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The Banking System in Ukraine

by

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1. Introduction - the Soviet Era

Banking services, during Soviet times were primarily provided by a government dominated bureaucracy that processed documentation. Bank personnel were used to provide financial accounting records on credits obtained by entities for projects approved under five year plans. The banks' activities did not include serious financial analyses, or a review of the profitability or credit worthiness of projects and their sponsoring entities. These traditional banking activities were effectively considered to be irrelevant by bankers. One could say that the clients of the banking system were essentially government ministries, rather than the enterprises who received credits approved by higher authorities in government.

2. Beginnings of the two-tier banking system in Ukraine

The major characteristics of the banking system in Ukraine in the 1990's are traceable to changes which began under 'perestroika' in the Soviet Union in the late 1980's.

In the latter half of the 1980's, the Soviet's reorganized the banking system along specialized sectoral lines to streamline the monstrous centralized bureaucratic structure that had arisen. The new banks provided separate services for government, foreign trade, agriculture, industry, social services and savings. The first commercial banks with private ownership under 'perestroika' were registered in 1988. In 1990, Agroprombank, Promstroibank and the Social lnvestment Bank, three of the five sectoral banks in Ukraine transformed themselves into joint stock companies as Bank Ukraina, Prominvest and Ukrsotsbank.

At the declaration of independence in 1991, the former and existing state sector banks accounted for almost all commercial banking operations conducted by registered banking entities. The less than one hundred newly formed commercial banks under private ownership were an insignificant portion of the financial structure of the country. The role of the National Bank was essentially a theoretical concept. Nevertheless, the financial framework that would eventually evolve in the first years of independence was already becoming visible.

An independent Ukrainian banking system began to form naturally during 1991 as the disintegration of the Soviet state gathered momentum. The Ukrainian portion of the USSR State Bank, of necessity made credit allocation decisions when the all Union bank failed to prepare a credit plan early in 1991. In March 1991, the republic adopted a law on "Banks and Banking" which provided for the establishment of the National Bank of Ukraine from the Ukrainian Republican division of the State Bank of the USSR. By the summer of 1991, the instructions of the Soviet State bank were no longer binding on Ukraine. In December, 1991 the USSR State Bank was formally liquidated and the National Bank of Ukraine was unequivocally the effective central banking authority.

A two tiered banking system was envisaged under law, wherein the National Bank would act as a central bank and all other banks would be responsible for commercial banking transactions. However, the peripheral administrative and legislative base of the nation had not been developed in a manner that would properly support a market oriented banking system. The early years of Ukrainian independence constantly reflected the underdeveloped nature of the National Bank and the underdeveloped nature of newly formed commercial and legal structures in the country.

In theory, the National Bank of Ukraine was to divest itself of all commercial banking aspects in which the State Bank in the former USSR had been involved. The National Bank's role was to be the bank of the government responsible for monetary policy, the printing (emission) of money, the foreign exchange authority, and the organizer and administrator of inter bank settlements. It was also to provide for the registration, licensing and supervision of commercial banks in the country.

In mid-1991, the National Bank of Ukraine issued a number of regulations that established its authority over commercial banks. In August 1991, it required newly created commercial banks to maintain minimum statutory funds in an amount of 5 million rubles (approximately 500,000 USD) and cooperative banks 500 thousand rubles (approximately 50,000 USD). In October 1991, the commercial banks registered by the former State Bank of the USSR were required to reregister with the National Bank of Ukraine. The state sector banks were also reregistered in their traditional roles.

The National Bank, quite legitimately extracted itself gradually from most of its remaining commercial banking operations during 1992. At the same time, however, there was a strong concern expressed by many of its advisors, that through a lack of competent staff and a very disorganized administrative structure, the National Bank would also be incapable of exercising legitimate central bank authority over commercial banks, national and commercial foreign exchange operations and monetary policy. It was obvious from the outset that simultaneous transition to independence and a market economy could not be accomplished without a great deal of confusion with respect to the proper financial roles of government, the National Bank and commercial banks.

3. Problems in understanding the role of the National Bank and monetary policy

The legal status of the National Bank, its authority and the legal authority of the legislative and executive branches of government were poorly defined and often misunderstood in 1991 and 1992. It was clear that Parliament intended that the National Bank should report to and be subservient to the will of Parliament. However, the mechanisms and the administrative framework for the enactment and proper implementation of decisions taken by Parliament and the National Bank was lacking.

A very trite, but a very real excuse on the part of Ukrainians was a constant refrain that all decision making power during Soviet and Czarist days had been concentrated in Moscow or St. Petersburg. As a result, the executive structures and the administrative habits relating to independent decision making were missing in Ukraine, despite the declaration of independence and the apparent passage of domestic legislation.

An excellent example of the confused state of the National Bank's role, its relationship with government structures in the first years of independence and the extremely important psychological and emotional state of the populace can be illustrated in the confusion relating to some of the National Bank's and the government's financial obligations.

In late 1991 Ukraine, as a newly independent nation did not have access to foreign credits for the purchase of trade goods. To make matters worse, Vnesheconombank, the former Soviet foreign trade bank had declared that more than $7 billion USD in hard currency deposits were 'missing' and could not be accounted for. Over $1 billion USD of that sum belonged to Ukrainian enterprises and individuals. Vnesheconombank also stated that it would no longer process foreign trade payments for former Soviet Republics.

In Ukraine, this was viewed as a disaster. There were very cogent historical reasons for this point of view and the depth of feelings that existed.

Ukraine, although the bread basket of Europe prior to the First World War and still the richest agricultural region in the former Soviet Union had suffered the ravages of an artificial famine created by Stalin in the 1930's. By most estimates, five to seven million people had starved to death. In eastern and central Ukraine, almost every family had elderly relatives who either personally remembered the tragedy or remembered friends and relatives who had perished. The event had occurred primarily in the rural ethnic Ukrainian areas of the country and had become identified as a communist instigated anti-peasant, anti-Ukrainian act of genocide. The national psyche had been deeply affected, fear of famine during turbulent times was extremely high and self confidence in the ability of Ukraine to survive independently was extremely weak.

Spring planting for the 1992 agricultural season was approaching. The national supply of herbicides, pesticides, fertilizers and grain seeds were considered insufficient for the country's needs. The agricultural sector did not know how to arrange financing in a newly independent country which could no longer expect Moscow to generate economic plan orders for the delivery of all the raw materials and financial resources required for spring planting and harvesting.

Parliament demanded that funding for the purchase of fertilizers, herbicides and pesticides be provided to the agricultural sector by the National Bank. Unfortunately, neither the legal basis nor the responsibility for such a decision had been determined by Parliament or the executive branches of government in the past. Nevertheless, officials at the National Bank granted guarantees and promissory notes to foreign seed suppliers for Ukrainian purchases of their goods. Former officials of the National Bank later admitted that they had not identified laws by which the National Bank had been granted authority to enter into such agreements.

After the harvest in 1992 had been gathered, the government of Ukraine refused to accept responsibility for the debts incurred by the National Bank on behalf of the Ministry of Agriculture and did not honor payment demands (arguably because it did not have the financial resources) required under the promissory notes and the guarantees. The sum of the obligations owed by Ukraine was ultimately demonstrated by western agricultural suppliers to amount to at least 200 million USD. Amidst the confusion, it also became apparent that officials at the National Bank had not kept, or were unwilling to reveal proper accounting records or documentation relating to their guarantees.

The new nation's international financial reputation was severely damaged when it appeared that it was unable to accept responsibility and was incapable of meeting its financial responsibilities. The authority and the financial integrity of the National Bank of Ukraine had also been seriously impaired by the inability of the government and the officials of the National Bank to determine and come to an agreement on fiscal and monetary responsibilities.

The overpowering, indeed almost sacrosanct strength of the state and collective farm directors, who built a formidable agricultural lobby in Parliament, allowed them (through Parliament) to order the National Bank to provide subsidized funds for agricultural purposes every spring, summer and fall in Ukraine from 1992 to 1994. Credit emissions to the agricultural lobby inevitably became a major cyclical cause of the inflation and later hyper inflation tendencies that haunted the nation.

The industrial lobbies centered in the urban areas of the Donbass would also regularly subject the country to economic blackmail by threatening general work stoppages and strikes. It was feared that the huge steel mills of the Donbass and the many electric power stations in the country would cease operating in the absence of energy supplies, particularly coal.

All Ukrainians were also aware of a huge East West linguistic and ethnic divide in the country that could fracture. The prospect of civil strife in a country which had arguably experienced the heaviest damage in the former Soviet Union during the two world wars and had suffered through an artificial genocidal famine in the 1930's created a psychology in the population and within the leadership that made it desperate to avoid civil disturbances.

Threatened strikes by coal miners for improved working conditions (which were arguably atrocious), higher wages, or even more relevant, payment for unpaid back wages would inevitably be temporarily resolved through an instruction to the National Bank to print money.

Similarly, the 'red' directors in the Donbass whose ties in the very large heavy industry, military industrial complex had been extraordinarily strong under the Soviet system were effectively able to politicize cyclical 'payments' crises. True to form, the directors of factories, who were used to being rewarded on the basis of the volume of goods manufactured, continued production long after it did not make economic sense. Following the collapse of the Soviet Union and the Soviet planned economic system it was extraordinarily difficult to obtain supplies of many raw materials and component parts from other production sites. Nevertheless, production continued and, at first, an inventory of uncompleted and unsaleable goods grew and was stockpiled in factory warehouses.

In an environment where credit was no longer provided at will by the state, revenues from the sale of completed goods declining dramatically, bank transfer payments taking weeks and even months to be completed and inflation making it extremely profitable to defer payments for purchases of raw materials and component parts, regular payment crises were inevitable.

During the Soviet, the state arranged, even mandated regular non cash bookkeeping settlements amongst state enterprises. After all, the government owned all the enterprises so a Peter/Paul transfer of financial resources did not seem to be totally inappropriate. In the new environment the directors seemed to believe or continued to argue that the government should be responsible for the credit logjam. Since many of the directors and government officials retained a Soviet style production mentality that favored ever increasing production at all costs, the 10 to 30% annual declines in production were seen to be catastrophic indicators of the destructive nature of market oriented economic policies. Inevitably, the National Bank would be instructed by Parliament to provide a credit emission that would ameliorate the problems or temporarily solve the crisis.

By 1994, advisors to the new reform-minded government of President Kuchma, realizing that a non-inflationary resolution to the recurring problem was required, prepared the groundwork for the introduction of a bills of exchange program that would ultimately provide a market based mechanism for the settlement of inter-enterprise debt. Unfortunately, they were not yet capable of also introducing an effective bankruptcy process that would liquidate the most serious inter-enterprise debt offenders. Needless to say, both the bills of exchange and the bankruptcy developments were strongly resisted by the directors from the industrial lobby groups who realized the economic consequences for the inept and for uncompetitive producers (which in Ukraine's large but dilapidated industrial sector included the majority).

In late 1991 and early 1992, Ukraine experienced shortages of ruble currency bills when the central bank of Russia failed to deliver sufficient rubles to Ukraine (as well as to other republics). Ukrainian authorities feared that Ukrainian goods (especially food and other agricultural commodities) would be siphoned to Russia as a result of higher prices allowed in Russia under its much more aggressive price liberalization policy.

The Ukrainian response to the crisis mischievously undermined the value of the ruble, and set the stage for the ultimate demise of the ruble zone. Upon the introduction in 1991 of coupons, which were at first required to be used in tandem with rubles for the purchase of consumer goods, and later upon the introduction of independently reusable coupons. Ukrainians gained the ability to simultaneously ensure that they would have large amounts of currency script and would be able to purchase domestic consumer goods. They were thereby able to prevent the export of consumer goods to Russia for resale.

The ability to print and utilize reusable coupons or pseudo currency units had an unfortunate side effect for all ruble zone countries. Inflation, long artificially suppressed in the Soviet Union gathered even greater momentum under conditions of unfettered printing of monetary substitutes. Effectively, Ukrainians in the short term managed to ensure their ability to purchase domestic goods by independently printing monetary script, which artificially increased the monetary supply in all of the republics that were still in the ruble zone.

Russia, in a desire to maintain its central role in an empire, continued to allow CIS republics (including Ukraine) to maintain large credit payment balances at the Central Bank of Russia. In the summer of 1992 the Central Bank of Russia realized that it was impossible to control monetary policy, if the republics refused to give it the right to have a monopoly on the printing of money in the ruble zone. In July 1992, the Central Bank of Russia finally refused to clear payments by large creditor republics.

Ukrainians, who had been printing monetary script and had been major beneficiaries of large credit balances at the Central Bank of Russia, unfortunately began to believe that inflation, which they had helped create, was not a terrible demon if it allowed domestic production to be boosted artificially and if it facilitated domestic purchases of consumer goods. This attitude was to cost Ukrainians dearly when they enacted large artificial subsidy programs for agriculture and industry which caused hyper inflation in 1993 and 1994.

Ironically, Ukrainian authorities were briefly reminded of the destructive characteristics of beggar the neighbor inflation policies in the spring of 1994 when the autonomous republic of Crimea threatened to take control of Crimean monetary policy in a way that would export inflation to Ukraine.

4. Foreign exchange regulations

By the summer of 1992, under the leadership of a new, less conservative National Bank Governor, Vadim Hetman, the National Bank slowly extended its authority over foreign exchange controls and legitimized its international presence as an independent financial authority. In July, the National Bank of Ukraine began to establish correspondent bank account relationships with other CIS countries. In August, the Foreign Currency Exchange was established as a division of the National Bank.

In November, the National Bank introduced the Ukrainian karbovanetz into non-cash circulation and Ukraine officially withdrew from the group of countries that used the ruble as a legal tender. This was the starting point for the establishment of an official exchange rate for the Ukrainian karbovanetz against the ruble and other currencies.

In late 1991, Vnesheconombank of the Soviet Union indicated that it was no longer capable of recognizing the liabilities of many of its former republican clients, would be incapable of servicing their needs and would no longer process their foreign trade payments. As previously indicated, one billion USD in hard currency assets claimed by Ukrainian entities and individuals at Vnesheconombank also 'disappeared'.

In January 1992, of necessity, The State Export Import Bank of Ukraine was established by Presidential Decree to carry out the functions formerly assumed by Vnesheconombank. The State Export Import Bank, although not the formal legal successor to Vnesheconombank took over the physical assets of the branches and hired employees of the former Soviet institution who were located on the territory of Ukraine.

In April 1992, responsibility for many foreign exchange activities moved from the National Bank to The State Export Import Bank. The vast majority of the government's hard currency bank accounts, as well as those of the National Bank were moved to accounts under the control of the State Export Import Bank. The stated reason for the move was that greater expertise in foreign exchange operations was concentrated at the Export Import Bank and that a small amount of foreign exchange reserves necessitated the concentration of all of the government's foreign currency transactions in one entity. The National Bank temporarily lost one of the major roles of most central banks, i.e., direct control of foreign exchange resources. The State Export Import Bank, on the other hand, also obtained the right to act as an official agent of the government of Ukraine in negotiations for sovereign foreign hard currency loans (a role that the National Bank seems to have presumed would be provided to it).

In February 1993, the Ukrainian government approved a decree on "Foreign exchange regulation and control" under which belatedly reaffirmed the position of the National Bank as the chief foreign exchange authority. In July, the Foreign Currency Exchange of the National Bank was reorganized into the Ukrainian Inter-Bank Foreign Currency Exchange.

The foreign exchange policy of the Ukrainian government, commencing with the February 1993 decree became an unending example of misguided disasters that sabotaged the economic environment in Ukraine during 1993 and the first half of 1994.

The essential problem of the policy was that it was founded on the premise that all currency flows must be heavily regulated and controlled by government. In October 1993 when the short-lived reform government of Prime Minister Kuchma had been replaced by a Cabinet headed by Acting Prime Minister Yuhym Zvyahilsky, the Inter-Bank Foreign Currency Exchange's operations were halted and a new 'official' government derived exchange rate was mandated.

The official exchange rate was supposed to be applied to all non-cash transactions, utilizing a concept from Soviet times that bank transfers or bookkeeping entries between enterprises could have differing currency exchange valuations applied to them than would be applied to cash transactions. The government, unfortunately also attempted to apply this same officially determined exchange rate to cash transactions. Not surprisingly, most of these efforts failed ignominiously, as institutions and individuals ignored the desires of authorities, and frequently created contracts and invoices that posted fictional prices which offset the effects of the artificially imposed exchange rates.

The official exchange rate was consistently calculated throughout the term of its existence to be less than half and sometimes less than one third the street rate of exchange (see Table 1). The economic rationale provided by the government for this course of action was that it lowered the cost of imports and increased the cost of exports. It was argued that this was beneficial to Ukraine since its imports far exceeded its exports (primarily because of energy purchases).

This pseudo logic soon disintegrated. Russia's exports of natural gas and oil were quickly redenominated in Russian ruble or hard currency equivalent units. Nevertheless, Ukrainian entities or individuals with 'contacts' were able to proceed with the fiction by 'officially' completing hard currency purchases at one half to one third of their real foreign exchange values.

An example of this practice appears to have been neatly demonstrated by the Acting Prime Minister who was later accused by the procurator's office of having personally pocketed more than $25 million from the purchase of petroleum products at artificially low prices in Russia, and subsequently exporting those same goods from Ukraine. After he lost his position as Acting Prime Minister, Mr. Zvyahilsky left the country and went to Israel for 'health reasons'.

One of the very unfortunate economic consequences of the exchange rate policy pursued by the government was that it exacerbated the foreign balance of trade payment problem that it was supposed to cure. As a result of the artificial exchange rates, the posted price for imports was one third to one half of the real values and the consumption of imported goods was indirectly encouraged. Exports, on the other hand were effectively priced at two to three times their true costs, and the ability of manufacturers to be cost competitive in foreign markets was significantly reduced. In addition, the government passed a requirement that 50% of hard currency proceeds from export revenues be surrendered to the National Bank at the official exchange rate. This regulation effectively amounted to a partial confiscation of hard currency proceeds and a hidden tax on those revenues.

The inequities of the artificial exchange rate policies were finally remedied by Leonid Kuchma when he was elected President, replacing Leonid Krwchuk. Assisted by the vigorous lobbying provided by other economic reformers and members of the industrial sector who had suffered from the distortions created by the debilitating foreign exchange policy, and at the strong urging of the International Monetary Fund Mr. Kuchma reopened the Ukrainian Inter Bank Foreign Currency Exchange in the autumn of 1994. The government and the National Bank then gradually reunified the various official and unofficial foreign exchange rates in Ukraine.

5. Macroeconomic instability problems

Among the many other problems facing the National Bank, one of the most serious related to a lack of macroeconomic stability. The immense, visible fiscal deficit problems were further exacerbated by less visible subsidized interest rate loan programs dictated by parliament and the executive branches of government, and the lack of a government treasury bill or bond market to fund the fiscal deficits. Only late in 1994 did Parliament pass a motion requiring the government to issue treasury bills within the next calendar year.

The extent and the effect of the subsidized loan programs are visible if one compares the official rediscount rate of the National Bank to the effective weighted average interest rate of funds provided by the National Bank. In 1993 when inflation was raging at 10,000% per annum, the government directed that loans be provided to the agricultural sector at an interest rate of 30%. Not surprisingly, the actual weighted average rediscount interest rates at the National Bank in the third and fourth quarters of 1993, when adjusted for subsidized interest rates were approximately 150% and 84%, even though the official posted rediscount rate was 240% .

One of the great problems of the Ukrainian government in establishing a treasury bill market was a lack of faith or trust by the public in government securities. Hyper inflation compounded the problem in Ukraine.

Hyperinflation had destroyed the value of domestic savings and the investments in government bonds that the citizens had been forced to purchase during Soviet times. The loss of past savings, a lack of confidence in the ability of the new government of Ukraine to survive in the long term and most importantly, extreme cynicism with respect to the government's honest intention to pay its obligations, meant that citizens and most institutions were unwilling to invest in new government obligations. The lack of faith of the citizens in the government's financial integrity and the knowledge that the government was prone to constantly change the rules (often on a retroactive basis), meant that for a long period of time, the government was unable to issue treasury bills. The inability of the government to issue treasury bills to fund its huge fiscal deficit was one of several causal factors in the growth of inflation. The growth in inflation undermined the citizens' faith in government and reduced their desire to invest in government treasuries. In other words, a classic vicious circle.

It is remarkable that in the midst of all of these difficulties and the limitations imposed on it by parliament, the National Bank was able to provide any kind of resistance to inflationary forces. Yet, ultimately that is indeed what happened! Under an extremely strong governor, Victor Yuschenko, appointed in early 1993, the National Bank several times reabsorbed parliamentary decreed credit emissions and limited the superfluous supply of funds in the economy. To accomplish this, it sometimes used unusual draconian measures.

In December 1993, for instance, at the height of hyper inflation, the National Bank decreed that all future disbursements on loans, even if previously contracted would have to be approved by the National Bank prior to disbursement. Essentially, the entire bank lending industry was brought to a grinding halt. In the months following the publication of the regulation, and in response to the outcry of distress from both lenders and would be borrowers, the National Bank gradually eased conditions for loan approvals.

Normally, financial experts would expect that this kind of aberrant behavior would be extremely destructive to an economy. Retroactive cancellation of loan agreements, for instance would make contractual deliveries of many products impossible. Non-delivery of input goods would normally cause production to plummet.

Yet, the effect of the decree was generally quite positive. The draconian credit ceiling limitation made it possible to attack the entrenched hyper inflation mentality of most Ukrainians. Ukrainians had begun to believe that nothing could be done to halt the hyper inflationary process. The temporary curtailment of credit threw a 'monkey wrench' in the operations of many of those enterprises and individuals who had programmed their activities to benefit from hyper inflation. The National Bank correctly perceived the overwhelming value of breaking the inflation psychology.

The National Bank also demonstrated that it had evolved to the point that it was no longer blindly copying regulations and policies previously introduced by Russia. It had begun to realize that those same policies quite often did not work when transplanted to Ukraine. The National Bank of Ukraine had truly learned to develop policies in an autonomous manner.

6. The commercial banking sector

Commercial banking in Ukraine in the early years was completely dominated by the state banks and the former state banks. The State Export Import Bank and the savings

Oschadny Bank (the former Soviet Sberbank) remained the only officially state owned commercial banking operations in the country, although in fact most of the shareholders of the so called commercial banks in the early 1990's were still primarily state enterprises and therefore heavily government influenced.

In 1990, Bank Ukraina (the agricultural sector bank), Prominvest (the heavy industry bank) and Ukrsotsbank (the social and municipal services bank) were registered as joint stock companies. However, at that time their shares, as mentioned above, were owned primarily by state owned enterprises and government entities. Ownership had been established essentially by utilizing assets of the enterprises at the banks as payments for equity. In other words, some of the liabilities of the banks (e.g. savings, deposits, etc.) were reclassified as equity. In 1993 when the government indicated that shares of state enterprises would be controlled by the Ministry of Finance, the banks responded by transferring most of the ownership rights from state owned enterprises to new private institutions and to employees of the banks and state owned enterprises.

At the close of 1994, approximately two thirds of Prominvest's capital was owned by individuals. 235,000 of the 250,000 shareholders of Bank Ukraina were individuals and almost 25,000 of the 27,000 shareholders of Ukrsotsbank were individuals. At Prominvest, State enterprises accounted for only 2% of total share holdings. At Bank Ukraina, 31% of the share holdings of the open joint stock company were held by collective farms, 28% by private enterprises and 41% by individuals. At Ukrsotsbank, also an open joint stock company, state owned enterprises accounted for only 6% of the legal entities who owned shares in the bank and accounted for less than 2% of the share holdings.

The aforementioned three banks accounted for more than 80% of the banking activity in Ukraine from 1991 to 1993. Each of these three banks, despite their new found corporate structures continued to be utilized frequently by the government for economic program purposes. Nevertheless, the new corporate structure clearly fostered a more commercial corporate attitude at those banks and a strong desire to distance themselves from the more damaging economic policies of the government. In many conversations, it was clearly evident that profit generation was a major objective in their operations. It is interesting to note that in Ukraine, unlike most of the countries of Eastern Europe the overwhelming majority of the banking system had been privatized very early in the economic reform process.

The two sole remaining state banks, Oschadny Bank and the State Export Import Bank continued to be tools of government policy, but each of these banks also developed commercial banking aspects.

Oschadny Bank, as a government owned savings bank served as a conduit for many public payment purposes such as household accounts, pensions and latterly as a record keeper and distributor of privatization certificates. It did lose its privileged position as the sole bank allowed to accumulate personal savings, but it remained the only bank that could offer government guaranteed deposit insurance to its clients. Oschadny Bank, as a result continued to offer interest rates on savings that remained well below levels offered by other commercial banks. Its share of household deposits accordingly had also declined to less than 60% by the end of 1994. The majority of savings obtained by Oschadny Bank during 1991 to 1994 were forwarded to the National Bank of Ukraine for its own internal utilization or for on lending to other banks.

In 1990 the Oschadny Bank began to take on direct lending activities and to expand its activities to include almost all retail banking services. Direct lending activities at first were concentrated on the inter bank market and only latterly to direct end user loans.

The Oschadny Bank had far more branches in Ukraine than any other bank. Its 13,000 branches employed more than 60,000 individuals. Bank Ukraina with the next largest branch network had approximately 800 branches and 25,000 employees.

The State Export Import Bank acted as the primary agent for the government of Ukraine for negotiations relating to sovereign borrowings. From 1992 to 1994 the bank had arranged more than 2 billion USD in loans, of which approximately 1.2 billion USD had been drawn down. The bank claimed that it accounted for more than 80% of the foreign exchange operations in the country in 1992 and approximately 60% of the activity in 1994. The State Export Import Bank together with Prominvest and Bank Ukraina were believed to account for 95% of all foreign exchange operations. Approximately 90% of the operations of the State Export Import Bank were transacted in hard currencies.

The State Export Import Bank although primarily a government agent and a corporate/wholesale bank also conducted commercial banking operations for its own account. Although not large, these operations did account for slightly more than 10% of all loans administered by the bank and served to remind management of the commercial banking implications of its operations.

The independent private commercial banks which arose in the late 1980's and early 1990's numbered approximately 220 at the end of 1994. Originally, most of these banks had been founded by state enterprises to provide financial services for themselves. In many ways this is quite understandable. In the late 1980's and the early 1990's the old order was crumbling. Along with the decay of the Soviet order, the financial system as it had previously existed, also began to break down. Credit allocation no longer operated along the principles mandated by Five Year Plans or the State Bank and payments for goods, services and salaries began to exhibit longer transfer delays.

Enterprises found it expedient to organize financial institutions that could provide services for themselves. Soviet era factory managers, used to vertical integration, no doubt found it natural to create for themselves one more appendage to their operations to compensate for services they could not otherwise reliably obtain. Most founding institutions did not believe that there was anything wrong in a bank providing loans to its shareholders. In fact, one banker was quite blunt in expressing the beliefs that existed at the time. When questioned about the practice he caustically replied "Why else would anyone set up a bank?"

In the very loosely regulated environment of the early 1990's, ease of entry into the banking sphere was such that bank founders were not required to demonstrate previous banking experience and initial investments of equity capital were minimal. The minimum statutory fund requirement had been set during the Soviet era, in August 1990, at 5 million rubles for newly created entities applying for a commercial banking license. The minimum statutory fund requirement was subsequently raised by the National Bank of Ukraine to a minimum level of 50 million karbovanetz in May 1992, 500 million karbovanetz in December 1992, 2 billion karbovanetz in September 1993 and 3 million ECU in December 1993. Typically, the increases in local currency denominations required investors in newly established banks to provide a minimum USD capital equivalent of approximately 500,000 USD .

In the summer of 1992, the National Bank of Ukraine required that commercial banks who wished to engage in foreign exchange activities apply for a special foreign currency license. In September 1993, the National Bank, which had maintained that only larger banks should be allowed to enter into foreign exchange activities, stipulated that banks authorized to conduct foreign exchange transactions be required to maintain a statutory capital level of 4 billion karbovanetz (or approximately 200,000 USD). Existing banks were constantly allowed to operate with far lower capital requirements.

National Bank authorities indicated only in late 1994 that existing commercial banks would be required to increase their statutory capital to a minimum of 500,000 USD by January 1, 1996. They also implied that the subsequent increase would be to a minimum of 3 million ECU.

It is interesting to note that as late as December 31, 1994 slightly less than twenty Ukrainian banks had 500,000 USD in statutory capital and more than 100 banks were reputed to have had statutory capital of less than 100,000 USD. Not surprisingly, the National Bank was predicting, or more accurately orchestrating, a severe shake-out of the smaller, weaker participants.

Throughout this period, inflation constantly eroded the minimum requirements stated in domestic currency values. If we were to reflect the share capital requirements for newly established banks in U.S. dollar terms, we would note that because of inflation, the minimum capital requirements for newly established banks had effectively declined to only 40,000 USD in April 1992, and slightly less than 100,000 USD in November 1992, August 1993 and November 1993, the months immediately preceding new statutory capital increases.

In February 1994, the National Bank stipulated that commercial banks with foreign ownership would be required to demonstrate a minimum of 1 million ECU in foreign equity investment and 5 million ECU in total equity, if less than 50% of the bank was foreign owned. If more than 50% of the bank was foreign owned then the equity had to be at least 10 million ECU. By 1994 nine banks had foreign shareholders. One western bank, Credit Lyonnais of France had established a fully owned banking subsidiary in Kiev. Another bank, First Ukrainian International was majority controlled by AIOC Corporation of the United States and Mees Pearson Bank of the Netherlands.

It was clearly a desire of the Ukrainian government to encourage foreign participation in banks in Ukraine with one possible exception - Russian banks. National Bank officials have informally indicated that approximately thirty five Russian based banks had been operating in Ukraine in 1991. By 1994, it appears the majority had 'chosen' to leave the market (especially in central and west Ukrainian regions) or had been unable to reregister or maintain their licenses.

National Bank of Ukraine officials frequently complained that Ukrainian banks were not given open access by the Central Bank of Russia to the Russian market. It is likely that unofficial political retribution and perhaps nationalism affected Ukrainian-Russian banking relationships.

The statutory capital requirement for foreign participation when compared to the 3 million ECU entry requirement for nationally owned banks was however clearly designed to show (non-Russian) foreign entities that hurdles to foreign bank participation would be minimal.

7. Main characteristics of commercial banks activity

Commercial bank operations in Ukraine were extremely crude financial operations in the period just after independence. It would be fair to state that activities from 1991 to 1993 could be more properly characterized as being akin to merchant banking operations during the 18th century in Western Europe. The new independent commercial banks essentially operated as financial institutions willing to enter into almost any kind of business transaction that might turn a profit. It is clear from the comments of clients that often banks were clearly equity style participants in transactions. By 1994 when banks realized serious loan losses on operations and attempted to secure ownership rights to collateral, prior to providing loans, the character of their activities was labeled by one western adviser as financial pawn brokering.

Transaction banking activities and high inflation rates meant that almost all bank loans were less than three months in duration and the majority were closer to a one month term. Long term capital investment lending was virtually non-existent.

From 1991 to 1993 commercial banks in their inexperience lent aggressively with very little or poor security. It was only when bad debts were recognized that banks restrained their activities. The bad debt problems were exacerbated by poor collateral laws e.g. lack of a centralized collateral & liens registration system and a very primitive, extremely ineffective bankruptcy law.

Fortunately, one of the financial factors which balanced the high risk lending practices of the commercial banks were extremely high interest rate margins which partially covered large bad debt levels. The high interest rate margins were primarily a function of a lack of deposits to fund loans, and the undeveloped competitive state of the banking market, rather than a perceived compensation for risks. The Ukrainian banks, by the way were not cognizant of the high rate of defaults they were soon to experience.

Throughout the period, U.S. dollar deposit rates at commercial banks ranged from 0% to a maximum 10/15%. Effective interest rates on U.S. dollar loans normally ranged from 20% to 30% and were sometimes as high as 60%. Interest rates on Ukrainian currency loans were also extremely high, but quantifying the effective rates is extremely difficult, since we know from client comments that banks consistently used side deals to boost their real rates of return. This was especially true in the period prior to 1994 when the National Bank tried to impose interest rate ceilings on bank loans.

The extraordinarily poor public image and a low level of public understanding of appropriate banking practices combined to create a public stereotype of banks as the vilest of institutions and individuals. To truly appreciate the popular public point of view, we must remind ourselves that in the Soviet era banks were viewed more often as conduits of credit and government policy, and not as financial decision makers or rationers of a precious economic resource. Banks were also to provide funds to stimulate production through preferential (i.e. subsidized) loans to troubled economic sectors. The idea that banks would refuse credit to deprived or needy economic sectors (such as agriculture) or would confiscate property for non- payment of loans was viewed as a criminal, inhumane mode of activity. Similarly, posted interest rates on domestic currency loans at 200% or higher was viewed as usurious. This, despite the fact that inflation reached 10,000% in 1993 and therefore implied immense real negative rates of interest.

Banks were also seen as the perpetrators of inflation, in a grand scheme designed to steal the wealth of the public. This conviction was most firmly held by pensioners and those millions of individuals who had seen savings that would have been sufficient to purchase a car in the late 1980's, sufficient only to pay for a loaf of bread in 1994. The public believed quite simply that if they had been robbed of their life savings, it was obvious someone must have manipulated the environment to steal it from them. Who could be more obvious than the banks and bankers with whom they had placed their funds?

The perception of financial theft was reinforced by payment transfer delays of three to four weeks prior to 1994, and frequent errors or 'lost' evidence of payment transfers (arguably frequently caused by bureaucratic incompetence as well as through willful misconduct).

Tied loan transactions (i.e. business deals and services set at artificial prices and tied to loans granted) and fee boosting attributes (i.e. the purchase of insurance for bank loans through associated companies) added to the belief that banks were malfeasant perpetrators of fraud.

Many of the founders and major shareholders of the banks first amassed capital funds through 'personal' management of a large number of the new cooperatives that arose in the late 1980's and later through the administration of many of the commodity exchanges that operated to facilitate barter transactions from 1990 to 1992. The wealth and the 'contacts' established during those periods tended to give the new elite a very high profile at a time when the public believed that the new business class had become wealthy by 'manipulating' cooperative ventures and stealing state assets.

The ostentatious lifestyle of bankers also tended to reinforce the stereotypic image. Bankers typically were one of the first members of the new business class to purchase expensive foreign cars. They dramatically paraded their use of cellular phones (in a country where the average citizen could expect to wait more than ten years for phone hook up services). Bankers took frequent trips to western countries and were often seen in the company of the 'nouveaux riche' at expensive restaurants. Bank premises were also the first buildings to be upgraded to fancy western standards and to be updated with the latest computer equipment.

In the first years of independence, banks tried to secure client deposits through boisterous media campaign advertisements and large philanthropic expenditures in an attempt to portray themselves as wealthy financial institutions (even though the vast majority had less than 100,000 USD in equity). Even these activities, however, tended to reinforce a negative stereotype of the banks. In the public mind, banks had obviously become wealthy through ill-gained criminal activity and were simply blandishing their success. It was a foregone conclusion that all bankers were 'Mafia'.

The public perception was supported and aggressively propagandized by conservatives and members of communist or socialist organizations who continued to view them as ideological enemies. In the environment that existed they had a field day!

The extraordinarily poor public image undoubtedly made it less difficult, even politically valuable for Parliament to punish bankers for their supposedly errant behavior. In 1994, for instance, banks were forced to pay a crippling tax rate of 55% on revenues (not profits). Bad loan provisions on potential losses were also not tax deductible.

Throughout 1991 to 1993, despite these very negative conditions the private commercial banks were able to survive, though just barely. During that period of time, they accounted for less than 10% of the banking system's activities, indeed by some measures less than 5%. Nevertheless, they learned quickly and proved themselves far more aggressive than the state banks and former state banks.

Whereas in 1991, few of the private commercial banks had more than three or four branches, by 1994 a half dozen of the newcomers had branches in almost every oblast' of Ukraine. Banking services were also surprisingly broadly based. Only 1 of the 25 regions of Ukraine lacked a bank headquartered in the area. Kiev, although the dominant center for banks and banking had only one third of the head offices of banks, while six other oblasts had 10 or more head offices. Branches of banks were similarly widely dispersed. None of the oblasts had more than 15% of the branch offices.

Although the new privately owned commercial banks continued to hold a minority position in banking operations, the proportion attributed to them in 1994 was a significant improvement from the 5 to 10% portion of the market held by them from 1991 to 1993. The oligopolistic position of state and former state banks, while not ended was certainly eroding under the aggressive banking practices of the newcomers.

It is also probable that government policies, which forced former state banks such as Prominvest and Bank Ukraina to provide subsidized loans to poor credits (temporarily artificially boosting their market share) will ultimately be revealed to be a suffocating yoke, as losses become recognized under international accounting and audit standards. In 1994, institutions representing less than 10% of the Ukrainian banking system had commenced audits under international standards, but by the end of the year institutions representing more than 80% of banking activity had agreed to commence the process in 1995. It is highly likely that more than one quarter of the loans in the former state sector banks will ultimately prove to be uncollectable and will be revealed through tougher accounting practices.

8. Commercial Banking Success Features

There were several prerequisites for commercial banking survival in the harsh economic environment that existed.

One of the consequences of inflation in the 1990's was a sharp decline in savings deposited by the populace at banks. Although in 1990 Oschadny Bank had a monopoly on savings accounts, which it was forced to share with commercial banks as the financial system developed, the commercial banks were not able to take full advantage of the opportunity. In the absence of a deposit base or a credit auction, the banks which were able to obtain funds from the National Bank, at interest rates which were frequently below inflation rates were able to relend at exceedingly wide gross margins. Even if loans were below inflation rates, as often occurred, those margins frequently compensated the difference.

The other major source of wealth to banks were foreign exchange transactions. Until 1993, a large amount (probably the majority) of retail foreign exchange transactions were conducted by citizen street vendors. However, banks with foreign exchange licenses were able to tap into a gold mine. Spreads on foreign exchange transactions ranged up to 10%, a margin that dropped to approximately 2.5% by late 1994. Banks with greater abilities to obtain funds, or approval for transactions through the National Bank or the inter bank market, inevitably prospered. There is considerable circumstantial evidence to indicate that 'contacts' in government played a significant role in this process.

In the midst of all the economic travails there is a shining star of banking services, in which the Ukrainians at first matched and then superseded world standards. From 1991 to 1993, payment transfers, as previously indicated, normally took several weeks to settle. In September, 1993 Ukraine became the second CIS country - following Russia - to join the S.W.I.F.T. international bank payments system. The National Bank of Ukraine and ten commercial banks became members immediately. By the end of 1994 their membership had doubled. Since the larger banks joined first, the oligopolistic nature of the Ukrainian banking system ensured that virtually all international banking in Ukraine by the end of 1994 was conducted at international standards of reliability and security.

The domestic payment system even more surprisingly has managed to overcome the payment transfer delays associated with almost all of Eastern and Central Europe. In January 1994, the National Bank instituted a national electronic mail payment system. In each of the 25 regions a network of regional clearing houses was set up and linked nationally, with the Central Clearing House in Kiev. Local banks and regional branches of commercial banks communicated their payment instructions to regional offices of the National Bank, which in turn forwarded interregional payment instructions to Kiev.

Payments through this surprisingly simple, yet extremely effective Personal Computer based system took less than an hour. The structure of the system also allowed the country to minimize the effects of a poor telecommunications system network. Ukraine, in spite of its telecommunications disadvantages is one of the very few countries in the world where same day inter bank transfers are the norm, not the exception.

9. Summary

Banking in Ukraine faced one of the harshest economic environments imaginable in a newly independent country simultaneously developing a market economy. Yet, sufficient elements of free enterprise and liberalization crept into the country to allow the primitive outlines of a functioning banking system to arise. Within a few years, the banking system in Ukraine had accumulated knowledge and developed banking practices that industrialized nations had taken centuries to develop. By 1994, the country had a banking system functioning along rudimentary market norms and a National Bank that the country and the world were beginning to take seriously.

In 1992, a new Ukrainian currency had been printed and stored in the warehouses of the National Bank. In the first years of independence, the currency awaited introduction as a legitimate symbol of the country's economic and political identity. The banks, although they had achieved considerable progress, also waited to be accepted as legitimate symbols of the country's financial sector.

Table 1: Foreign Exchange Rates -Nominal and Real- ((Krb/USD) Average for the Period)

Period	Official exchange rate	Non-commercial inter-bank exchange rate
1992 Q3	181	293
1992 Q4	563	788
1993 Q1	1,382	1,893
1993 Q2	3,344	3,133
1993 Q3	5,900	8,350
1993 Q4	8,557	26,667
1994 Q1	12,610	35,597
1994 Q2	14,134	43,466
1994 Q3	21,416	46,657
1994 Q4	78,493	110,242

Source: Ukrainian Economic Trends, Monthly Update, June 1995, TACIS, European Center for Macroeconomic Analysis of Ukraine

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