thus, measures to achieve sufficient capitalisation are clearly needed. With sufficient capital, it is quite likely that banks will resume lending activities soon.

An adequate level of capital would also send a strong signal to investors and depositors in terms of rising confidence, which helps to ease funding pressures. This relates to external funding issues (e.g. ensuring roll-over of existing external debt and the attraction of new debt) and the attraction of domestic funding (e.g. deposits).

What needs to be done concretely? Here, a differentiated picture is needed, as this depends very much on the institution:

<u>Institutions owned by private domestic investors</u>

The NBU needs a realistic view of the true level of NPLs and their impact on the own capital of banks. In case this is considered to be insufficient from a regulatory point of view, the NBU must force owners to increase capital, or exit the market. This must be done within firm deadlines, in order to ensure the confidence in the system. At the same time, any remaining open cases in the state recapitalisation process (most prominently Bank Nadra) need to be tackled as soon as possible by the NBU and the government.

<u>Institutions owned by the state (traditional state banks and recently recapitalised banks)</u>

Currently, the fragile and gradual economic recovery is mainly driven by exports, as domestic demand is still very weak. However, for many companies in the export sector, there is severe shortage of working capital. In such cases, successful state-owned banks like Ukreximbank can play an important role to ease the credit crunch by providing loans to such companies within their lending mandate.

For the recently recapitalised banks, a development strategy needs to be worked out. Issues to be clarified in such a strategy relate to questions like a restructuring of the business model, future privatisation (if commercially viable), or eventual resolution. It is important not to resort to the practice of directed lending to state-owned companies at non-market conditions, or any financing of the state budget.

Conclusion 4: A properly capitalised banking sector is a key factor for the eventual resumption of lending to the economy. The strict enforcement of existing capital requirements needs to be ensured by the NBU. A tighter control of banks' compliance with capital norms is a crucial part of this.

Conclusion 5: State banks can ease the credit crunch within the context of their lending mandates to some extent. However, the recently recapitalised banks by the state should not be used for directed lending purposes.

4.2 Currency regulation

The reaction of the authorities during the crisis with respect to foreign currency lending[7] can be summarised in two major measures[8]:

- NBU Resolution No. 406 from December 2008 introduced provisioning requirements between 50-100% for credits to borrowers without regular sources of foreign exchange (including natural persons and legal entities).
- In November 2009, the Anti-Crisis Law No. 1533 "On the Introduction of Amendments to Certain Laws of Ukraine Aimed at Overcoming the Negative Consequences of the Financial Crisis" came into force. Here, a legislative temporary prohibition of loans in foreign currency to individuals (natural persons) was established, which is valid until January 1, 2011. Entrepreneurs are excepted.

Thus, foreign currency loans remain possible only for legal entities including entrepreneurs with regular sources of foreign exchange.

While certain regulatory restrictions (including a ban) on foreign currency lending should be thoroughly discussed in response to an analysis of the factors that aggrevated the crisis, it seems that right now the introduction of this instrument is mistimed. In our view the de-facto ban of foreign currency loans is a major impediment for resumption of lending in the short term, especially in a crisis environment. The funding base is currently mainly in foreign currency (foreign currency deposits), and in the near future, with an expected opening of

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[7] While the measures were from a legal point of view part of currency regulation, the underlying motivation was rather the stabilisation of the banking sector.

[8] Most recently, some relaxation of the restrictions on foreign currency lending took place, which we not cover here. This relates to the Law No. 6337, which was approved in May 2010 and is now in force. According to it, by July 16 2010 the NBU has to set loan loss reserve requirement below 3% for loans in foreign currency classified higher than doubtful without source of foreign currency income. However, President Yanukovych has suggested amendments to this law which would cancel these new provisions, allowing the NBU to fulfil its duties independently without interference from third parties.

external capital markets will continue to be dominated by foreign currency. Since foreign currency loans are practically banned, the only way to lend this surplus in foreign currency liquidity would be in form of local currency loans. However, in the absence of respective swap-markets, banks are understandably not willing – and not allowed from a regulatory point of view- to take on such major currency risks.

Conclusion 6: The prohibition of providing loans in foreign currency should be lifted as soon as possible, substituting it with less radical measures to avoid foreign currency loans such as higher risk weights on such loans. If such a lift is politically not feasible, the current anti-crisis legislation should at least not be prolonged.

4.3 Fiscal policy

A credible program of fiscal consolidation is, among other things, a major step forward to reduce crowding out pressures on private sector borrowers. In this respect, the recently announced plans by the authorities[9] in terms of medium term fiscal consolidation are in principle very much welcome. However, the foreseen decrease of the budget deficit by 1% of GDP per year is in our view not ambitious enough. Here, a more substantial and faster consolidation should be tackled.

While it is unrealistic that fiscal deficits will disappear any time soon, the question of how to finance these deficits is important. In the medium to long term, the authorities should commit to the development of a liquid domestic bond market for such funding purposes. In the short term, however, we propose a reliance on external sources as opposed to domestic sources, as this helps to disengage from the competition for scarce domestic financial resources. Among external sources of finance, support by international financial institutions like the IMF and World Bank should be a top priority, as well as (later) tapping private capital markets via Eurobond issuance.

Conclusion 7: An ambitious program of fiscal consolidation, coupled with a reliance on external funding in the short term is needed to avoid the crowding out of private sector borrowers by the state. This will help to ease the credit crunch.

4.4 Monetary policy

The liquidity position of the aggregate banking system is rather comfortable, as high balances, low interbank interest rates and declining policy rates indicate. From this point of view, there is no need for further action. The question asked by many policy makers is if the

[9] See for more details the "Economic Reform Program" launched by President Yanukovych on 3 June 2010.

NBU can do more to support a resumption of growth in crediting, apart from normal liquidity provision to the banking system?

The NBU Resolution No. 47 from 10 February 2010 established the possibility to provide long-term loans by NBU to commercial banks in certain circumstances. Ukrainian banks can ask the NBU to provide long-term refinancing and use it to issue medium-term loans (for up to five years) to enterprises that are strategically important for the country's economy.

In our view, this resolution is not the right instrument to stimulate crediting for a number of reasons. First, it is not the task of the NBU to credit (even though only indirectly) companies from the real sector. This is the main task for commercial banks, and the economic rational for their existence. Second, if policymakers want to support certain industries, they should use public funds in form of subsidies/guarantees in a transparent manner rather than the balance sheet of the NBU. Third, severe negative economic side-effects might result from such measures. The practice of directed lending might lead to a misallocation of scarce capital, and eventually increase inflation in the medium to long run.

In sum, this regulation establishes an instrument with huge economic risks and very debatable benefits. Furthermore, it is not in line with international best practices.

Conclusion 8: Monetary policy cannot contribute to solving the credit crunch in an active manner. In particular, the instruments in Resolution No. 47 will not improve the situation but rather create additional problems. The main task of the NBU is to guarantee banking sector stability trough its various macroeconomic and regulatory policy instruments.

Annex

Table A.1:

Main characteristics of international bank lending surveys

	National Bank of Hungary	Bank of England	Bank of Japan	ECB	Fed	Bank of Lithuania	National Bank of Poland
Published objective of the survey	Exploring loan supply behaviour, analysis of nonprice factors	Monetary and fi nancial stability aims: understanding of lending trends and of credit conditions	Understanding Japanese lending market tendencies, examining its role in monetary transmission, similarly to the FED's practice	A better grasp of the role of bank lending in the business cycle and monetary transmission, providing support for monetary policy decisionmakers	Better understanding of bank lending processes and trends, as well as a better grasp of the role of lending in the business cycle and monetary transmission	Acquiring information on non-interest rate credit conditions, developments in the cost of funds and banks' expectations	Gaining an understanding of changes in the Polish banking system's loan supply (standards and conditions) and loan demand behaviour
Frequency	First semi-annual, quarterly as of 2009	Quarterly	Quarterly	Quarterly	Quarterly	Semi-annual	Quarterly
Start	2003 H1	2007 Q2	2008 Q2	2003 Q2	1964	2006 H2	2004
Segments examined	Households' lending, corporate lending, municipal lending	Retail lending (secured and unsecured), corporate lending	Non-financial firms (large, medium and small enter-prises), households (housing and consumer loans), local municipalities (a total of 13 questions)	Corporate and household (housing and consumer loans) lending	Corporate and retail lending	Retail lending (housing and other consumer), Corporate lending	Non-fi nancial fi rms (large enterprises, SME); Retail (housing loans, other consumer loans)
Number and market share of banks surveyed	Household lending: 13 banks Housing loans: 9 banks Consumer Loans: 13 banks + 6 leasing companies Corporate loans: 7 banks Municipal loans: 6 banks	Not disclosed, but approximately 10-15 banks per segment, with market share of 75-85%	TOP 50 banks are queried, accounting for 74% of the market (the list is reviewed every 3 years)	112 banks, approx. 40% market share	Most recently 52 domestic banks and 21 foreign bank branches/ "agencies"	11 banks	24 banks, 75.9% of the banking sector portfolio
Processing metho-dology (weighting)	Proportion of net increases/those tightening(%) (previously equal weighting, market sharebased weighting as of March 2009)	Proportion of net increases/ those tightening (%) Weighting: market sharebased weighting + slight and considerable tightening weighted differently (weighting of slight tightening/ easing 0.5) ("diffusion index")	Proportion of net increases/ those tightening (%) Weighting: market sharebased weighting + slight and considerable tightening weighted diff erently (weighting of slight tightening/ easing 0.5) ("diffusion index")	Proportion of net increases/ those tightening (%) Weighting: equal weighting within the country, use of country weights within the EU	Proportion of net increases/ those tightening (%) (equal weighting)	Proportion of net increases/ those tightening (%) Weighting: equal weighting	Proportion of net increases/those tightening (%) factors: contributes to easing or tightening

Source: National Bank of Hungary (2009)

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