

Ukraine
The Financial Sector and the Economy
The New Policy Agenda

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Ukraine: The Financial Sector and the Economy: a New Policy Agenda

Section 1: Introduction and Outline

- 1.1 This Report provides an up-dated assessment of the situation in Ukraine's financial sector (banks as well as non-banks) and defines a policy agenda for the next stages of reform. An earlier version was discussed in seminars in Kiev and Washington in August and October 2000 and April 2001. The Report is addressed to those in authority in Ukraine who have influence over the future development of the sector. To economise on space the main body of the Report is supplemented by six substantive Annexes providing elaboration on key points. The reader who wishes to obtain an overview of the main policy components of the reform agenda can consult Section 7 of the Report. The other chapters provide the arguments and justification for this agenda.
- 1.2. The report updates a 1995 report prepared by the Bank that has served as the framework for much of the Bank's involvement with the sector in the intervening six years,¹ and has also been a significant influence on the government's own reform efforts in the sector.² The earlier report gave considerable emphasis to improvements in the legal, regulatory and supervisory framework for banking including the urgent need to move to an IAS system of accounts. Considerable progress has been achieved in these areas in the past six years and the authorities are to be commended for this.³
- 1.3 Regrettably this progress has not translated into a major improvement in the financial health and general performance of the sector. Nor, more importantly, has it led to the significant increase in the size of the sector and its capacity to deliver credit and other products in the amounts that Ukraine's large productive sector needs. This fact is clearly documented in a special survey of businesses undertaken for this study and reported in Annex 3. There is broad agreement, within and outside Ukraine, that the reforms already put in place have been necessary, even essential, but they have demonstrably not been *sufficient* to motivate the recovery of the sector. This is why a new and deeper agenda of reform is now called for.
- 1.4 In designing this agenda, this present Report has tried to learn the lessons from the past six years. They tell us that the building of an effective and deep financial system in a transition economy such as Ukraine, is a complex multi-faceted exercise. It cannot be achieved by focusing narrowly on the activities of banks and the non-bank financial

¹ Ukraine: Risks and Transition: A Review of the Financial Sector, Green Cover, Report No. UA 14526 UA., June 30th 1995

² The Bank and the authorities worked closely together beginning in early 1997 to develop as Financial Sector Adjustment Loan. This loan was approved by the World Bank Board in September 1998 and so far \$260 million of the agreed \$300 million has been disbursed to Ukraine.

³ A recent summary of the changes and remaining gaps in the regulatory structure is contained in IMF, Banking Sector Reform, Basel Core Principles Compliance Assessment, Monetary Operations, and Central Bank Accounting, Monetary and Exchange Affairs Department, January 2000. Because the IMF Report already exists there is no need for this present report to examine the regulatory system for banks in any detail.

institutions (NBFIs) , and the manner in which they are regulated.⁴ In addition, it is vital to recognise that the environment in which banks and NBFIs operate has been and remains extraordinarily unfriendly: improvements achieved in 1999 and 2000 notwithstanding. It is unfriendly because it is uncertain; because most productive enterprises are losing money and so constitute poor credit risks; because government policies still subject banks and NBFIs to very large indirect costs which they have to pass on to their customers; and, above all, because the Ukrainian authorities have tolerated a huge system of barter and non-payment that throttles activities which would normally be carried out by formal financial institutions. Taking account of all of this, the wide-ranging reform agenda set out in Section 7 embraces:

- measures to encourage the strengthening and accelerated restructuring of the banking sector;
- further actions to improve bank regulation and supervision and especially enforcement;
- a systematic campaign to reduce the costs on banks that are caused directly by government policies;
- actions, building on those in 1999-2000, to eliminate those features of the operating environment and especially the barter, non-payment phenomenon which cannot co-exist with effective formal financial institutions;
- general actions including de-regulation to encourage a far more favourable environment for bank clients and especially small and medium enterprises.
- measures to lay better foundations for the gradual emergence and growth of a more significant non-bank financial institutions sub-sector.

1.5 The new agenda may also need to include selective and limited actions to create new financial institutions – the pronouncements of the authorities frequently refer to the need for this. But past experience in Ukraine readily confirms that this approach is **not** a priority. It must be subordinated to the more fundamental reforms listed in the six bullet points above. In the current environment it is extraordinarily difficult to create successful and self-sustaining new institutions. In the absence of basic reforms, new financial institutions – especially those owned and controlled by the state – will be irrelevant to Ukraine’s problems.

1.6 This Report looks in detail at a sub-set of the necessary policy reforms. Some other matters such as deregulation and the detailed proposals regarding banking supervision have been the subject of other detailed Bank and IMF reports and so are not considered here. The remainder of this Policy Report is organised as follows.

- Section 2 has two main purposes. The first is to identify the main elements in the recent performance of the real economy that have complicated the task of developing a stronger financial sector. The second is to identify the various ways in which the financial sector is failing to make as large a contribution as it could to the economy’s recovery and future growth. Annexes 1 and 2 provide further elaboration.

⁴ This is the criticism we would level at most recent Ukrainian documents which have set out to define the next stages of the reform agenda – they contain many important ideas but are too narrowly based.

- Section 3 sets out the basic framework for designing the reform agenda for the banking component of the sector. It describes the three main inter-related elements in that agenda namely the need to radically improve the operating environment for banks; the need for a sustained attack on the excessively high costs of banking; and the need to address a wide range of institutional and regulatory gaps.
- Section 4 provides a forward looking perspective of what might realistically be expected by way of new financing for the economy through the period to 2005 in the event that a sustained reform effort is now adopted. It does this by comparing Ukraine's performance so far with that of other transition economies in the FSU and Central Europe where financial sector performance has so far been more impressive.
- Section 5 looks in more depth at the banking sector and analyses the size and nature of the reforms in individual classes of banks – especially the larger ones – that will be needed to realise the stronger future performance for the sector as set out in Section 4. This analysis draws attention, in particular, to the types of banks which seem likely to increase market share in the medium term and the implications of this for the regulators.
- Section 6 provides a similar in-depth analysis of the situation of the non-bank financial institutions, including some whose activities interact very directly with the capital market institutions⁵. This analysis identifies the main structural changes in the sector that are necessary (and likely) and the consequences of this for the future regulation of the sector.
- Section 7 defines the integrated reform strategy for the sector which emerges from the analysis in the report and related reports by others. It stresses above all that the multiple components of this strategy need to be regard as unified package in which all parts will be critical to achieving the favourable outcomes outlined in Section 4.

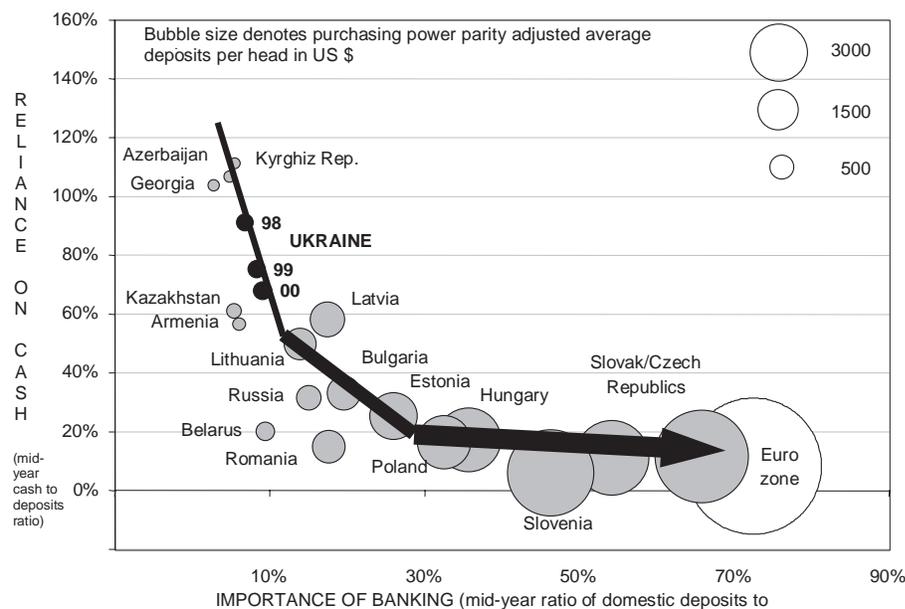
⁵ This present report has explicitly avoided in-depth analysis and discussion of Ukraine's Capital Market Institutions. This is because, these have recently been analysed in considerable detail in a US-AID- sponsored study. See C.M Seeger, H.C Patton, Financial Markets Development in Ukraine, Financial Markets International, January 2000.

Section 2: How and Why is the Financial Sector Failing the Economy

Malfunction in the Sector

2.1 Ukraine has a large number of banks⁶ and NBFIs⁷. However, most of these are very small; and many are extremely inefficient/high-cost. Most important, a significant number of the existing banks and NBFIs are financially too weak to be trusted with the public's money.⁸ Collectively they are able to mobilise only small volumes of saving and lend even smaller amounts of money to support productive purposes. The Ukrainian public and enterprises still prefer to hold much of their savings off-shore or in cash rather than in domestic banks. Far more Ukrainian enterprises (probably more than 90%) finance themselves by failing to pay wages on time than by using medium or long term bank loans (only about 5% of enterprises do this according to our survey). The involvement of banks in the payments system is also far lower than is normal in a well-functioning economy: payments in cash or non-payment via barter, arrears, mutual-offsets are far more prevalent in Ukraine than is normal (see Annex 2). The present situation in the sector is quite accurately referred to a one of *chronic malfunction*.

Figure 1: Three stages of banking sector recovery – cross-country mapping (1999)



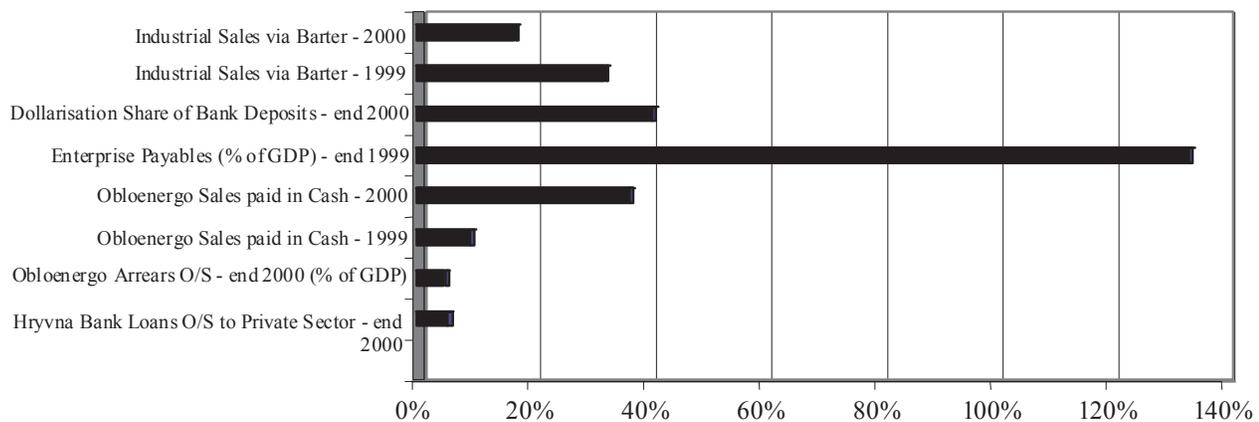
⁶ Numbers and further details are in Section 5 below.

⁷ Numbers and further details are in Section 6 below.

⁸ More than 60 of the country's 190 registered banks are either earmarked for liquidation or are in various states of rehabilitation under the wing of the NBU's Bank Resolution Department. Two of the largest banks namely Bank Ukraina and Oschadny Bank are chronically de-capitalised. In the insurance sub-sector, total reserves in 1999 of the 250 companies were less than \$200 million. The 100 private pension funds include 80 from the notorious 'Oberig' pyramid which defrauded almost 200,000 pensioners in 1995. The largest fund outside that group – accounting for over 50% of all premiums is operated by a chronically insolvent bank. In both banking, insurance, pensions and other sub-divisions of the sector the capitalization and capacity to conduct business is equivalent to no more than one medium sized Western organisation.

- 2.2 Figure 1 indicates the scale of banking activity in Ukraine for the three years 1998-2000 (horizontal axis) relative to the ongoing use of cash (vertical axis). It also puts Ukraine into context on these indicators with other FSU, with Central European transition economies; and with the Eurozone. Notwithstanding some improvement in 1999-2000, the unusually small size of bank deposits per capita and the exceptionally high reliance on cash (rather than bank deposits) is very evident in the numbers in the Figure.
- 2.3 Figure 2 describes some other selected indicators of the scale of banking activity and the corresponding scale of activity of the main alternative forms of payment and credit. Notice the small stock of total bank lending to the economy (about 6% of GDP) relative, in particular to the accumulated payments arrears (more than 120% of GDP) and even to the accumulated arrears of payment to power companies (now about 5% of GDP). Notice also that an important sector such as electricity generation and distribution collected only about 37% of its sales proceeds in the form of monetary payments in 2000. This was a great improvement over 1999 performance but still low. The dollar element of total banks deposits still exceed 40%. The dollar element of cash holdings is likely to be even higher than this.

Figure 2: Indicators of Malfunction



The Main Consequences

- 2.4 There are several major consequences of this present malfunction. These adversely affect both financial sector support of enterprise development and economic growth, and the contribution that the sector should be making to social development and poverty alleviation.

Consequences for Enterprises and Growth

- 2.5 The first point and the major concern to the country's politicians is that the mal-function has a *quantitative* aspect. The volumes of finance which the sector was able to intermediate and make available to the private non-bank sectors in the years 1996 to 1999 averaged only 0.9% of GDP. This is equivalent to only about Uah 1 billion or \$ 200 million annually.⁹ In the crisis year July 1998-June 1999 the figure was actually negative.

⁹ This is almost entirely from the bank part of the sector (see Section 4 below). The financing contribution of the NBFIs is only a fraction of 1% of GDP – see Section 6 for more detail.

Preliminary data for the year 2000 certainly indicate a significant improvement on the record through 1998 (see also Table 5 in Section 5 below). However, the political instabilities in early 2001 may threaten this and it is certainly too early to regard it as the start of a new trend.

- 2.6 It would be an error to blame this low rate of intermediation on the rapacious demands of the state sector. In reality, the state sector has also been able to draw very little voluntary finance from the finance sector – an average of much less than 1% of GDP during the five year period to 1999. Indeed, the domestic debt-management problems which the authorities faced after September 1998 derive in part from their inability to sell much new public debt to the banks and the NBFIs. The reality today is that the capacity of Ukraine’s financial sector is so small that its quantitative contribution in terms of credit to the *whole* economy (state and private combined) has averaged only about 2.1% of GDP in the past five years including even the good year of 2000. This compares to 9.6% in Estonia and 7.2% in Hungary over a similar period (see Section 4 for greater detail and also an indication of how much this figure could realistically be increased through 2005). Even if the Ukrainian government ceased all borrowing from the banking sector tomorrow, this would result in only a small absolute increase in the funds available to the economy’s productive sectors. The financial sector itself has to get larger before it can support enterprise to any significant extent.
- 2.7 The second regrettable consequence of the present financial sector malfunction concerns the *structure and the restructuring of the productive sectors*, especially in industry and agriculture. It is well known that Ukraine has many thousands of productive enterprises that are loss-making (See Table 1 below) and that have either to close down or fundamentally reconfigure their operations in order to survive and contribute to the economy’s future growth.

Table 1: Enterprise Profitability, 1992-2000¹⁰

	Profits (UAH mn)							% of loss making enterprises	
	1992	1995	1996	1997	1998	1999	2000*	1999	2000*
Industry	1298	9343	7376	7916	2548	7429	7135	51.9	57.9
Agriculture	478	832	-1328	-3362	-4424	-3750	na	84.0	n.a.
Construction	113	1258	1002	1092	830	591	-63	51.8	62.9
Transport & Communication	123	3791	3690	3747	5095	4460	467	61	68.0
Trade & Catering	117	951	877	1459	-1879	-1649	-478	44.8	43.3
Distribution	35	426	324	226	108	34	-39	57.1	66.1
Procurement	14	88	97	62	4	33	-2	50.4	57.1
Services	4	41	23	43	21	na	na	na	na
Housing & Municipal	-25	298	310	305	-216	-461	64	56	52.9
Finance, Insurance etc	353	1300	1460	1709	853	1442	278	33.8	40.8
Other sectors	45	478	610	671	479	-702**	1493**	na	na
Total All Sectors	2555	18806	14418	13868	3419	7427	8855	55.7	51.3

Source of data – Publications of the State Statistical Committee of Ukraine

*preliminary data

**including services

¹⁰ It should be noted that this table is compiled using unadjusted Ukrainian accounts. As a consequence it probably overstates profitability mainly because that system associates ‘production’ with ‘sales’. In a situation characterized by significant inventory

- 2.8 This necessary restructuring will have a huge price tag – many billions of dollars – in terms of the investment costs of new machinery and technologies, the redundancy payments to retrenched workers, re-training costs etc. The quantitative point made already means that today's financial sector is the equivalent *only of a flea on an elephant's back*. But equally serious is the fact of the very small percentage financial stake of banks and NBFIs in the typical Ukrainian enterprise¹¹. This means that these financial institutions cannot be expected to be the *instigators* of major restructuring. There is no capacity for banks (a) to identify and (b) to help finance the huge adjustments in physical capacity, the necessary changes in product mix, etc., which Ukrainian industry definitely needs. In well developed financial systems whether of the universal banking type such as Germany and Japan or more institutionally diversified types such as Britain and the USA, the financial institutions are major stake-holders in most major enterprises and so can contribute actively – even aggressively – to the ongoing pressures for industrial change. In Ukraine where there is an immediate and urgent need for huge amounts of industrial and agricultural restructuring, the leverage of the existing financial institutions over this process is regrettably close to zero.
- 2.9 What the authorities face instead is a situation where the process of industrial change is often dependent on political decisions and budgetary resources. Creditors' powers and so the potential leverage for change is located with the oblast administrations, the electricity power companies, the national government and the many other enterprises. In other words that leverage belongs to the creditors of those enterprises that need either to close down or to fundamentally change. As Figure 2 above illustrates, aggregate enterprise debts to other enterprises and other non-bank institutions is now some *25 times greater* than their credits outstanding to banks. In other words the leverage to force restructuring is more than 25 times greater in this amorphous set of other creditors than it is in the banks. Regrettably, that leverage is diffused and also lies in the realm of politics and not finance. Most outstanding non-bank credits originate in some form of political-economy logic (e.g., oblast administrations pressuring power companies not to close non-paying enterprises). Consequently, political decisions will have to play a far greater part in driving forward the process of industrial change than would be necessary had the financial sector advanced further than it has.^{12 13}
- 2.10 A third problem for potential financial sector support of the enterprise sector relates to a somewhat less obvious point – the disconnect between enterprise efficiency and post-tax profitability. This arises in Ukraine because of the ongoing widespread tolerance of non-payment as well as the granting of large numbers of discretionary tax privileges.¹⁴ These together result in the stifling of the incentives for enterprises to pursue greater efficiency as the main route to increased market shares. Indeed, inefficient enterprises are allowed to survive because of special favors regarding taxes and payments discipline. In some cases, their post-tax profitability even compares favorably with that of the more efficient enterprises. In short, enterprise efficiency and the levels of after-tax profitability get

accumulation, this will overstate revenue as will the widespread dependence on barter sales as described in Chapter 3.

¹¹ Some data on orders of magnitude for key sectors is available in Oksana Novoseletska, 'Privatisation: the impact of financial markets on the enterprise development', Ukraine Economic Trends, December 1999

¹² As various authors from Kornai to Schaffer have stressed that political decision needs to combine privatization (already achieved in most cases) with the elimination of government explicit and implicit subsidies.

¹³ examples are J. Kornai, 'Transformational Recession: the Main Causes' Journal of Comparative Economics, Vol 19, August 1994 and M.E. Schaffer, 'Do Firms in Transition Countries have Soft-Budget Constraints? A reconsideration of Concepts and Evidence' Journal of Comparative Economics, Vol.26 March 1998

¹⁴ These are documented in some detail in Annex 2 where the improvements achieved since 1999 are also referred to.

disconnected. Banks as a result lose the objective empirical basis needed to guide their allocation of scarce funds to the more efficient enterprises. Instead banks get involved in non-commercial and partly politicized modes of credit allocation.¹⁵ Hence economic growth also gets stifled and banks find their own performance weakened.

2.11 This point has been very well documented for the case of Russia by the October 1999 McKinsey Global Institute in-depth study of ten representative sectors of the economy. Their key conclusions included the following:

- old enterprises from the Soviet days have seen their productivity halved because these enterprises have seen almost no restructuring in spite of large falls in the demand for their products as consumers have increasingly been supplied by imports;
- the more productive enterprises in world terms are paradoxically often the least profitable and, in general, have not been gaining market share;
- in nine out of ten of the sectors the direct cause of poor economic performance is market distortions motivated either by attempts to address social concerns, by corruption or by inadequate information;
- in the manufacturing sectors, regional governments channel implicit subsidies to unproductive enterprises in the form of lower (even zero) tax and energy payments that are allegedly intended to prevent companies closing down and laying-off workers. However, this puts potentially productive enterprises at a serious cost disadvantage and blocks growth and new employment creation by these better enterprises;
- in the service sectors where employment definitely can grow, investments by efficient companies are discouraged by the presence of well connected incumbents who benefit from favorable regulations, weak law enforcement, and privileged access to land or government procurement.

2.12 It is highly probable given the close parallels between Russia and Ukraine which are documented in Annex 2, that these conclusions will apply *pari pasu* to Ukraine. Initial confirmation of this is to be found in the results of an in-depth survey of more than 1000 Ukrainian enterprises conducted under the leadership of the German Advisory group based in Kiev.¹⁶ These results indicate that in Ukraine as in Russia, loss-making firms are *not* constrained from access to credit and especially not from credit in the form of delayed payments to suppliers and to the tax authorities.! Nor in general does credit of *any* type go systematically to those enterprises that are most productive and where the return on credit can therefore make the largest contribution to growth.¹⁷ This of course is

¹⁵ Experience with World Bank credit lines in Ukraine has given ample evidence of the difficult change of attitudes which banks have to achieve in order to adopt objective credit procedures.

¹⁶ Source: Preliminary results from survey and study by Dr. Volkart Vincent, Osteuropa Institut Munich and German Advisory Group at the Government of Ukraine.

¹⁷ The regression results from that study identify some of the main determinants of the credit allocations (for five classes of credit namely bank credit, trade credit, overdue trade credit, unpaid taxes, unpaid wages¹⁷). In the sub-sample of firms which were profitable in 1998, the amounts of credits allocated generally increased with the size of the profits achieved. However, this effect was not statistically significant in the case of bank credits. Conversely in the sub-set of firms that were loss-making, the credits allocated in all five classes move inversely to the size of the losses (measured as negative numbers). In short as losses increase, the credits obtained rise. Furthermore in almost every case, including the case of bank credits, the regression coefficients are statistically significant. Additionally, the level of an enterprises own receivables (credits which it itself has extended to others), exert a positive and statistically significant effect on its use of all categories of credits from other sources except for wage arrears. There is in other words significant circularity in the process of credit extension when one consider a full array of credit sources including the informal

a very disturbing conclusion – Ukraine today has such small volumes of available saving and inter-mediation available that it cannot afford to waste these in unproductive uses.

Consequences for Social Policy and Poverty

- 2.13 The effects of the sector's mal-function on the economy's social development and on the fate of poor families are equally serious. This works in a number of ways. The vast majority of Ukraine's 50 million population do not own valuable assets. Assets such as housing and agricultural land which, in many other countries, are partly under the ownership and control of ordinary people are still significantly owned or controlled in Ukraine by state institutions, or by powerful factions which control these. Certainly the exercising of property rights over such assets for the purposes of, for example, collateralizing a bank loan is not an option available to more than a tiny fraction of the population. This fact contributes to the substantial non-empowerment of the majority of ordinary and almost all poorer families in the economy. Their assets cannot work for them because they do not exercise reliable control over them. It is a main source of the sense of disillusionment with economic reforms which is reported in all major surveys.
- 2.14 Insofar as ordinary, including poorer families own **financial** assets, the record of the past ten years has shown merely that these assets are extraordinarily unreliable. A succession of financial scandals have lost many people the money that they have assigned to pension funds, trusts and to some banks (for example, 194000 losers in the Oberig Pension fraud of 1995; 10000 losers in the Bila Tservka credit union failure; and several million losers in the Trust frauds of 1993-94). The perpetrators of the scandals are typically seen to have survived and even prospered in spite of their failures. The ordinary families who have lost their savings have been treated largely with disdain both by the failing institutions and also by the organizations that are supposed to regulate them and prevent such abuses.
- 2.15 An important point here is that this situation is both unacceptable morally but also represents a lost economic opportunity of some magnitude. An effective market economy has to be one in which all citizens, rich and poor, have some ownership and real control over valuable assets be they tangible assets such as housing or financial asset. A functioning financial system is one which helps to protect the value of such assets; enables them to generate incomes for the owners; offers arrangements whereby assets can be freely bought and sold in transparent markets; establishes mechanisms whereby the illiquid assets can provide temporary liquidity to the owners should this be needed; and generally add-value to even small volumes of accumulated savings. Poor people generally cannot be expected to save much. But since there are large numbers of them (the latest 1999 household survey estimates that 26.7% of Ukrainians are below the poverty line), their collective saving can be extremely large and, if properly used, can provide the means to mitigate some of the worst consequences of poverty and provide a window of possibility to escape from it. Imagine for example, the billions of hryvna that would be transferred to ordinary families if the agricultural land which many of them work became their own undisputed property and markets were established to enable some of this to be traded.
- 2.16 The financial system in Ukraine today fails to offer this sort of possibility to the mass of

the country's families. They in turn respond by largely turning their back on formal financial institutions that have treated them with such disrespect and that are widely caricatured as the 'play-things' of the rich and powerful. The one exception to this proposition is the Savings Bank where a substantial proportion of the population still hold small deposits mainly for payments purposes. This is explained by the continuation of historical Soviet practice and also by the government's guarantee on deposits. The several million of small depositors together provide a significant pool of resources. However, even this is threatened by the authorities' inability to follow through with the necessary restructuring and re-capitalization of the bank. Politically influenced loans to Energoatom and to other energy companies in the second part of 2000 have done nothing to make these problems easier and secure the long term financial health of the bank. So even in this case, we see evidence of the interests of ordinary Ukrainians being subordinated to other agendas and more powerful interest groups.

Selected Causes

- 2.17 Section 3 below provides a more systematic diagnosis of the sources of the malfunction discussed above. Here note is taken of two especially malignant influences on the situation in 2001 which derive from Ukraine's particular economic circumstances in the period since end-1994 when reform began. These are:
- the compromised nature of the general economic reforms undertaken from end-1994; and
 - the impact of the September 1998 economic and financial crisis.

Compromised Reforms

- 2.18 As regards the first of these it can be noted that, beginning in December 1994, a degree of macroeconomic stabilization was quickly achieved. Soon after that important structural reforms were implemented: initial price and trade liberalization; the curtailment of credit subsidies to loss-making enterprises; and the launch of the successful small scale and mass privatization programs. Damaging enterprise subsidies channelled via banks were replaced in large measure by direct subsidies through the budget.¹⁸ By September 1996, two years of responsible monetary policy had rendered the domestic currency sufficiently stable to justify the delayed launch of the new national currency – the hryvnia. In spite of the interruptions caused by the 1998 crisis, by mid-1999 it seemed likely that inflation was stabilising at around 10-20%; that the cash deficit of the budget had been reduced successfully to around 2% of GDP and that the decline in GDP was bottoming out. Taken at face value this looks like a reasonably sound record of achievement.
- 2.19 However, behind the scenes and increasingly in the period 1995-2001, a number of things were going on which had the effect of disfiguring the good results which the macroeconomic and structural reforms should have generated. These factors together have severely damaged the environment for the operation of financial institutions.
- Powerful economic factions established up in the country during the early pre-reform years have continued to exert excessive pressure

¹⁸ By 1994 these had surged to 34 percent of total spending, pushing the budget deficit to about 9 percent of GDP. Direct budget subsidies were themselves reduced starting in 1995, and other reforms were put in place to further limit budgetary deficits and monetary expansion.

through a variety of corrupt practices which embrace senior government officials, deputies elected to the Supreme Rada, and significant parts of the business, including the banking, community. This dynamic has fostered an unhealthy form of competition in which political influence, including the ability to influence the granting of official favours such as tax exemptions and the discretionary application of regulatory requirements, has taken the place of the healthy forms of competition based on relative economic efficiency and associated profitability.

- These groups have continued to scramble for the easy profits of the type which were readily available in the early years of Independence from sources such as the re-sale of gas imports; from other key industries such as metals and chemicals; from Forex speculation; from various budgetary subsidies; and from control of some banks. The incentives motivating this scramble have not been eliminated by the post-1994 liberalisation and other structural reforms. Indeed these incentives have persisted and taken on new forms as described in Annex 2. They remain today as a dead-hand on economic progress. Regrettably they seem to be a more important influence on behavior than those deriving from competition in the realms of real production, innovation and a genuine search for improved productivity.¹⁹
- Ukraine has institutionalized a part-way reformed socialist economy elsewhere labeled a ‘hybrid’ economy. In this hybrid many important activities including parts of banking retain a serious dependence on the state. However, the state plays its role not via visible policies but via ubiquitous and mainly non-transparent special arrangements for large numbers of ‘deserving’ enterprises, farms and banks. These arrangements include tax privileges; waivers or deferred payments of taxes; the connivance of the authorities in the barter settlement of tax obligations;²⁰ the write-offs of budget loans and tax debts; and insider access to public procurement (see Annex 2).

2.20 These three factors conspire with the poor basic profitability of the enterprise sector to create an extremely opaque and confusing environment for the development of successful financial inter-mediation. Markets, and especially financial markets cannot work if the information about relative efficiency is obfuscated by myriad distortions and if the state still plays a significant role in determining how and where resources get allocated. It goes without saying that the same factors have conspired to create an extremely fractured society in which a minority of powerful individuals and groups exert control over almost all the economy’s valuable assets, both tangible and financial. Meanwhile the mass of the public including the rising number of poor families are excluded from access to, and benefits from those assets

¹⁹ Anders Aslund estimates that the quasi rents earned on commodity exports alone amounted to more than \$4 billion or 20% of GDP in 1992. However, price stabilisation and some more transparent processes gradually reduced this percentage to single figures and so reduced the total pickings though not to the attractiveness of these to the relatively limited number of so-called ‘clans’ that hope to lay claim to them. It is claimed that Pavlo Lazarenko who was Prime Minister in the period 1996-97 and who is now remanded in San Francisco personally siphoned off as much as \$ 700 million mainly via his association with important energy companies. See Kyiv Post, June 8th 2000.

²⁰ Although tax revenues were reported to be around 30 percent of GDP, actual tax collections in cash are now only 18-19 percent of GDP. By allowing failing enterprises to remain in operation and ‘pay’ their taxes with barter if at all, the government has helped create a large virtual economy that operates in addition to the shadow economy.

Damage from the 1998 Crisis

2.21 This already difficult environment for banks and NBFIs was then further complicated by the consequences of the September-1998 crisis, the genesis of which is discussed in Annex 1. The local banks and some other financial institutions were impacted in at least *four* main ways by the events surrounding this.

- The direct losses on T-Bills holdings impacted negatively on both liquidity and earnings.²¹
- After the T-Bill write-down there was no longer an asset in the system that could be regarded as truly ‘safe’. This fact continues to affect adversely the technical management of liquidity positions in most financial institutions. The volatility of markets is now impossibly high for successful liquidity management (see Annex 4 for some facts on volatility).
- A number of banks took significant foreign losses on their uncovered foreign exchange borrowings (though never on the scale of Russia).²²
- The adjustment to the 1998 crisis required deflationary policies, including belated fiscal adjustment through 2000 which further deepened the already serious recession and further damaged the health of already weak loan portfolios. The positive economic growth achieved in 2000-01 has provided a welcome but belated respite to these pressures.
- A fifth potential source of damage was a run on deposits. Such a run materialized in the immediate aftermath of the major run on the Russian banks in the Summer of 1998 and a 10% reduction in household deposits occurred very quickly. But this was quickly reversed as it became evident that the banking problems in Ukraine were really not on the same scale as in Russia.

Conclusion

2.22 In summary, the performance of Ukraine’s financial sector today is seriously inadequate relative to the needs of the economy. There are many explanations of this most of which are discussed later in the Report. For the moment it is noted merely that the financial institutions themselves do not carry all of the blame for this situation. The environment that policy and circumstances have conspired to create for their operations is extraordinarily difficult. The agenda for reform must include serious actions to create a far better environment for banking and NBFi operations. These actions need to be additional to the specific technical problems in the sector which are discussed in later sections.

²¹ The restructuring of the approximately \$5 billion of domestic debt involved the exchange of old securities for new ones having lower yields and longer maturities. At the time, Standard and Poors categorized this transaction as a default (although it was never presented as such by the authorities), and some foreign holders contested it in the courts. Domestic holders of Treasury securities and especially the commercial banks volunteered a restructuring of their own holdings in September 1998 but nonetheless had to swallow a substantial degrading of both their income and their liquidity positions

²² Unofficial Bank estimates indicate that by July 1998 Russian banks had built an exposure to non-residents in excess of \$22 billion. This is a figure which was far larger than Russian foreign reserves at the time and which reflects the more developed state of the Russian banking system and the greater interest of Western – and especially German – banks in working with Russian partners. By contrast the Forex liabilities of the Ukrainian banks was only around \$500 million which was a figure far below the pre-crisis level of foreign reserves. This latter fact is partly explained by the efforts made by NBU regulators from late in 1997 to monitor and control the un-matched positions of the local commercial banks.

Section 3: A Framework for Understanding the Failures and Designing the Solutions

High-cost Banking

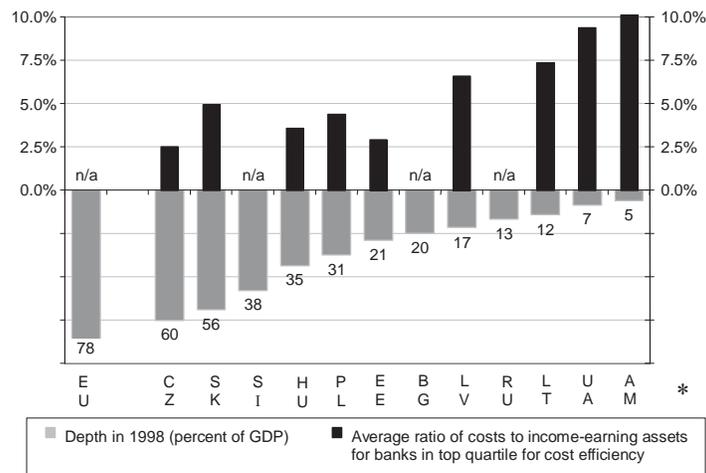
- 3.1 As Section 2 has suggested, Ukraine's banks and NBFIs operate with numerous handicaps. Hence the policy agenda necessary to achieve a significantly faster pace of progress in this sector is multi-faceted and complex. In designing this agenda, the starting point has to be the banking sector rather than the wide set of non-bank financial institutions. Action to build a larger and more effective banking sector has to be the major priority area for the next 3-5 years. The international evidence on this point is clear. Non-bank financial institutions including securities markets can play a potentially large role in a country's growth and development. But they almost never acquire significant size and a truly important role until banking itself is well and firmly established.²³ Since this is not yet the case in Ukraine (see Sections 2 and 4) – banking development has to be given priority at least in the medium term. There is not an alternative pattern of financial sector development that is truly credible.
- 3.2 Recognising this, the present Section and Sections 4 and 5 below largely focus on the banking part of the financial sector. In order to ensure coherence in the policy recommendations which are proposed, a simple analytical framework is needed which can encompass most if not all of the dimensions of that reform agenda. For this purpose, use is made in this Section of the unifying idea that most of the problems facing Ukrainian banks can be represented in one way or another as problems which increase their costs. These higher costs in turn necessitate higher margins (than in lower-cost banking systems) and this makes their on-lending costs unusually high. This in turn discourages sound enterprises from borrowing and results in much of the available lending going to weaker enterprises²⁴ (see Section 2 which refers to survey evidence on this point). But then a vicious circle emerges since the weaker enterprises are less reliable borrowers and present the banks with high burdens of non-performing loans. By end-2000, Ukraine's major banks had classified loans requiring loan loss provisions of Uah 2.5 billion which is equivalent to 24% of all their loans. The burden of these losses add further to the interest margins which banks need to charge. The high costs and increased unreliability of banking products associated with this further discourages the banking habit among the mass of the population.
- 3.3 Figure 3 shows comparative data on the operating costs of banks in Ukraine and other countries for 1998/99 (the upper segment of the figure). It is included to demonstrate just how far out of line Ukrainian banking costs are from stronger transition economies with much deeper banking systems. The data show a clear tendency for higher cost banking systems to be much smaller relative to GDP. The levels of financial depth are in the lower segment of the diagram. In 1998/1999 (the latest period for which comparable data is available) even the most cost-efficient large Ukrainian banks had the second highest ratio of costs to earning assets within the sample. Ukraine as a country had the second smallest banking system in the sample.

²³ Some of the evidence is cited in Section 6 below.

²⁴ This is the familiar 'adverse selection' problem of the theoretical literature.

3.4 The data underpinning Figure 3 shows that in 1998/1999 operating costs ranged from 8% to 37% of the earning assets of the top-7 Ukrainian banks. This is high by international standards even at the bottom end where comparators achieve 2-3%. It is extraordinarily high at the upper end (12 times the EU norms). Why is the cost situation so bad? In order to answer this question

Figure 3: International comparisons²⁵ of Bank Cost Ratios



costs need be to sub-divided into two distinct components depending on their source. These two components are:

- those costs which arise from the *banks' own operational inefficiencies* including over-staffing and excess network costs in some key cases (Oschadny Bank and Bank Ukraina for example);
- those costs directly caused by various *government interventions with banks*. These are numerous but include the losses associated with a substantial burden of politically-directed lending; the costs to earnings and liquidity management connected to the 1998 failure of the T-Bill market; and the costs to banks of having to act as unwilling agents of tax collection.²⁶

3.5 The consequences of the high costs are those already summarised in paragraph 3.2 above. However, they can also be represented in a stylised way in the Diagram used in an earlier paper on Ukraine by Sultan and Mishev.²⁷ This is shown in an adapted form as Figure 4.

3.6 The supply and demand curves for banking products in an economy less distorted than that of Ukraine would be those indicated by the solid lines.(Supply 1 and Demand 1). These curves would suggest an equilibrium price of bank services (credit, payment etc.) of R1 at which price the quantity of services sold would be Q1. But the cost-raising factors just discussed shift the cost (supply) curve of banking services to the higher

²⁵ Comparison countries are shown by standard international codes (as used for example in world-wide web addresses). The countries shown are CZ – Czech Republic; SK – Slovakia; SI – Slovenia; HU – Hungary; PL – Poland; EE – Estonia; BU – Bulgaria; LV – Latvia; RU – Russia; LT – Lithuania; UA – Ukraine and AM - Armenia

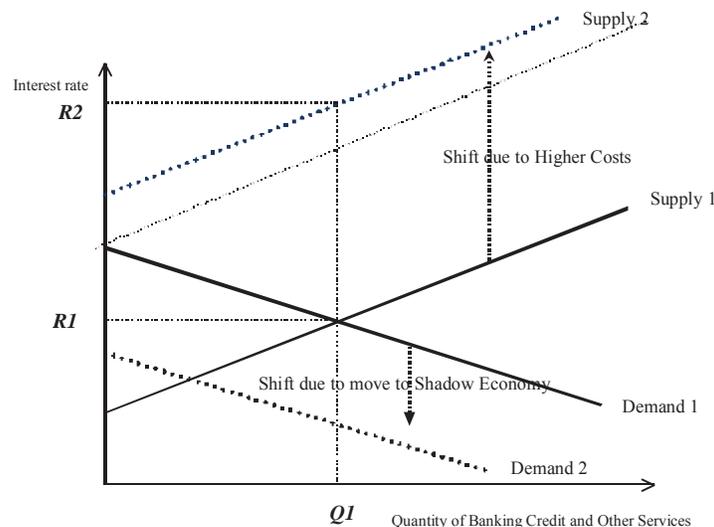
²⁶ Other examples are provided later. The Kartoteka system to which this comment relates began to be dismantled in April 2001

²⁷ K.M.Sultan and D.G. Mishev, Banking System in Ukraine: Sector Analysis and International Comparison, HIID Ukraine Macroeconomic Project, February 2000.

position indicated by the dotted line.(Supply 2) This shift comprises first an element attributable to policy interventions (the shift from the Supply 1 to the lighter dotted line) and the further shift to Supply 2 associated with pure operational inefficiencies. Because these high costs of *supply* are combined with the repressed *demand* on banking services associated with Ukraine’s large shadow economy, the supply and demand curves now intersect (if at all) at a much lower level of Q and, probably, at a much higher level of R. At least two adverse economic consequences emerge.

- Commercially motivated banks will lend relatively little but will need to charge high interest rates to accommodate their high costs and their small scale.
- The motivation to lend will be diminished even further by considerations based on adverse risk selection – sensible banks knowing that only poor credit risks will borrow at high interest rates.

Figure 4: A Representation of the Impact of High Banking Costs



3.7 But how will the typical bank react knowing that, because of high costs, they can only commercially sell credit and other banking products in amounts far below Q1 – possibly as drawn the equilibrium commercial supply is zero or below. Will the banks close down and move into other lines of business? No, the experience in Ukraine as in Russia suggests that in reality they face strong incentives/pressures to depart from strict commercial criteria in their attempts to achieve profit and remain in business. Among other things they have strong incentives to indulge in excessive risk-taking; excessive insider-lending; active use of bank funds for political purposes in order to enhance the banks’ level of ‘political protection’; and active efforts to by-pass some of the regulations which increase their costs irrespective of whether these regulations are sound or unsound. Some banks, including some of the high-cost banks will succeed with this inherently non-commercial form of banking and will achieve some profits. Other less well-connected banks will fail. In this messy and distorted environment, the real disaster for financial sector development is that efficient banks cannot gain market share on the basis of their lower costs. But, inefficient banks will continue to lobby for special favours to keep themselves alive. Conventional regulation of banks is compromised in this type of environment especially when, as in Ukraine, many of the least efficient banks are also the

politically best-connected.

- 3.8 However, there is a positive policy message coming from this analysis. This is as follows. Since a significant part of the excessive costs of banking are attributed in this analysis to *policy-induced* costs, these costs can in principal be eliminated or reduced as the first target of policy reform. This cannot eliminate the bad banks from the system but it could directly increase the equilibrium volume of services that the banks would want, and be able to provide commercially (see Figure 4). This would at least reduce the clamour for special political and other favours from the higher cost banks.²⁸ A second and parallel role for policy would then be to reduce those further excessive costs associated with the banks own operational inefficiencies to pull the system close to Q1. At this second stage, market forces can begin to drive the consolidation process. The NBU and the other relevant authorities need to set the rules for this process but above all they need to avoid the temptation to protect failed banks from closure or merger. The first step of eliminating the *policy-based* source of banks' costs would set the stage for a more active competition between banks based on their relative efficiency. The second stage would then be expected to encourage an expansion of the lower cost banks and the gradual disappearance of the others. Through the two stages together, the overall cost characteristics of the whole sector would be lowered significantly.

Causes of the High Costs

- 3.9 This is the theory but what about the reality in Ukraine. If the costs in banking are as exceptionally high here as Figure 3 suggests, what are the main causes? In particular, what are the *policy-induced* causes that could be removed by the first part of the reform so as to move the equilibrium closer to Q1 in Figure 4? Previous studies combined with the work undertaken for this report have identified a very large menu of contributory factors. The most important of these are summarised in the matrix of Table 2 below.
- 3.10 Shown there are *nine* symptoms of problems, each of which give rise to higher than necessary costs in Ukraine's banks. Some of these apply equally to the costs incurred by some of the NBFIs. In one way or another all nine of these can be shown to be implicated in increasing the costs of banking either because they raise costs directly or indirectly by reducing the scale on which banks are presently able to operate. *This matrix is presented here as the core of the new agenda for reform of banking.* It should be noted that, although actions by the NBU are represented in that agenda, there are numerous other necessary reforms for which responsibility lies elsewhere. As was noted in Section I above, the lessons of the past six years tell us that effective financial sector reform in Ukraine cannot today be achieved just by concentrating on the activities of banks, NBFIs and their regulators. A direct attack on the numerous factors damaging the operating environment must also be a priority.
- 3.11 The matrix identifies at least eight ways in which the government generally contributes to high cost banking (first row). These include the consequences of the government's unreliability regarding its own debt management; its complicity in tolerating high levels of barter and non-payment; its out-dated system of taxing banks at the branch rather than the consolidated level; its excessive tolerance of failed and failing banks and its maintenance of a complex and arbitrary system of state subsidies.

²⁸ The abolition of the Kartoteka 2 is one of a number of obviously desirable measures. Others are in the matrix shown as Table 2.

- 3.12 The matrix also incorporates a number of ways in which the NBU itself could strengthen its performance to help lower costs in banks (row 2). These include greater efforts to re-establish functioning money including inter-bank markets; the possible establishment of new institutional arrangements such as credit-rating agencies to help banks avoid poor credit risk; a program to gradually reduce the burden of the high reserve requirement; and a series of actions to force through a more rapid consolidation of the banking system in order to increase the market share of those amongst banks which can operate at the lowest costs. The in-depth agenda of actions to further strengthen bank supervision and its enforcement as discussed in the recent IMF-MAE report is an important additional part of this sub-agenda.
- 3.13 Finally, the matrix identifies remaining gaps and weaknesses in both the legal system and other parts of the institutional infrastructure which impact on bank costs (row 3). The responsibility for remedial action in these areas is broadly diffused across a range of government agencies including the Ministry of Justice, the NBU, and the Ministry of the Economy.

Conclusion

- 3.14 This is the framework and the core of the reform agenda for the banking component of the sector. The next two sections of this summary report look first at some beneficial consequences of adopting this agenda (Section 4) and then at some selective elaborations (Section 5).

Table 2: Diagnostics Of The Ukrainian Banking Sector’s Disfunctionalities By Major Cause

Causes	Symptom 1 No price for money. No risk-free 'safe' instrument	Symptom 2 Non-level playing field for banks	Symptom 3 Inadequate protection of Creditor's Rights	Symptom 4 High cost of banking due to regulations	Symptom 5 Excessive weight of barter and arrears	Symptom 6 Not enough credit-worthy customers	Symptom 7 No client trust in the banking sector	Symptom 8 Poor and narrow Range and quality of bank services	Symptom 9 Slow restructuring of banks
Failings of Government Policies	Unreliable behaviour of government in relation to T-Bill and veksel obligations. As a result T-Bills have lost their function as low risk instruments. The absence of transparent debt management strategy to inform markets	Unresolved overdue directed credits in some banks. New non-commercial energy credits even in 2000 Unpaid government capital contributions to some banks.	Retroactive government regulations create great uncertainty	High taxation of banks Taxation at the branch level of banks should be eliminated in favour of a consolidated approach.	Government itself is active in accepting barter and mutual settlement of tax obligations. (Annex 2). It still fails to act sufficiently against energy arrears	Complex and arbitrary system of state subsidies to non viable sectors and enterprises (Annex 2). Slow pace of privatization.	The existence of Kartoteka. Many enterprises - clients of banks lose control of their own accounts (reform initiated in 2001)		The state still protects some failed banks that should be liquidated promptly due to inadequate capital, poor management, and other factors.
Gaps in NBU support to system	NBU should make stronger efforts to foster inter-bank markets.	Insufficient transparency and consistency in (i) bank re-financing (ii) license withdrawal (iii) liquidation decisions		Reserve requirement in local currency is high (16%). ²⁹ It also penalises banks with FX deposits.	The systems for sharing information about (i) major credit risks and (ii) quality of collateral and borrowers are largely missing. This makes it harder for banks to make informed credit decisions.		Minimum capital requirements are still too low. Enforcement against weak banks is not sufficiently timely. Consolidation of banks not enforced.		NBU needs to be more proactive in dealing with failed banks and others showing serious weaknesses due to poor management etc.
Failures and Gaps in Legal System	Law for Promissory Notes or for Bills of Exchange has been introduced only in April 2001. Contract enforcement is unlikely to be taken seriously until the Government timely, honours its own obligations.	No law governing public procurement of banking services. Central Treasury for government funds not yet fully functional.	There is no law for the assignment of liquid collateral. Great confusions in registration of company ownership. Total lack of shareholder transparency (who are the owners?).	No requirement for the publication of prices of banking services. (i.e. no Truth in Lending Act).	Weak enforcement of bankruptcy law	Slow pace of accounting reform in the enterprise sector. It is hard for banks to evaluate potential borrowers	No effective law for Deposit Insurance	Missing legislation reduces the instruments that banks can use. Examples: land cannot easily be used as collateral; there are no - warehouse receipts	
Other Gaps in Institutional Support			Multiple registries increase costs and enhance confusion. There is no central depository		Weak judicial system undermines the work of banks, NBFIs and the NBU.	Insufficient supply of professional accounting skills and local companies		No system for licensing and independent inspection of warehouses. No cadastre registration system.	Functioning assets markets do not exist – assets cannot be properly valued. No asset resolution agency exists or can easily function.

²⁹ This was changed after introducing new Law on Banks and Banking which resulted into new NBU Resolution on differentiated obligatory reserve requirements.

Section 4: A Perspective on Achievable Progress through 2005

- 4.1 The agenda of reforms which this Report recommends (Section 7) is a long and daunting one. Its successful implementation will face a variety of political questioning and opposition. So it is important to define some progress markers to provide a rallying point for the advocates of that agenda and also to provide opponents with some tangible explanations of why it is all necessary. The purpose of this section of the Report is to do that by focusing on the volumes of new finance for the productive sectors of the economy that could be realised given the successful completion of the reform agenda for the sector. The target year of 2005 is somewhat arbitrary.³⁰ The methodology used is a careful examination of what has been achieved in transition countries which have demonstrably achieved greater progress in financial sector development. Most other FSU countries and a few Eastern European countries faced the post-Soviet period with ostensibly similar problems to Ukraine. Several have dealt with these with greater success as far as financial sector development is concerned. As Figure 1 above can indicate, this is true of all three Baltic states, to a lesser extent of Russia and to some degree of Poland. So these are among the comparators that can be used for this type of exercise.

Placing Ukraine in the Wider Context of Banking Transition

- 4.2 There is now growing evidence that the transition from a socialist banking system to a market-oriented one comes in *three* major phases:
- catastrophic dislocation from hyperinflation. In this phase, there is no confidence in any form of money – cash or deposit based. This phase for Ukraine was prolonged until end-1996 with the delayed introduction of the Hryvna;
 - sound cash money is established. This usually occurs through currency reform. However, in this phase, the population is not yet confident enough of banks to use deposits. This means the banking system remains suppressed below its natural level relative to GDP and the ratio of cash in circulation remains high. It is the end of this phase that Ukraine now appears to have reached – it is the last European transition economy to do so (even war-torn Georgia had started the third phase by 1997);
 - the third phase is when the rebuilding of the banking sector can really begin as an integral part of the new market economy. This happens principally by reducing relative reliance on cash and by increasing deposits as both the platform for economic transactions and as one of the prime savings instruments. It is this phase that Ukraine seems about to enter provided that the improvements of the past year are sustained.
- 4.3 Since the third phase is the most immediately relevant to Ukraine, it can be sectioned out into three distinct sub-stages as follows:
- the first sub-stage is to at least bring down the very high cash to deposit

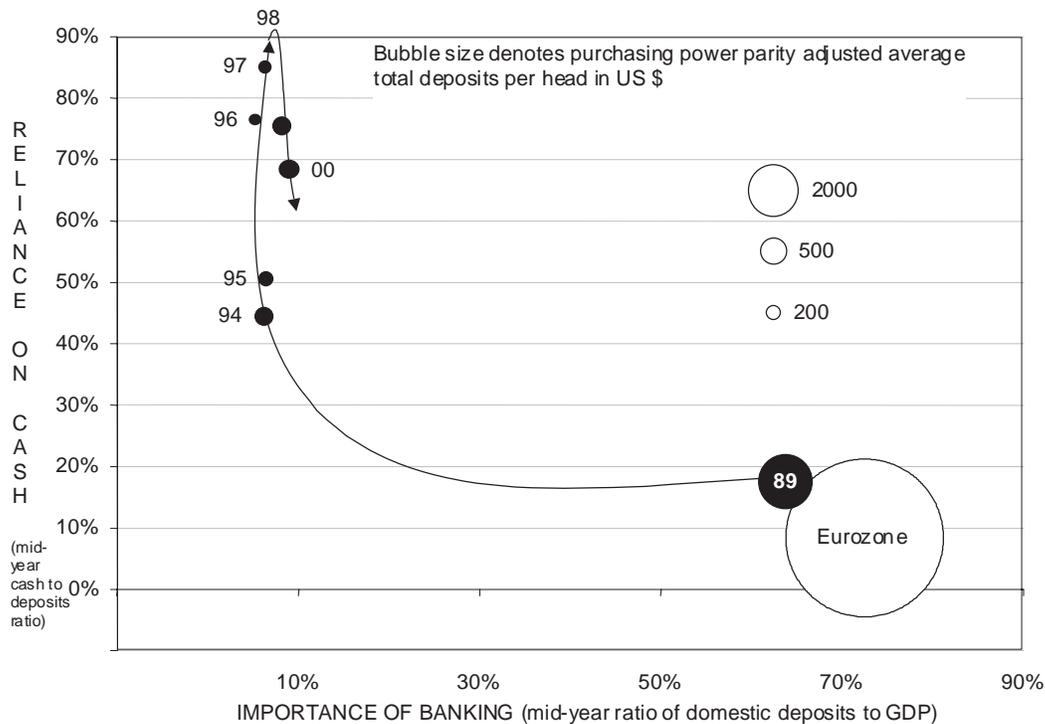
³⁰ It has the merit of being sufficiently far in the future to allow complex reforms to realise their beneficial results in full. It is also sufficiently close as to remain relevant to the political and election calendar.

ratio typical of the end of phase-2, so that non-cash transfers via banks start to take over from cash transactions and other alternatives to banking such as barter. Other transition countries at this stage are some Central Asian and all three trans-Caucasian States (Armenia has already virtually completed it);

- the second sub-stage involves a mix of (i) a further reduction of the cash to deposit ratio but more important (ii) the beginnings of a genuine mobilisation of new savings into banks. This is the stage that the three Baltic States, Russia and the two largest South-European transition economies (Bulgaria and Romania) currently occupy;
- the third sub-stage involves deposit growth in banks predominantly via new savings mobilisation. At this stage too the cash:deposit ratio achieves near EU levels. Countries in this phase include almost all the first wave of Central European candidates for accession to the EU.

4.4 Graphically, the stage reached along this progression by different countries is represented in Figure 1 in Section 1 above. The actual progression from 1989 to 2000 for Ukraine is represented in Figure 5.

Figure 5: Ukraine’s Progression Through the Major Phases of Banking Transition



4.5 Figure 5 shows data for 1989 to 2000. It confirms (i) Ukraine’s extraordinarily weak progress through 1998 and (ii) the beginnings of significantly more positive movements in 1999 and 2000. More specifically, in 1999 we see the first registered falls in the cash to deposit ratio since transition began. This in turn contributed to a 2.5 percentage points rise in the ratio of deposits to GDP. This was five times the net change achieved in the

previous four years and was sufficient to allow the banking system to grow at a compound 20 percentage points faster than nominal GDP (itself growing at a compound 30% per year over the last two years). This represents a widening of the differential growth rate from the previous two years even though the 1999/2000 period actually includes the impact of the 1998 Russian crisis.³¹

- 4.6. In spite of this, Figure 5 confirms the propositions advanced in the previous two sections – for the moment Ukraine still does not have a banking sector of any real significance to the economy and it still lags most other FSU and Central European economies. Looking into the future, it is extremely unlikely that Ukraine can return to the level of monetisation seen towards the end of the Soviet era.³² The highest ratio of deposits to GDP Ukraine might achieve is unlikely to exceed 45~50% – 5 times the present level. Even this could take a decade or more to attain. The practical question is what is realistically possible by, say, 2005? Experience from other FSU countries (notably Armenia and Estonia) shows that the first stage of recovery as defined above need not take more than three to four years to complete. This alone would be enough to put Ukraine in 2005 where Lithuania is now (see Figure 1 in Section I), with a total money supply to GDP ratio of 22% (1.8 times current levels) and a deposit to GDP ratio of 16% (one and three quarters times current levels). On the basis of nominal dollar GDP growth of 10% per annum and unchanged exchange rates from now on, this could mean up to \$2 billion of new domestic finance mobilised via banks each year. This compares with an outstanding stock of domestic bank lending of only \$3 billion by end-2000. If this extra bank intermediation were to be achieved, it would make a profound difference to financing possibilities for all branches of productive activity.
- 4.7 This simple comparison can be improved by looking at what the progression from the 1989 starting point has meant for financial savings across a larger number of transition economies. The peer-group taken for this purpose is a selection of the European former Soviet States for which comparable data are available. Table 3 below compares current and pre-reform levels of PPP-adjusted per capita GDP, broad money and deposits measured in US dollars

Table 3: Impact to Date of Transition on Incomes and Financial Savings

³¹ This is because of the way the data is constructed with the changes in deposits relative to GDP measured from mid-year to mid-year.

³² The near Eurozone levels of the deposit to GDP ratio in Ukraine witnessed in 1989/1990 were largely the result of forced saving as the economy failed to supply consumer goods to match consumer incomes – the so-called monetary overhang. Various estimates have put the proportion of household savings that this might have represented at between 25% and 50%. With household savings typically some half to two thirds of total domestic money supply this means the 1989 deposit to GDP ratio was some 10~20% above its natural level.

All figures PPP-adjusted US\$	Ukraine	Russia	Armenia	Estonia	Latvia	Lithuania
Pre-reform levels (1989):						
- GDP per capita	3314	5871	5058	4914	5094	5505
- Deposits per capita	2114	4042	2112	2227	2210	3620
- Broad money per capita	2484	4750	2746	2800	2950	4306
Most recent levels (2000):						
- GDP per capita	2875	4400	2525	7425	6850	6900
- Deposits per capita	250	650	200	2250	1300	1075
- Broad money per capita	450	850	300	2800	1975	1500
Percent change (1989~2000):						
- GDP per capita	-13%	-25%	-50%	51%	34%	25%
- Deposits per capita	-88%	-84%	-91%	1%	-41%	-70%
- Broad money per capita	-82%	-83%	-89%	0%	-33%	-65%
Trough year(s) / peak declines						
	1996	1999	93~96	1993	92/93	93/94
- GDP per capita	-36%	-44%	-63%	-23%	-40%	-38%
- Deposits per capita	-94%	-87%	-97%	-81%	-81%	-89%
- Broad money per capita	-92%	-86%	-95%	-74%	-82%	-89%

- 4.8. Table 3 shows that all countries have experienced larger declines in their financial sectors than in their levels of GDP. Ukraine has suffered a similar decline in financial savings (broad money or deposits) to Russia and Armenia, even though its per capita GDP has fallen by less than in those two countries. This evidence suggests that today's limited depth of the Ukrainian banking system cannot be explained by its sustained economic recession alone. There are other forces at work.
- 4.9 Additional explanations are suggested by the Baltic States, which suffered similar peak-to-trough declines in per-capita GDP to Ukraine but have progressed far better in recovering lost per capita income and financial savings (Table 3). Closer study has shown that recovery in those cases bears a direct relation with the degree of banking system consolidation that has been achieved in the past five years.³³ The clearest example of this is Estonia, where GDP per capita is now 50% above the pre-reform levels and where all of the 1989 level of broad money per capita has been recovered (compared to only 18% in the case of Ukraine), but this time on a voluntary basis.

Two Possible Paths for Ukraine to Take

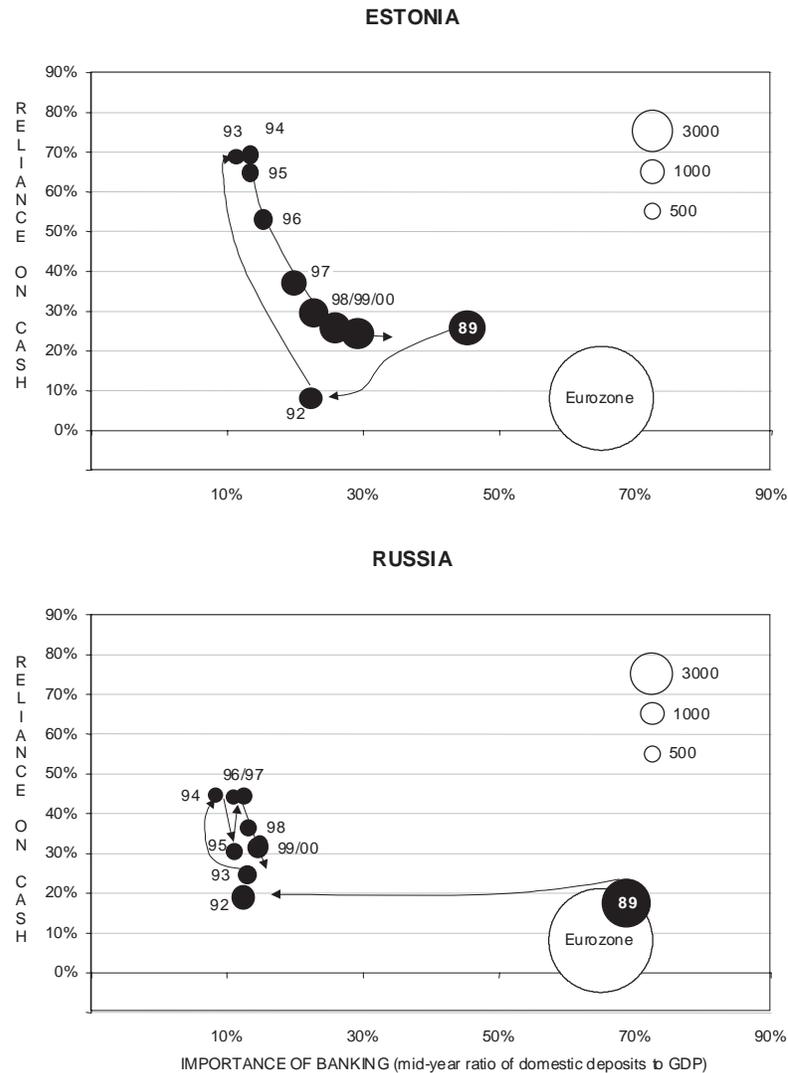
- 4.10 The comparison of how different countries have progressed through the transition process described above offers some interesting insights about how much progress Ukraine can aspire to by 2005. There seem to be clear, good and bad paths. We can illustrate these by comparing banking transition charts for Estonia (a strong performer) and Russia (a weak performer) in Figure 6.
- 4.11 Estonia has followed an aggressive reform path, with no protection for weak banks from failure. In the early 1990s, banks accounting for around 40% of total banking system assets failed with no compensation for depositors. This cost the economy the equivalent of 11% of GDP in lost real savings, but within five years this had all been recovered. Estonia now boasts two of the three largest banks in the Baltic States (despite being the smallest of the three economies). Both of these now have strong strategic investors and

³³ Fuller elaborations of this can be found in S. Peachey and Alan R. Roe, "Financial Deepening and the Role of Financial Crises" paper to World Bank Annual Meetings, Prague, September 2000.

- are expanding abroad. Recovery of the banking sector survived the twin shocks of the Asian and Russian crises and now appears to be accelerating again. This is despite further bank failures in 1998 and 1999.
- 4.12 Cumulatively the banking system has grown substantially in terms of deposits but has shrunk in terms of numbers of banks from around fifty banks in 1993 to just five now. Overall domestic deposits stand now at 30% of GDP and over the last five years (1996~2000 inclusive) the equivalent of 10% of GDP annually has been injected into the economy by way of new credit, more than half of which has been domestically funded.³⁴
- 4.13 In contrast Russian reform has been at best sporadic, with a large degree of politicisation of the banking system and both overt favouring of selected banks as well as protection for both depositors and shareholders from the consequences of failure. Even the Bank Rehabilitation Agency established in the wake of the 1998 crisis has been blocked by political pressures (particularly at regional level) from closing banks that have been weakened to a point where a return to solvency and viability is impossible. In short the Russian banking system has been treated in a similar way to the Ukrainian banking sector.
- 4.14 Russia has never suffered a single banking crisis of the same magnitude as the Estonian one in 1993, but equally it has not witnessed such a strong and sustained recovery. Moreover every few years, what progress there had been was reversed. Over the last five years its banking system has injected less than 4% of GDP on average annually by way of new domestic finance and less than half of this has gone to the non-bank non-government sector (NBNGS) to fund potentially growth-supporting investment. Russia has done marginally better than Ukraine but suffers from most of the same structural problems – its record on banking development is clearly not one for Ukraine to seek to emulate.

³⁴ It may be argued that Estonia being only a small country is not a valid comparator for Ukraine. But larger economies such as Poland and Slovenia have also seen the same sort of transition recovery of financial depth

Figure 6: Progression Through Banking Transition – Estonia and Russia Compared



- 4.15 These two starkly contrasting examples show the economic costs of trying to prop up failing banks - despite starting 1993 with a banking system 20% larger than Estonia's on a like for like basis,³⁵ Russia now has a system not even 30% of Estonia's relative to GDP. The unavoidable conclusion is that the fear of banking sector consolidation is much worse than its reality – even where consolidation involves a large crisis such as happened in Estonia (or indeed repeated failures), recovery is possible well within a five-year time horizon and puts a country on a much better growth path.
- 4.16 Further evidence about how much funding of the economy through the banking sector is possible is summarised for more comparator countries in Table 4 below. Comparisons are available for three fast adjusting economies where the banking sector operates on a fully commercial basis (Hungary, Poland, Estonia) and three economies where government has

³⁵ Based on comparisons of per capita ppp-adjusted deposits in US dollars.

used various direct and indirect means of support to try and manage the process of consolidation or protect banks from the consequences of failure (Russia, Lithuania, the Czech Republic).

Table 4: New Lending and Net Supply of Funds by Sector (1996~99)

% GDP Annually	(A) New lending to NBNGS	(B) Net flow to state*	(C = A+B) Net lending to economy	(D) New deposits by NBNGS	(E = A-D) Net finance of NBNGS	(F) Net foreign finance**
Ukraine	1.1%	0.4%	1.5%	1.1%	0.0%	0.0%
Fast adjusters						
Hungary	4.4%	2.7%	7.2%	5.5%	-1.1%	0.0%
Poland	5.8%	0.9%	6.8%	6.8%	-1.0%	0.7%
Estonia	7.2%	2.4%	9.6%	5.0%	2.2%	3.3%
Slow adjusters						
Russian Fed.	1.4%	2.4%	3.8%	2.4%	-1.1%	-1.2%
Lithuania	1.7%	1.3%	3.0%	0.8%	0.9%	0.4%
Czech Republic	-0.6%	2.2%	1.5%	4.4%	-5.0%	-4.3%

Notes:
* includes buildup of cash holdings and reserves at the Central Bank (ultimately available to fund gov't)
** change in commercial bank net foreign assets, sign reversed (i.e. minus means bank export of funds)
Source: IMF International Financial Statistics plus various central bank web-sites

- 4.17 Lithuania is an interesting example of a country that appears to have switched modes. Up until 1997, the authorities there took various steps to avoid the consequences of large bank failures. In some cases this involved depositing public funds with banks approaching crisis and after the inevitable failures attempting to mitigate the consequences of failure with transfers of deposits to the state savings bank. The identifiable costs of these unstructured efforts were equivalent to several percentage points of GDP (at a time when total deposits in the banking system only amounted to 14% of GDP). Then in 1997 a properly constituted deposit insurance fund was established with publicly subscribed capital of barely 0.1% of GDP. This fund has since had to pay out on two further bank failures but without any interruption to the remonetization process. Indeed, within just two years of establishing the fund, total deposits recovered all the ground lost relative to GDP during the crisis and household deposits relative to GDP surpassed pre-crisis levels. The establishment of a strong, well-funded deposit insurance system was accompanied by concerted moves to restructure, properly privatise and seek significant foreign strategic investors for the two remaining large state banks – agricultural and savings – as well as the merger of the two largest private banks. In part the switch of emphasis in Lithuania was part a stark choice between muddling on as before, or having any realistic chance of joining the EU alongside other Central European States.
- 4.18 There are clear parallels here with the choice facing Ukraine – to embrace consolidation and maintain the impressive remonetization dynamic established over the last two years, or try to avoid it, lose growth momentum in the banking system and ultimately increase the cost of bank failure to the public purse. Obviously the recommendation of this review is to follow the Estonian/Lithuanian model rather than the Russian one.

What is at Stake for Ukraine?

4.19 Put in monetary terms, the cost of failing to force through consolidation of the three slow-adjusting banking systems described above has been to deprive their economies of extra potential new domestic finance worth 3~4% or so of GDP (compare the entries for fast and slow adjusters in column C). For Ukraine the gains from consolidation could be even more significant, because the past bank supply of domestic finance has been lower on average even than in the slow adjusting systems shown in Table 4. This is clear also on a year-by-year basis as shown in Table 5 below.

Table 5: New Lending and Net Supply of Funds in Ukraine (1996~99 and 2000)

% GDP annually	New lending to NBNGS	Net flow to state	Net lending to economy	New deposits by NBNGS	Net finance of NBNGS	Net foreign finance
2000	4.4%	0.5%	4.9%	3.6%	0.8%	-0.1%
96~99 average	<u>0.9%</u>	<u>0.2%</u>	<u>1.1%</u>	<u>1.5%</u>	<u>-0.6%</u>	<u>-0.9%</u>
1999	1.2%	0.4%	1.6%	1.7%	-0.4%	0.0%
1998	-0.4%	0.7%	0.2%	0.4%	-0.8%	-1.0%
1997	1.8%	0.9%	2.7%	1.3%	0.6%	1.2%
1996	1.9%	0.1%	2.0%	1.0%	0.9%	0.3%

4.20 In the year 2000, the greater public confidence in the government and the achievement of positive growth stimulated a significant rise in deposits in the banks on the part of both enterprises and households. We can surmise that this rise may also have been helped by factors such as (i) the governments far more disciplined attitude to non-payment (especially in the energy sector); (ii) improved NBU supervisory performance that resulted in better information about and differentiation between good and bad banks and (iii) the first pay-outs under the deposit insurance scheme. But a competing hypothesis is that the surge in deposits is the passive consequence of higher payments balances associated with the impressive GDP growth – itself a consequence of the temporary oil-driven gains in Russia. Either way it is too early to say whether 2000 marks the start of a promising new trend or merely a one off blip around the old and disappointing trend.

4.21 The conclusion we draw is that the Ukrainian authorities should use all their efforts to sustain the good performance of 2000. In particular, the improved supervisory capacity should be used to accelerate the delayed consolidation of the banking sector thereby enabling a pattern of future development closer to that of Estonia and other Baltic states. This has the prospect of directly and quickly improving the average costs in Ukrainian banking as discussed in Section 3. It is an approach that must allow the failure of those banks that can no longer operate at reasonable margins. If parallel progress can be initiated to reduce the policy-induced costs identified in Table 2 of Section 3 above, then a multiple increase in bank financing of the economy is a possibility by the target date of 2005. If the authorities reject this possibility and instead persist with a more protectionist approach, the 2000 performance will likely be shown to have been one blip around the old trend and the sector will likely face a pattern of future development closer to that of Russia. In this case, the medium term future to 2005 will see a moribund banking system that is failing (as until very recently) both to mobilise domestic savings and to provide new credit to the domestic economy in significant volumes. Obviously the bolder of these two alternatives may itself seem very risky but the lessons from other transition economies are definitely encouraging. To repeat, the pay-off could be substantial. With net lending to the economy routinely in the region of 4-5% of GDP, more than \$ 1 -2

billion of bank credit could be provided to the economy annually by 2005.

Summary and Policy Issues

- 4.22 The analysis presented here suggests that a feasible target for what a more efficient banking system could achieve by 2005 is net new flows of domestic financing of at least \$1 billion **per year** rising to \$2 billion. This compares to cumulative net credit creation of less than \$3 billion in the previous ten years of transition;
- 4.23 This turn-around cannot happen unless Ukraine adopts the structural reforms of the more successful of the FSU reforming countries. The crucial ones – consistent with the framework proposed in Section 3 and defended in more detail in Section 5 below are:
- allow a significant number of today's higher-cost bank to disappear – including some of the top-7 currently subject to rehabilitation – and allow banking activities to concentrate around the lower cost base of the remaining banks;
 - for the larger and politically sensitive banks, the focus should be on more directly distinguishing the potentially efficient from the clearly defunct. This should then be allowed to form the basis for a managed consolidation of the larger banks;
 - for most banks the NBU needs to be more consistent in the application of its policies as well as transparent and expeditious in enforcing liquidations (including mergers) on banks which are indisputably unable to meet its own capital and other prudential requirements.

Section 5: Banks: Consolidation around Efficient Low-Cost Banks

The Structure of the Sector

- 5.1 How do the possibilities presented in the previous section translate into prospects for individual parts of today's banking sector? This section attempts to provide an answer by first reviewing the present structural features of the sector and then evaluating the growth prospects and challenges facing different groups of the existing banks. It is not the purpose of the Report to predict the future performance of individual banks. Rather the task here is to connect the known characteristics of various broad classes of banks with the more generic analysis of Section 3. This can provide broad markers about how the consolidation strategy we propose might proceed in practice.
- 5.2 The basic facts about the banking sector today are as summarised in Table 6 below.³⁶ The major structural features include the following:
- there are still 156 operating banks in the system even though the total assets of the whole system add up only to the equivalent of \$5.2 billion. Total banking capital is reported as Uah 5.98 billion in 2000 or about \$1.1 billion; but much lower if full account is taken of impaired assets which are subject to loan-loss provisions – by end-2000 these amounted to Uah 2.5 billion;
 - the system remains highly concentrated with the 7 largest banks still accounting for over 60% of all bank assets. This latter situation is changing. The process of intensive diagnosis of the 7 largest banks begun at the end of 1998 has revealed the need for far greater write downs of loans and other assets in these banks than was previously thought to be necessary and this has reduced their effective total size;³⁷
 - the process of rationalization and elimination of smaller non-viable banks anticipated in the Bank's 1995 report has been slow to materialize. Although 76 banks have been liquidated or otherwise excluded from registration since 1991, no large bank has yet been liquidated even though several have become chronically insolvent.^{38 39}
 - there is now a significant presence of foreign banks in the system –

³⁶ A general caveat to most of the data presented in this Section is that data from the National Bank of Ukraine still show major differences to accounts produced (and audited) in accordance with International Accounting Standards (IAS). Although Ukrainian banks have been required to comply with the NBU requirement to produce IAS based financial statements since January 1998, banks comply with this requirement to varying degrees and therefore, some distortions in NBU aggregated data are also evident. In addition time series of data going back some years prior to 1998 need to use the Ukrainian rather than IAS.

³⁷ The numbers shown in the Table do not fully reflect this since they are based on Ukrainian accounting standards that have converged towards international standards but not yet fully. Most likely fully adjusted accounts would reduce the assets share of the largest 7 banks to only about 50% of the system total. The concentration is particularly evident in relation to household deposits where Oschadny Bank, Bank Ukraina and Privat Bank among the top 7 are the most important.

³⁸ Some of the 37 banks currently in liquidation have been there for lengthy periods of time. So far the beneficial lessons from large bank liquidation as seen in the Baltics have not been replicated in Ukraine (see Section 5).

³⁹ There is general acceptance that the liquidation procedures for banks remain unsatisfactory – their reform has been long in preparation but has also been compromised by the political influences referred to in Ch.1. The promulgation of radically new procedures as in the new Law on Banks and Banking Activity will be the necessary (but not the only) condition to turn this situation around. This Law was enacted in January 2001.

certainly an increase over the situation in 1995 – but this is not secure and at least two such banks have exited the system in recent years.^{40 41}

- liquidity management and volatility in inter-bank funding rates has been an overwhelming problem for the majority of the banks especially since the 1998 crisis and has further increased their costs;
- operating expenses are generally very high (see Section 3) and exert a drag on net income. The loan portfolio is too small to provide a reasonable spreading of expenses and therefore, interest spreads need to be unrealistically high;⁴²
- short-term lending – typically 3-6 months - still dominates with 75% of the loan portfolio. Virtually the only loans of greater than one year maturity are those financed from international sources. The EBRD SME credit line and the Bank’s Export Development Project are the main examples.

Total number of registered banks	194 banks
Total number of banks with foreign capital	31 banks
Total number of banks having a license for FOREX operations	150 banks
Total number of banks liquidated 1991-1999	76 banks
Total number of banks currently in liquidation	376 banks
Total number of banks with assets more than UAH 100 million	47 banks
Banks with 100% foreign capital	7 banks
Total paid in statutory capital of registered banks	Uah 3.86 bn

TABLE 6: Basic Data On Banks (April 2001)

Other Critical Trends since 1995

5.3 The research undertaken for this Report analysed the main operational trends in individual banks which are essential to any understanding of their future prospects for survival and growth. The main elements of this analysis in brief are:

- as regards the provisioning of bad loans and capital adequacy, banks have generally shown significant progress. Five of the seven largest banks which were subject to in-depth diagnostic reviews in 1998/99, have now achieved reasonably satisfactory capital adequacy ratios as measured by the NBU’s ‘H4’ normative indicator. Data for the next tiers of banks by size show a similar picture. There are only 3-4 medium sized banks, in addition to the two large problem cases that pose serious problems in these two key dimensions of performance. At the beginning of 2000 two large banks accounted for over half of the system-wide

⁴⁰ An earlier limit on the allowed penetration of foreign banks based on the maximum share of total bank capital that such banks could attain - has been removed, and there are no legal or formal restrictions on further entry.

⁴¹ The foreign banks have been a positive influence in demonstrating the way forward in some technical areas such as the introduction of IAS accounting and improved MIS systems; and in helping to define possible new banking activities such as advice on debt restructuring (e.g. the ING involvement in the March 2000 restructuring of Eurobond debt). However, their limited branch activity and preference for wholesale and especially foreign trade transactions has limited the extent to which they can serve as role models or even take over the dominant market positions of Ukrainian banks in deposit mobilization, retail lending, and large and small value payments systems

⁴² This problem in turn contributes to the increasing presence of non-payments, barter agreements, and inter-company arrears.

provisioning shortfall of around Uah 3 billion (and this situation appears to have worsened since);

- bank profitability is increasingly under threat⁴³ and 2000 saw the sector as a whole drop into loss-making although this was driven by losses at just twelve banks (particularly the largest, which were being forced to push to make previously unrecognised provisions). The restructuring of short-term government securities into government debt with longer maturity after August 1998 also had a major negative impact on both profitability and bank liquidity⁴⁴;
- the environment since 1995 has been one of generally decreasing interest spreads. It has been increasingly difficult for banks to absorb the high costs to which they are subject by charging a high spread,⁴⁵
- banks generally have been slow to cut costs and raise efficiency to accommodate to this more demanding environment. The ratio of operating expenses to average assets in OECD countries, will usually lie in the range from 2-5%. The cost-cutting to achieve this level in Ukraine has been slow to occur.⁴⁶

Implications for the Larger Banks

5.4 The tendencies described above have been evaluated more precisely for the seven largest banks in Figure 7 overleaf, which shows possible combinations of (i) the cost to income-earning assets ratio (diagonal scale) and (ii) the ratio of income-earning assets to total assets (horizontal scale). The height of any point on the resulting (grey-shaded) surface represents (iii) the minimum required combination of margin/fees to still earn a reasonable (20%) return on capital and cover moderately high annual bad-debt provisions (5% of assets going bad each year).

5.5 The figure shows the position of large Ukrainian banks (the black-shaded areas – accounting for 60%+ of total banking sector assets) split into two groups based on relative efficiency. It also shows comparative data for the most efficient large banks in the Baltic and Visegrad economies. Data for two periods is shown. Figure 7a shows full-year 1999 data adjusted to a basis that would have applied if the capital recovery programmes for each bank had all been complete at the beginning of the year (whereas actual implementation was staggered at different rates for different banks through the year). Figure 7b shows a provisional analysis for 2001 based only on first quarter data.

⁴³ In the hyper-inflation years through 1995, banks were able to command large margins and achieve high profits on the basis of Forex speculation and other inflation-related activities. Even in the period 1996-98, banks found other sources of earnings in fee-generating income such as trading in government securities, privatization vouchers, etc. But after the Autumn crisis of 1998, many of these possibilities largely disappeared and now profitability overall is reducing further

⁴⁴ In addition there is a resourcing problem looming for some banks. Data from the HIID quarterly report for January 2000, shows that funds from budgetary sources amounted to Uah 15 billion at end-1999, 46% of total borrowed funds of the banking sector (although NBU data shows lower levels, possibly reflecting year-end window dressing). As these funds are withdrawn consequent upon the establishment of a central Treasury, the liquidity problems of some banks will be intensified. See also Table 4.5

⁴⁵ This has led an increasing number of banks to recognize the importance of diversification toward fee generating business lines. This is reflected in the aggregated income statement of the banking sector. Specifically by January 2000, fee income at Uah 1633 was almost equal to the banks' net interest income. Two years earlier it had been less than Uah 1 billion.

⁴⁶ Reference to aggregate data indicates that the sector had operating expenses of Uah 1578 million in 1998 and Uah 1863 million in 1999. Based on estimated average assets this means that the expenses:assets ratio was around 9% in 1998 and 8% in 1999.

Figure 7a: Drivers of Bank Margins – 1999 adjusted

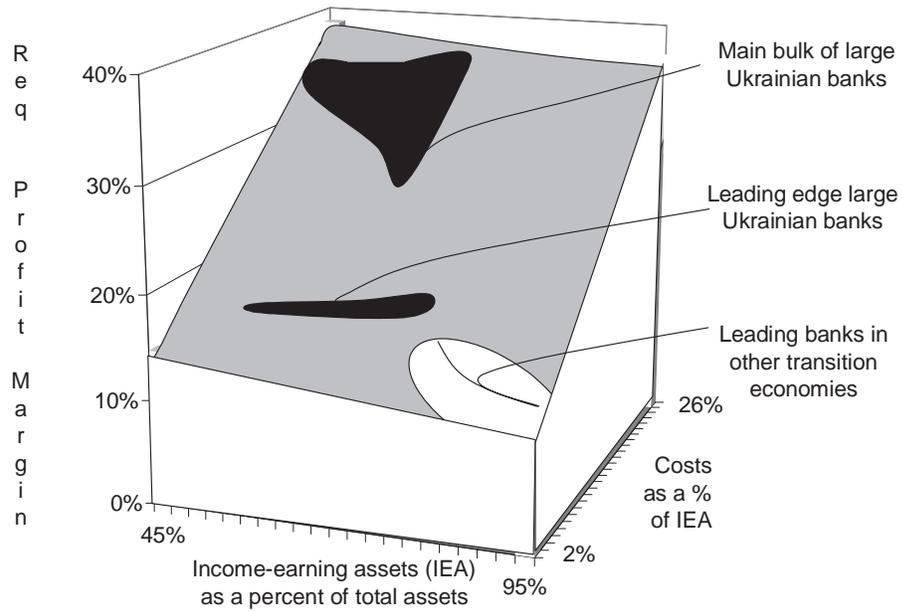
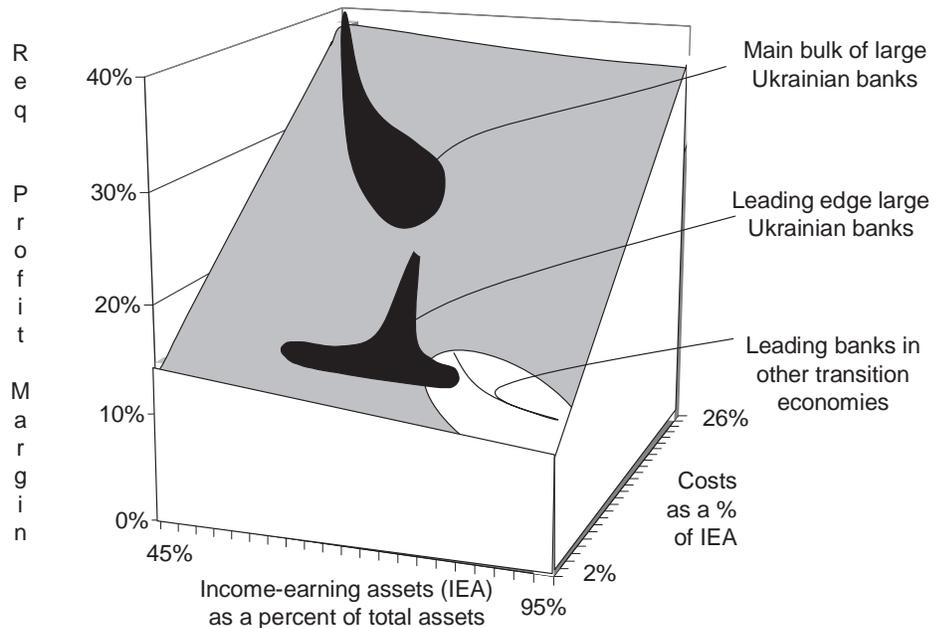


Figure 7b: Drivers of Bank Margins – 2001 1st Quarter



5.6 Figure 7 highlights the wider economic implications of the inefficiency of leading Ukrainian banks in a number of ways:

- even after completing the 1998~2000 capital recovery programs (see figure 7a), *non* income-earning assets remained high – very high in at least four of the banks. As a result the remaining income-earning assets had to yield a gross profit margin of 20~40% per year (above the cost of

funds) if these banks were to operate without continuous new crisis capital injections (even after sorting out under-provisioning/capitalisation);⁴⁷

- even these very high yields would have been insufficient to make the banks self-capitalising at the sort of growth rates discussed for banking sector in aggregate in Section 3;
- but the situation at the most efficient of the top-7 banks was already beginning to close the gap with the lower required yields (for self-sustaining growth) typical of more developed Baltic and Visegrad banking systems (i.e. the light shaded zone in both charts);
- these trends are reinforced by the provisional analysis for 2001 (first quarter only – see figure 7b) where the leading large Ukrainian banks, at least in terms of efficiency, now have costs running at about 4% of income-earning assets – absolutely on a par with leading-edge banks in other countries – and this competitive pressure also seems to be gradually forcing up the efficiency performance of other large Ukrainian banks;
- at the same time, there seems to be greater disparity between the least efficient of the large banks: the situation of the worse having deteriorated since 1999;
- this will, however, only continue to happen if cost and balance sheet advantages translate into larger market shares for more efficient banks and therefore larger balance sheets relative to their cost bases.

Where will the Banking Sector Go from Here?

- 5.7 This brief financial analysis paints a fairly bleak picture of the prospects for the sector with its present structure (dominated as it is by a few large and mainly high-cost banks) to sustain financial viability and achieve significant growth. However, this is not a conclusion that can be generalised necessarily to all banks. The in-depth bank-by-bank research conducted for this Report shows that there are already some banks in Ukraine which have the possibility to achieve both the required low levels of operating costs and the self-financing to sustain a sound rate of expansion. The paragraphs below provide a summary of this research and comment on the directions in which the sector will need to re-structure in order to realise the potential efficiency gains.
- 5.8 The starting point is a classification of banks based on important differences in bank performance which help to determine the likelihood of their future survival or failure.
- A The five state and former state owned banks (Bank Ukraina, Savings Bank, Ukrasotsbank, Prominvestbank, Ukreximbank). In spite of a great deal of foreign technical assistance and their recent rehabilitation programs, these banks are characterized still by weak institutional capacity; often close links with government; generally low levels of efficiency; and generally high costs. (the consequences

⁴⁷ The assumption is that shareholders will be willing to accede to a bank's growing capital requirement if it can make a good case that the capital concerned will earn 20% post-tax return on equity. It should be understood that the sort of balance sheet growth discussed at an aggregate level in earlier sections of this chapter will require new capital injections just to keep banks at the target 10% capital adequacy built into the rehabilitation programs.

are clear from Figures 7a and 7b).

- B Private banks, with assets over Uah 100 million. This group of about 30 banks includes a number of successful and well organized banks with good lobbying power and strong governmental ties but at the same time with strong management, sound internal information systems and efficient management systems generally. But there are others with features overlapping with banks in Group A. The stronger performers include banks such as Privatbank, First Ukrainian International Bank, Avalbank.
- C1 A small sub-set of the foreign-owned banks which are trying to foster business with strong local companies still considered as having good growth prospects (e.g. chemicals and metallurgy). This is tough business in the present environment and the foreign banks generally are not venturing into it.
- C2 The bulk of foreign owned banks that concentrate mainly on servicing the subsidiary companies of their multinational clientele, thereby limiting their own future growth potential. This sub-group has seen some decline in numbers in the recent past.
- D. Other private banks with assets between Uah 20 and Uah 100 million. These banks have many of the same attributes as the Group B banks but generally with much higher exposure to a limited set of clients and without the large financial and political muscle to help assure their long term positions.
- E. The rest of the banking sector, with assets under Uah 20 million. These banks too have a high dependence on a limited set of clients and thereby faced enhanced risks. Many of them are also seriously undercapitalized relative to the NBU's new requirements. This portion of the sector will be under the greatest pressure to consolidate with larger banks or disappear.⁴⁸

5.9 Table 7 overleaf summarizes some of the major prudential, efficiency, and profitability ratios based on NBU data for these different groups of banks as of year end 1999.⁴⁹

5.10 The main differences shown in Table 7 include:

- far weaker capital adequacy in the larger banks – groups A and B;
- extremely impaired portfolios especially in Groups A, B and E and to a lesser extent in groups D. Good performance in this regard in Group C reflecting the conservative lending patterns;
- low returns on equity and total assets in Groups A and E and reasonable performance in this regard in Groups B, and D;
- a high interest spread in all four groups of domestic banks relative to the foreign banks;

⁴⁸ Issues relating to the performance and efficiency of these different types of banks have been explored in part via in-depth work conducted with a limited sample of banks and partly via data collected by the NBU.

⁴⁹ It is only a small portion of banks that undertake external audits in accordance with IAS. Consequently, the figures may not reflect positions that could be revealed by audits undertaken according to IAS (International Accounting Standards).

- a very low ratio of post-tax earnings to staff numbers in both the two large bank groups (A and B) and in the group of smallest banks (E);
- high operating cost ratios in all groups of banks including the foreign ones.

5.11 Additionally, the earning assets of some of the Group B banks are already close to those of Group A banks even though (i) their employment levels are far lower and (ii) their numbers of branches/units are generally lower.

Table 7: Ukrainian Banks Ratios (at Jan. 1st 2000)

	A Five Largest	B Other Large	C Foreign (All)	D Medium	E Small
Capital to risk weighted assets and off-b/s items	4.55	16.00	39.61	31.04	33.00
Tier 1 capital to risk weighted assets and off-b/s items	1.60	11.43	34.28	22.96	26.52
Loan loss provisions as % total loans and contingent liabilities	13.97	20.32	7.39	12.83	12.43
Qualified loans (doubtful & bad) as a percent of total loans	45.01	21.72	3.18	9.43	19.31
10 biggest exposures/liabilities (on balance/contingent)	19	9	38	35	37
Liquid assets ÷ Total assets	26.79	35.03	40.11	35.69	28.63
Liquid assets ÷ Total liabilities	29.34	38.81	52.81	44.31	40.40
Net income ÷ Average equity	-9.22	15.76	9.96	19.97	5.40
Net income ÷ Average total assets	-0.37	2.20	3.35	5	1.52
Interest income ÷ Average total assets	21.90	20.39	13.19	18.68	18.29
Spread {(int. income ÷ av. assets) – (int. expense ÷ av. i-b* liab.)}	9.79	13.55	8.11	14.89	9.49
Margin {(int. income – int. expense) ÷ av. earning assets}	7.21	10.92	9.83	12.86	11.29
Non-interest income ÷ Non-interest expense	70.14	73.35	74.24	81.81	63.15
Non-interest income ÷ Average total assets	11.78	13.65	12.33	12.91	9.66
Net income after tax ÷ Total staff numbers	0.00	7	36	33	5
All operating expenses ÷ Average total assets	11.05	10.16	10.54	5.63	8.64
Average total assets	8937942	4490912	1361086	6700945	4141735
Total equity	1694469	643362	470728	1689051	1380007
Net income after tax	-33297	98915	45538	338645	62964
Increase in loan loss provisions (reserve) in current year	289001	336670	27945	228013	103254

Source: NBU

* i-b denotes interest bearing

5.12 What does this information and the bank-by-bank research suggest about the future prospects of the different groupings?

State-Owned and Former State Banks

5.13 The five banks in this category have a mountain to climb if they are to attain EU-type levels of operating efficiency and become capable of financing soundly the rates of asset growth which is part of our vision for the period to 2005 (see Section 4). Although there are some differences between the five banks (noted in parentheses) they suffer from the following problems:

- high operating costs associated with excessive branch structures and employment and other operating inefficiencies (exception

Ukreximbank);

- profitability affected negatively by various degrees of government-directed lending and so substantially impaired portfolios resulting in a reduced ratio of earning assets;
- ongoing governance problems associated both with badly-conceived government involvement in decision-taking and also with non-transparent interventions of key business groups, in some cases, as major shareholders;
- lagging performance in the up-grading of management systems and informational technologies to lower costs (again with important exceptions regarding certain banks and certain parts of the IT and other management technologies);
- the inability or unwillingness of the government to honour financial obligations to these banks in the form of payments on guarantees and capital contributions.

Foreign Banks

5.14 It is a reasonable expectation that the future of the sector will involve a rising share of business for foreign banks (Group C) paralleling what has already been observed in the Baltic countries. This is a reasonable expectation but one which is not unambiguously evidenced by what one currently observes on the ground. For the moment, asset growth in most foreign owned banks is limited by their prudent risk management responses to the exceptional difficulties of the Ukrainian business environment.⁵⁰ Raiffeisen bank is one of very few C1 category banks – those actively developing business in Ukraine’s traditional core industries. Having said this, both groupings of foreign banks are able to compete effectively with the local banks and especially in the field of foreign exchange lending because they do not have the costs of large branch networks.⁵¹ Overall foreign bank penetration is occurring and can be expected to accelerate once the numerous problems in the business environment start to be addressed.

Larger Local Private Banks

5.15 This group collectively – currently 31 banks – also contains some of the ingredients for strong future performance. These banks are less burdened by the legacies of over-sized branch networks and employment levels than are the state and former state banks. But their governance structures are seriously non transparent in many cases as are the nature of their inter-linkages with the political process and with key business groupings. The prospects for survival and future growth will arguably depend on (i) prompt introduction of the necessary internal improvements/ re-organisation measures to sustain the reduction

⁵⁰ For example, some of the foreign banks consciously avoid taking collateral even if they have no objection in principle in lending to Ukrainian companies. They assert that there are many interpretations to collateral law and the law courts are awash with malpractice.

⁵¹ So for example, they can offer funds at LIBOR + 9-10% i.e. considerably cheaper (by 6-10%p.a) than their local counterparts. However, trade-finance related products, that represent the most lucrative and low risk products to foreign owned banks in other emerging markets, do not have a significant weight in Ukraine as yet. One of the reasons could be the high country-risk of Ukraine. Western suppliers often request 100% prepayment from Ukrainian importers and are not willing to accept L/C-s not confirmed by reputable foreign banks. This is another environmental factor slowing down the penetration of foreign banks.

- of both costs and risks and (ii) appropriate skills in managing any ties *with the government and dominant shareholders* so as to mitigate operating risks without having to commit to major compromises in sound commercial practices. The last point is hopefully one which will not figure longer term. In the immediate short-term future, our survey results suggest that political contacts and influence remains as a key ingredient of success. It derives of course from the myriad of arbitrary influences on enterprise profitability described in Sections 2 and 3.
- 5.16 Judged against these criteria, several of the banks in Group B which were studied in detail would appear to have strong prospects. They all have established internal transfer price mechanisms and introduced management informational systems that rely on transfer prices. Given the limited inter-bank market and the effective disappearance of the T-Bill market, there is currently no real market price for money. The banks therefore apply a historical weighted average of the prices of their own resources as internal transfer prices. In one bank branches prepare two types of financial reports; one based on actual prices and another based on transfer prices.
- 5.17 As regards profit centres, most of the banks studied have chosen the traditional path of creating such centres along business lines such as credit, treasury, trade and finance, bills of exchange etc., rather than on the basis of different market segments. The more progressive banks have already started establishing profit centres along client segments, such as legal persons, physical persons or specific business lines such as credit cards. One bank in particular attracts praise from foreign-owned competitors for its cash management services for corporate clients (so-called sweep accounts via satellites to ensure that clients with numerous outlets can have their funds managed on a central account). Another has established profit centres according to traditional major functions such as lending, treasury, trade, finance, etc., and has also prepared calculations concerning the contributions of their biggest clients to the bottom line. A third focuses even more on clientele segments and consciously applies different sales approaches to their largest (VIP) customers than to medium-sized customers. They also measure internal profitability contributions using a sectoral breakdown and have purchased an integrated operational MIS system, 'MIDAS Capity' (well known in Western banks) and with the help of this system they are able to work on a real-time basis with their branch network.
- 5.18 However, even at the most progressive private banks, managers maintain the view that a successful bank in Ukraine cannot operate without having representative offices as well as branches. They refer to certain features embedded deeply in the cultural roots of Ukraine. Without appropriate governmental contacts, there are fewer chances for flourishing long term relationships. This is yet one more piece of evidence of the excessively high costs of conducting banking in Ukraine. The authorities need to be aware that this threatens good as well as bad banks.

Overall

- 5.19 The possibility cannot be ruled out that some of the state and former state banks could radically improve their internal management structures and reduce their cost bases in a way that would enhance their prospects of a long term presence in the sector. But as our schematic diagram above clearly shows, such an improvement will require monumental efforts to move away from the present cost structures and especially, in some cases, the

- very high costs of extended branch networks. The marginal adjustments made in the context of the 1998-2000 restructuring programmes have not gone nearly far enough in this regard especially in the Savings Bank and in Bank Ukraina. In the case of Bank Ukraina the failure of the bank and the authorities to face up to this reality is already manifest in serious crisis in the bank and questions about the bank's survival in its present form are now unavoidable. But even if crisis can be avoided, these banks offer little immediate possibility of significant soundly-based growth of assets in the medium term. The Savings Bank being most exposed to arbitrary political interference may be destined for a future as a payments agency of the government rather than as a broad-based bank.
- 5.20 Additionally a number of today's medium and smaller banks could grow either on the basis of large new capital injections from their shareholders or by merger, most likely with Group B banks. This seems likely to leave a rump of less than 20-25 Group D and E banks in 3-5 years time. These will compete for market share with a small number of substantially larger banks in Group B – those that can deal effectively with the twin challenges of operational efficiency and governance articulated above. Group C banks also seem likely to gain market share but only if the operating environment is improved fundamentally. We repeat again the strong conclusion from Sections 3 and 4 that a major consolidation of the existing banks is required if conditions are to be created in the sector for its more rapid development and growth. The more efficient banks as identified by the type of analysis outlined above must be allowed to see their market shares increase relative to the less efficient – average margins cannot come down and banking penetration generally cannot increase until this happens.

Main Policy Implications

- 5.21 Linking this analysis to the overall agenda for reform defined in Section 3, it is here important to stress the key role of the NBU. The NBU in future needs to be more pro-active in relation to the consolidation process suggested by our analysis here and in Section 4 above. Certainly it should end its tendency to erect defensive barriers to preserve the weaker banks. The closure and liquidation procedures for failing banks must be applied far more promptly than in the past. Additionally NBU supervision must become increasingly alert to the key role of bank costs and efficiencies in creating sustainable growing banks. It must also be more pro-active in supporting banks to achieve sound and transparent governance. Its own monetary management must be conducted in ways that gives greater emphasis to efficiency. The accounting information base now permits the NBU to be much more sensitive to this need. Enhancing its own skill base to manage these various elements of the consolidation process more effectively is a main priority for the next 2-3 years.
- 5.22 Finally, the pace and effectiveness of consolidation in the banking sector remains vitally dependent on the early creation of a better operating environment for all banks. Reforms to remove the more insidious of today's constraints to effective banking are a critical part of the agenda and are taken up once more in Section 7 of the Policy Recommendations from this Report.

Section 6: Non-Bank Financial Institutions

Introduction

- 6.1 Non-bank financial institutions (NBFIs) can in principle play a very important part in the economic development of an economy. They can do this first by providing an array of financial instruments far broader than that available from banks. This in turn can create an additional stimulus for the inter-mediation of savings, especially from households, and an extended menu of financing options for productive enterprises. Experience from many other countries also indicates that NBFIs have an extremely important role to play in mitigating some of the consequences of low-incomes among a large part of the population. Poor people generally cannot be expected to save much. But since there are large numbers of them, their collective saving can be extremely large and, if properly used, can provide the means to mitigate some of the worst consequences of poverty and provide a window of possible escape from it.
- 6.2 However, the critical question for this present report is whether these potential benefits can realistically be achieved within the time span of this reform agenda in Ukraine? Or, does there have to be a maturing process for the economy and the financial system before an NBFIs sector of any significant size and importance can be established? International experience offers us plenty of insights as regards this question. For the most part they would caution that the building of a large and effective NBFIs sector is a long and difficult task. Recent research has shown, for example, that countries with banking sectors as small as that in Ukraine are unlikely to have a securities market capitalisation of more than about 10% of GDP. The low availability of reliable securities which this implies must inevitably constrain the activities of NBFIs such as pension funds and life insurance companies, which rely on such securities. So low banking development puts a damper on the development of the financial sector as a whole including the NBFIs.
- 6.3 The situation in Ukraine today is one in which the NBFIs are indeed very small and in which their contribution to increased financial inter-mediation and poverty alleviation is almost negligible. This point is documented further below. But equally important is the extremely poor reputation for the safety of the public's money which has so far been associated with at least some major categories of NBFIs such as pension funds and trusts. Not only have many of these failed to help mitigate the problems of low-income households. In many cases their frauds and inefficiencies have served to reduce further the incomes and savings of some relatively poor families.
- 6.4 Hence the strong recommendation of this report is that the authorities should be appropriately modest in what they expect of the NBFIs during the next few years. Banking reform must come first and the new reform agenda for the next 5-7 years should *not* expect to build a large and sophisticated NBFIs sector – that would be unrealistic and premature in Ukraine's present circumstances. Instead that agenda should try to lay the foundations of law, regulation and other structures necessary to enforce much higher

fiduciary and efficiency standards on all categories of NBFIs. Once the improved fiduciary and efficiency standards are securely in place, together with a stronger banking sector (see Section 3-5) the expansion of the NBFIs sub-sector will come relatively easily.

Table 8: NBFIs Performance – an Overview⁵²

Indicators	Number of registered institutions	Number of operating enterprises as of respective date	Performance indicators (UAH million)	% GDP for respective period
Insurance companies – volume of insurance payments for 2000.	283*	180**	2136	1.22
Trusts – assets under management as at the end of 1999.	Not determined	186*	111	0.09
Credit unions – assets as at the end of 2000	601*	374*	36.8	0.02
Non-state pension funds (PPF) - assets as at the end of 2000	106*	21**	22.8	0.01
Investment funds and collective funds of investment co.– net assets end-2000.	252*	194*	372.5	0.21
Factoring companies	Not determined	Not determined	Not determined	Not determined
Leasing companies – leasing assets for 2000.	40**	22**	326.5	0.18

* According to official data
** According to expert assessment as no official statistics are available.

Scale of Activity

6.5 The data in Table 8 provides an overview of the scale of activity of some of the main categories of NBFIs. The data there confirm the very small scale of the present activities. The next table – Table 9 – shows comparative data for Ukraine and selected other countries⁵³. The data in the two tables together indicate how the low level of NBFIs development in Ukraine has held back the

Table 9: Assets Held by Institutional Investors in Transition Economies (% GDP – June 2000)

Country	Investment Funds	Pension Funds	Insurance Companies	Mutual Funds	Total
Czech Rep.	6	2	9	2	19
Estonia	3	0	3	2	8
Hungary	4	4	3	8	19
Kazakhstan	2	3	1	0	6
Latvia	2	0	1	3	6
Lithuania	4	0	0	2	6
Poland	6	2	5	2	15
Romania	8	0	0	0	8
Russia	1	1	1	1	4
Slovakia	4	0	4	2	10
Slovenia	2	0	4	3	9
Ukraine	0	0	1	0	1

⁵² Sources include the Ministry of Finance of Ukraine; the State Committee for Statistics; the National Bank of Ukraine; the National Association of Credit Unions of Ukraine (NACUU); ‘Ukrleasing’ Association; the Association of Non-state Pension Funds of Ukraine; the State Commission for Securities and Stock Market.

⁵³ The data and analysis in this section relies greatly on a recent Bank paper S.Claessens, S. Djankov, D.Klingbiel, Capital Markets in Transition Economies, which was presented at the Prague Annual Meetings of the Bank and Fund, September 2000.

Table 9 continued

Country	Investment Funds	Pension Funds	Insurance Companies	Mutual Funds	Total
Germany	22.7	13.0	31.9	4.6	72.2
Mexico	n.a.	2.7	1.7	3.6	8.0
Portugal	21.2	11.2	9.6	n.a.	45.6
South Korea	19.5	1.8	15.9	n.a.	37.2
Turkey	0.5	0.8	0.6	1.9	3.8
United Kingdom	29.3	101.0	88.9	30.4	249.6
United States	55.2	89.9	43.1	73.6	261.8

Source: Calculations for paper by S. Claessens and others based on OECD (1999), William M. Mercer (2000), and World Bank data.

capital markets and vice-versa. Capital market activity, for example, depends on strong demand from key institutional investors such as pension and insurance funds and these funds in turn need an attractive menu of stock market instruments for the effective investment of their mobilized funds.⁵⁴ The failure of the Ukrainian capital markets to provide this is indicated in the following selected comparisons:

- there are only 120 issuers in Ukraine, whose equity securities are listed on the stock exchange. This compares with about 220 in Russia, more than 800 in both Bulgaria and Slovakia, and with 2000 and 3000 respectively on the main London and New York stock exchanges;
- stock market capitalization in Ukraine is about 4% of GDP. This compares with 18-24% in countries such as Russia, Poland and the Czech Republic, with more than 30% in Estonia and Hungary; and with more than 140% in the most advanced markets such as the UK and the USA;
- market turnover (trading volumes relative to capitalization) is only around 15% in Ukraine as compared to 45 % in Russia; well over 50% in Poland, the Czech Republic and Hungary; and over 100% in the more mature markets as well as in several emerging markets such as Portugal, Turkey and South Korea;
- the concentration of that turnover on the top 5% of listed firms is extremely high in Ukraine. Specifically, 5 or 6 of the 120 listed firms account for around 95% of all market turnover. A very small number of players dominate.

6.6 It is not surprising in the light of these numbers that the magnitudes of the investments of Ukraine's NBFIs in stock market instruments is also extremely small. Table 9 shows that the amounts of such investments in the case of Ukraine sum to about 1% of GDP. This compares with amounts totaling almost 20% of GDP in the more advanced of the European transition economies and amounts in excess of 40% of GDP even for some emerging economies.

⁵⁴ This present report does not discuss the situation in the Capital/Security Markets in any detail. This is mainly because a US-AID team has recently completed a major review of the issues and there is little point in repeating that analysis with which we are in broad agreement. See C.M Seeger, H.C Patton, Financial Markets Development in Ukraine, Financial Markets International, January 2000.

Situation and Performance in the Main NBFI categories

6.7 There is a unanimous view amongst those who have studied Ukraine's situation that NBFI development remains unsatisfactory, sluggish and largely chaotic. Most refer to a broad range of inter-connected problems preventing proper development of these institutions. The most important include the following:

- a) an unfavourable macroeconomic climate: economic recession, currency and price instability etc.(see also Section 2 above);
- b) the absence of any purposeful long-term Government policy designed to build an efficient financial sector including efficient and reliable NBFIs;
- c) the poor quality of the protection afforded to participants in the main markets. This is associated with the absence of a coherent framework of legislation regulating NBFI financial operations, and the parallel absence of proper supervision;
- d) the deep distrust of the public generally in any financial institutions in the wake of the so called 'trust saga' of 1994-1995, and similar scandals involving pension funds
- e) the primitive nature of the professional environment associated with the unsatisfactory qualifications of many specialized personnel; the absence of good training arrangement to remedy this and the lack of qualification requirement to be met by these professionals.

6.8 These general factors hold back the growth of all categories of NBFIs in spite of the enormous *prospective* demand for their services. In addition each category of NBFIs studied for the purposes of this Report face a variety of problems specific to their own situation. These more specific problems are discussed in detail in Annex 6 to this Report. Here we focus mainly on the issues concerning the legal, regulatory and supervisory structure for the sector. It is the urgent strengthening of this which must figure prominently in the overall agenda for the reform of the financial sector.

The Regulation and Supervision of NBFIs

6.9 The absence of a coherent body of legislation and sound principles to regulate the NBFIs sector is the most serious of the numerous general problems in the sector. All the categories of NBFIs organisation discussed above stand in a fiduciary relationship relative to their clients. However, the evidence from the numerous financial scandals of the past few years demonstrates conclusively that respect for those fiduciary obligations is poorly developed and that the regulatory arrangements to enforce them are extraordinarily inadequate at the present time. Hence it is a matter of high priority to address this problem.

6.10 In relation to legislation, the work undertaken for this Report has revealed that the term 'non-bank financial institution' appears in no less than 80 laws, decrees and other normative acts. And yet in none of these can be found an *authoritative* definition of the term. Hence there is great confusion in the legislation about the nature of non-banks and

how they differ in terms of their roles, responsibilities etc from banks. There is also a remarkable proliferation of incomplete legislation – full of good intentions but with few positive effects of relevance to investors. This issue was examined in more detail and in particular an attempt was made to address this problem in the aborted draft Law on Financial Operations. Here we merely note that an integrated approach is now needed which tidies up the legal confusion and provides a workable framework for the detailed reform at the level of individual categories of NBFIs. At the very least the vacuum created by the failure to finalize and approve a number of pieces of key legislation of relevance, for example, to private pension funds and to credit unions needs to be filled so as to establish the core principles that in future will govern the work of these and all other NBFIs. Examples of high level issues of general applicability include accounting; taxation; separation of client and sponsors assets; reporting; responsibilities of sponsors; and sanctions for breach of the fiduciary duty.

- 6.11 The following few paragraphs briefly summarize what seems to be a wholly unsatisfactory situation in most groups of NBFIs. Annex 5 provides more detail.

Pension Funds

- 6.12 The first official version of the draft Law “On Non-state Pension Funds” was developed by the Cabinet of Ministers and forwarded to the Verkhovna Rada of Ukraine on September 17, 1997, and then, for the second time, on May 21, 1998. However, on September 10, 1999, the Verkhovna Rada rejected the draft Law and decided to reconsider it in first reading only after the adoption of laws on financial operations, on trustee management of property, and on obligatory state pensions. The consequence is that the private pension funds are currently operating on the basis of Article 42 of the Constitution of Ukraine, under which ‘every individual has the right to engage in entrepreneurial activities that are not expressly forbidden by the law.’ A number of other laws relate to one or more aspects of PPF activity including their tax obligations, but there is no consistent body of legislation and almost no supervision. In other countries this would be regarded as a scandalous situation and no PPF would be authorized to accept any money from the public until it was resolved satisfactorily. However, it can be noted also that the relevant committee of the Verkhovna Rada has practically completed the preparation of an improved draft Law “On Non-State Pension Funds,” which is scheduled for first reading in the near future. The likely outcome of this is difficult to assess.

Insurance Companies

- 6.13 The situation is slightly better in this category. Insurance companies are regulated by the Law of Ukraine *On Insurance* of March 1996 and by a set of subordinate normative acts passed by the central executive bodies. In May 1999, the Rada adopted in first reading the draft amendments to the 1996 Law. The main amendment being that the minimal amount of an insurance company statute fund should be increased from Euro 100,000 to 500,000⁵⁵. Introduction of this provision would have prompted a significant reduction of the number of insurers and resulted in a higher concentration of capital and transactions in the hands of several dozen major companies. Most experts agree that that would have raised the stability and efficiency of Ukraine’s insurance market. But the new amendment has not yet been approved. It should be noted also that the process of concentration of

⁵⁵ At the moment such a requirement exists only in respect of insurance companies with foreign capital

capital in the insurance sector could have actually started much earlier, if the insurance lobby in the form of the League of Insurance Organizations of Ukraine (LIOU) had not managed to obtain, in 1999, the annulment of the Rada Resolution *On Insurance* adopted in 1996, requiring the review of insurance company statutory funds as of March 31 each year. Had this Resolution not been cancelled, Ukraine's insurers in 1999 would have had to replenish their statutory funds by UAH 29 million, because of the devaluation of the national currency, and this would have resulted in the winding up of some 100 insurance companies before the above-mentioned amendments to the Law "On Insurance" became effective after being adopted in the second reading.

- 6.14 The legislation has also so far failed to address another important issue – that of the presence of foreign insurance companies in Ukraine's market. Under the present Law, a foreign investor stake in the statutory fund of an insurance company registered in Ukraine cannot exceed 49 percent. It is generally recognized that this legislative constraint is a serious barrier to the flow of foreign investment capital to Ukraine's insurance industry: in the final analysis, it helps to preserve the lack of the industry's competitiveness.
- 6.15 Pursuant to the Cabinet of Ministers of Ukraine Decree "On Insurance" of May 10, 1993, and the Law of 1996, which replaced that Decree, the functions of state supervision and licensing of insurance companies activity were assigned to a specialised body – a Committee for Supervising the Insurance Activities. However, in the course of administrative reform, this body was liquidated by the Decree of the President of Ukraine in December 1999, and its functions were transferred to one of the divisions of the Ministry of Finance of Ukraine. It is premature to judge whether this change has improved or worsened the quality of overall supervision – one year is a very short term for the MoF to set up appropriate new arrangements. However, the present state of affairs should probably be regarded as no more than a temporary arrangement pending the establishment of an independent integrated supervisory body for NBFIs which is advocated below.

Credit Unions

- 6.16 The situation here is also extremely messy and unsatisfactory. Legislation on credit unions is represented by two normative acts, namely the Interim Regulations on Credit Unions in Ukraine, enacted by the Decree of the President of Ukraine in September 1993, and the Model Statute of a Credit Union, which was harmonized with the Regulation of the NBU Board in February 1994. In June 1999, the President of Ukraine signed Decree 701/99, enacting the new Regulations on Credit Unions. However, the draft law that was submitted for consideration by the Rada in connection with the signing of this Decree, was not adopted. Instead the Rada adopted in the first reading – another draft Law "On Credit Unions" that was presented by the Cabinet of Ministers. However, both drafts were practically identical as to their content since they were simultaneously and independently promoted by the industry association, NACUU. On the whole, this draft Law makes it possible to address the main problems that prevent the further development of credit unions in Ukraine. In particular, the draft Law provides for regulation and supervision of credit unions to be carried out by a state executive body that is specially authorized by the Cabinet of Ministers of Ukraine. Their small size and other arguments suggest that it is *not* justified to establish a separate specialized body for this purpose, and that the integrated agency already referred to will provide a better arrangement.

Leasing Companies

6.17 Leasing operations are regulated for the moment by the Law *On Leasing*, adopted in December 1997. These operations were initially conducted in compliance with relevant provisions of the Civil Code of Ukraine on property rent (leasing); the Law *On State and Communal Property Rent*; as well as provisions on the taxation of leasing operations contained in the Laws of Ukraine *On Corporate Income Tax* and *On the Value-added Tax*. The 1997 leasing law is seriously deficient having many unfounded limitations, ambiguous definitions, internal contradictions, and obvious conflicts with other legislative acts. Specialists have referred to at least 20 serious problems found in the current Law that collectively impede the faster growth of the activity. The Verkhovna Rada Committee for Economic Policy with the participation of Ukrleasing Association specialists and the IFC has elaborated a new draft law to remedy this situation. After several unsuccessful attempts, this was eventually adopted in the first reading in October 2000, and in April 2001, in second reading. However, in addition to the Law *On Leasing*, there is a need for changes in the tax legislation concerning leasing. The existing tax arrangements result in not only a lessor's remuneration (margin), but also a lessee's own capital being subject to income taxation. Arrangements for levying value-added tax on financial leasing operations are also inadequate. In view of these factors (deficiencies in the Laws *On Leasing*, *On Corporate Income Tax*, and *On Value-added Tax*), the overwhelming majority of players in the leasing industry currently use operations which, are substantively similar to financial leasing, such as installment sales, rent and others. In short, for the moment the legal including the tax arrangements are unsatisfactory as indeed are the arrangements for supervising leasing companies and especially those promoted by banks. It should be noted also that in the nearest future the Verkhovna Rada will consider the draft Civil Code and the draft Tax Code. These two documents and, in particular, legal arrangements for leasing operations contained in them, will be of great importance for the development of Ukraine's leasing industry. The role of the state-owned leasing companies should also be put under critical review – their poor record to date suggests that their role should be diminished in future.

Investment Companies, Funds and Trusts

- 6.18 Trust companies operate in Ukraine under a Cabinet of Ministers Decree of March 1993. The scandals of 1994/95 resulted in numerous Rada and CoM resolutions to try to mitigate obvious problems and close down the main offending trusts. But the draft Law *On Trustee Management of Property* that was prepared and adopted in first reading in July 1997 has never been finally approved in future. The State Property Fund, the Ministry of Finance, and the State Tax Administration are the supposed regulators of the trusts but in reality little or no supervision is carried out by them. Investment funds and collective funds of investment companies were regulated until recently by the Regulations on Investment Funds and Investment Companies, enacted by the February 1994 Decree of the President. The Ministry of Finance, local finance agencies and the State Commission for Securities and Stock Market monitored fund activities. Activities relating to privatization certificates circulation were dealt with by State Property Fund.
- 6.19 On March 15, 2001, the Verkhovna Rada adopted the Law *On Collective Investment Institutions (Unit and Corporate Investment Funds)*, which provides for transformation of operating investment funds into fully-fledged collective investment institutions. This reflects the need to transform the existing collective investment institutions into fully-

fledged institutional investors and to end their role as mere tools of the mass privatization program. The State Commission for Securities and Stock Market is designated to exercise the regulation, licensing and supervision of Joint Investment Institutions activities. Additionally a number of normative acts of the past twelve months have sought to address the problem of the closure by year-end 2000 of most of the closed-end funds. Possible solutions would be their conversion to open-end funds, or redemption of own investment certificates, with subsequent liquidation.

Overall

- 6.20 As this brief review indicates, much time and effort has been expended in the past five years in trying to legislate on a piecemeal basis. This approach has both failed to produce appropriate legislation in a timely fashion and has also meant that the fine details of what needs to be done have often taken precedence over big principles. The result has been extremely disappointing with piece-meal rather than concerted regulation and supervision being the norm.
- 6.21 It is now time to streamline this approach by first establishing a simple Framework Law where a small number of key principles which should govern the work of NBFIs could be rapidly codified. This should be accompanied by the early establishment of a single *NBFI Authority* to regulate and monitor the work of ALL the NBFIs. The case for this is first that some NBFIs currently have no supervision of their activities. Something needs to be put in place, and quickly to avert yet more scandals. Second, none of Ukraine's NBFIs are currently large enough to justify separated and dedicated supervision – a single properly structured organization can deal with all of them (see Box 1 above). Third, there is a need to move rapidly to build the appropriate expertise – it is sadly lacking at the present time – and this is more easily done within a single larger institution than in a collection of smaller ones. Where the new Authority should be located and with what degree of independence is a matter which needs to be resolved. But arguments about location should not be allowed to obscure the urgent need to achieve some unified authority over the non-banks in parallel with the existing work of the SEC and the NBU for banks. Other arguments on this matter – both pro and con – as based on experience from other countries is contained in Box 1.

Box 1 – The Consolidation of Supervisory Structure

The main arguments for and against consolidating the present structure are:

For:

- For small financial systems like Ukraine, a unified approach permits substantial *economies of scale* and enables the *pooling of regulatory expertise*.
- In small financial markets with a high degree of *integration* especially if combined with any substantial degree of industry *concentration*, integrated financial regulation can improve the *effectiveness* of regulation and can reduce the scope for *regulatory arbitrage*.
- A unified approach permits financial services business to be conducted on the basis of a *single authorization*.
- A consolidation now rather than waiting for several years will *limit transition costs* that tend to grow with time.
- There will be much greater *flexibility in staff deployment* within one agency and more scope for staff *career moves* and professional development.

Against:

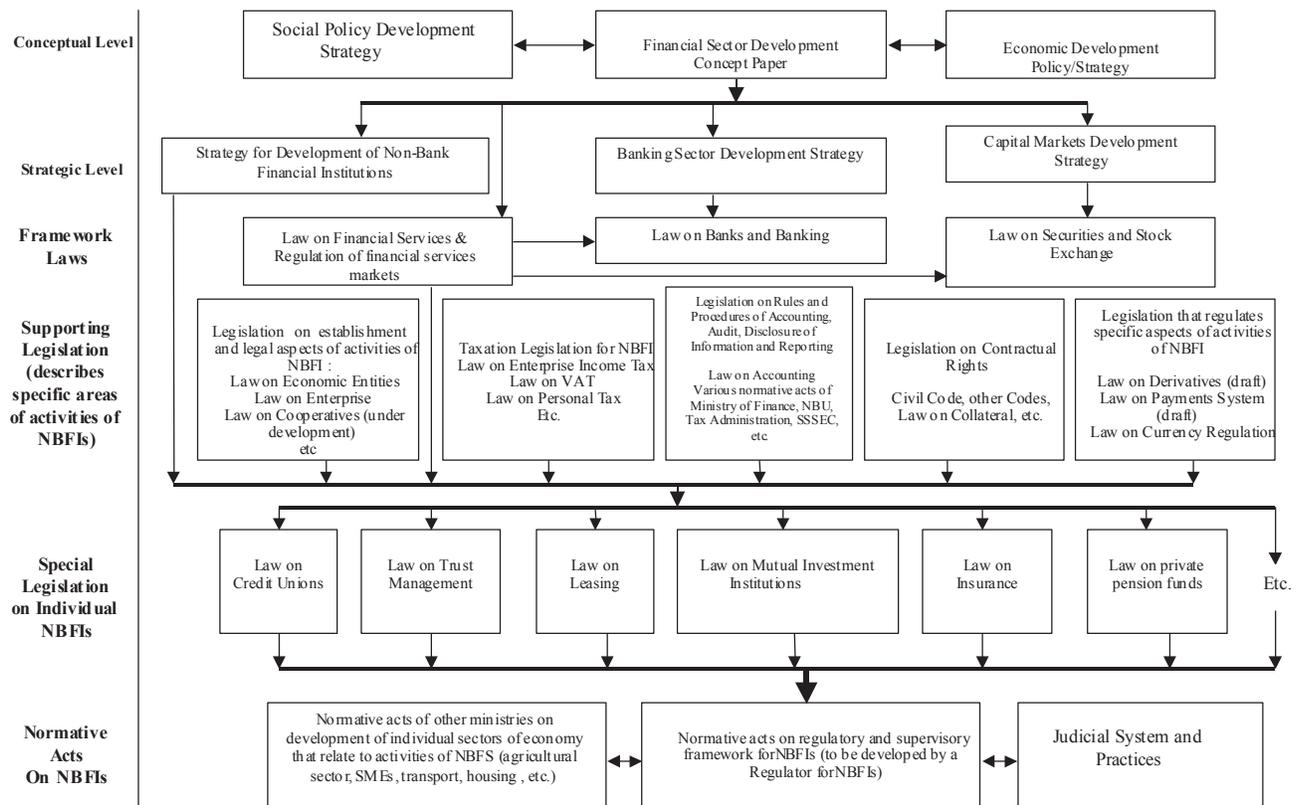
- An integrated approach appears to offer limited opportunities for *economies of scope* as opposed to

economies of scale.

- Problems can result from the existence of different *cultures of regulation* within a single body, in particular in case of securities regulation versus banking supervision.
- There may also be *diseconomies of size* and the de facto monopoly position may result in *less responsiveness* to industry concerns leading to excessive regulatory burden.
- The *objectives* of an integrated regulatory agency may be imprecise or hard to define, making it difficult to *hold management to account*.

6.22 A possible overall structure for financial sector regulation and supervision which locates the position and main roles of the new NBFIs laws and the new proposed NBFIs Authority is shown in Figure 8.

Figure 8: Basic legal Framework for activities of Non-Bank Financial Institutions in



Ukraine

Conclusions and Policy Agenda

6.23 Despite the huge potential demand for the products and services of the various categories of NBFIs considered in this Chapter, the present state of development of these institutions remains far from satisfactory. Thus the potential which the economy could obtain from the large volumes of financing that institutions of these types could provide is being lost.

Also being lost are the efficiency gains to which some at least of the institutions might contribute – gains from better governance of the enterprises which pension and investment funds for example might finance; from better and more complete insurance of risk; from enhanced credit to smaller businesses (SMEs) from credit unions; and from increased investments also in SMEs funded via an improved leasing system. The list of possible benefits is a lengthy one. For the moment at least, Ukraine's non-bank financial sector is at the infant stage; it is significantly inferior in its size and range of products to the corresponding sectors in many other transition economies (see Tables 8 and 9 above); and is also for the present, significantly inferior to the banking system from the standpoint of its importance, transparency, systemic organization, and legislative support.

- 6.24 The component-by-component analysis provided in Annex 5 suggests that in two areas namely *private pension funds* and *investment companies/funds*, there is already and should continue to be a decline in the number of active institutions. In these two areas it may be better to re-start the activity – especially private pensions – with a different approach and institutions more alert to their fiduciary responsibilities rather than try to resurrect anything from the extremely weak arrangements which exist today. This is a long-term program from which significant results are unlikely in the medium term of 3-5 years. In the three other areas, *insurance*, *credit-unions* and *leasing*, the performance and the existing institutions are rather better placed to make a serious contribution to domestic saving mobilization and investment. Leasing fills an important gap in relation to the financing of SMEs and could grow rapidly in response to the de-regulation program that has been proposed in other World Bank work. Credit unions play an important role at the small-saver/investor end of the market and could potentially fill a serious gap in Ukraine's present arrangements for ordinary families. But the legislative, supervisory and taxation arrangements for these components are in terrible condition and need a great deal of urgent attention if the potential is to be realized any time soon.
- 6.25 This is a strong and largely negative message. But it should not be interpreted as a message that the sector is condemned to remaining unimportant. On the contrary, because the country cannot allow this to happen, more thought and priority needs to be given to strengthening and, in some cases, rebuilding the sector's foundations. That re-think should put the interests of the providers of funds (mainly the small saver) at centre stage and emphasize above all else the need for a system of regulation that will safeguard those interests. The authorities are urged to take a longer term view of this situation.
- 6.26 If the basics – especially improved performance of the banking sector can be achieved then a number of reforms specific to the NBFIs would consolidate on that progress. The following specific measures are proposed to improve the existing state of affairs:
- (i) elaborate and then adopt an *integrated* long-term Strategy for Ukraine's Financial Sector Development aimed at creating favourable conditions for the development of the non-bank financial sector as a whole, and individual types of NBFI, in particular;
 - (ii) to this end, establish an *integrated* legislative framework for all NBFI activities. This needs to be a two-tier legislative framework covering (a) the framework and (b) special legislation. A new Law 'On Financial services' should be drafted and adopted as the main over-arching framework. This new Law in turn should:
 - provide a clear definition of what is encompassed in the term Non-Bank Financial Institution and provide a definitive list of such

institutions;

- define general principles for performing financial operations by all NBFIs;
 - define a mechanism and minimum performance standards for state supervision over and regulation of all NBF activities;
 - incorporate relevant provisions from other laws (e.g. payments system; money laundering; credit cooperatives; derivative securities, etc);
- (iii) re-examine special legislation on individual types of NBF in line with both the framework law and with the priorities of the overall NBF Strategy. This re-examination is likely to lead to the adoption of amendments to the existing normative acts related to the existing types of NBF, as well as legislative support for the possible creation and functioning of new NBF types;
- (iv) rationalize and integrate the operations of the various bodies, which currently have some responsibilities for supervising NBFs of different types. Set up, in the nearest future, a new and separate Authority that would supervise the activities of all the NBFs, including joint investment institutions and insurance companies. In this case, the State Commission for Securities and Stock Market would continue to perform all its inherent stock market regulation functions (new issues, registration of securities etc.), while the new Authority would deal with the regulation of the NBFs as coherent corporate or collective organizations. The new Authority would be able to ensure the enforcement of an integral holistic state regulation policy and supervision. This is extremely important because of the strong interrelationship and integration of the various types of NBF in practice⁵⁶ and underlies the graphic presentation of what the overall structure might look like (and how it would fit in with the existing arrangements for the banks and capital market institutions) as already presented in Figure 8.

⁵⁶ The main objectives of this agency would include, inter alia, the creation of across-the-board secondary legislation under the general authority of the framework law; operational supervision of all registered NBFs; the adoption of measures aimed at insuring the financial stability of all NBFs and the protection of savers' interests; continuous monitoring of sector status and submission of all new legislative initiatives; setting qualification requirements to be met by the NBF personnel; and creating a system for improved personnel training.

Section 7: An Integrated Strategy and Program for Reform

An Integrated Approach

- 7.1 Many of the specific recommendations for the reform of the sector are contained in the earlier Sections of this Report. This present Section re-iterates the case for an integrated approach. The present serious malfunction in the sector cannot be addressed through piecemeal measures focused narrowly on the institutions of banking. Nor is it realistic to pass the burden of designing and managing reform to a single part of government. In the past the largest burden for this has fallen on the NBU. However, that institution alone does not control many or even most of the policies that can influence the future of the financial sector. The government as a whole, national and sub-national, as well as the Presidential administration and deputies in the Rada have to accept a collective responsibility to put things right. So the central recommendation is for *an integrated and holistic strategy* which recognises the numerous inter-connected causes of the problems that the Report has identified. That strategy must enjoy the support and commitment of the highest political authorities in the country and must be promoted also at the regional levels of government – many of the problems start there.
- 7.2 As Section 4 makes clear, the economy is foregoing a great deal of potential credit to the productive sectors by its failure to establish a proper environment and policies for this sector. But the solutions do not start with the topic of credit – instead they must start with the innumerable factors that discourage savers from using banks and NBFIs, and from the reasons why existing banks and NBFIs do such a poor job in utilizing effectively those small volumes of savings that they are allowed to intermediate. This being the case, the recommendations of this report, and the potential components of the required strategy, sub-divide into five main components. This is a non-divisible list, *not* a menu that can be ‘mixed and matched’: all five elements need attention.
- 7.3 The first two of these emphasise improvements in the environment within which banks and NBFIs operate: today that environment is extraordinarily unfriendly. The proposed reforms are:
- (i) Further actions to help create a sounder client base for banks and NBFIs. This encompasses policy and institutional reforms to remove much of the implicit protection from failing enterprises and to allow more efficient enterprises to enjoy a significant profit relative to the others. Items (ii) to (v) below are unlikely to be effective without this first step;
 - (ii) policy and institutional reforms to remove as many as possible of the numerous other barriers to effective banking. This component is needed to lower the externally imposed costs on banks – costs which help to lower the quantities and raise the cost of those financial services which are provided (see Figures 3, 4 in Section 3 above and Table 2 which details the main reform components). The set of narrower actions in (iii) and (iv) are unlikely to yield significant gain without this step;

Next the report recommends further actions that recognise the critical medium-term priority to get the banking sector working more effectively. Specifically, it is necessary to implement,

- (iii) further regulatory improvements directed specifically at the performance of commercial banks. This component is needed to accelerate the elimination of those practices inimical to the more rapid development of banks and their greater acceptance by the public. The practices in question would relate to both governance and to inadequate operating practices. The NBU would also be charged with the task of achieving an accelerated program of consolidation of the sector so as to concentrate a rising share of banking business on the more efficient banks.

Finally, but of somewhat lesser priority, it is important to produce,

- (iv) a comprehensive reform agenda to deal with the wholly unacceptable performance and extremely weak regulatory arrangements for *non-bank financial institutions*; and
- (v) a clearer policy about the pre-requisites for establishing *any new financial institutions* which are to have a significant ownership stake from the Ukrainian state. Given the poor record of the past, these pre-requisites should be extremely demanding.

7.4 It is noted that these issues and the associated strategy for the sector get scarcely a mention in the new Government Program for the economy that was issued shortly after the November 1999 Presidential Election. But they have been reflected subsequently in two official documents namely the NBU Concept Paper issued in revised form in April 2001 and the Presidential Decree ‘On Strengthening the Banking System of Ukraine’ issued in July 2000. Both these documents and the proposals within them contribute to a part of the agenda of five items listed above (the NBU document focusing mainly on (iii) above, and the Decree having some proposals in most of the five areas). But neither of them promotes the case for the integrated approach which this Report advocates. The remaining paragraphs of this describe the main components of the work needed under each of the five heads.

Component 1: A Sounder Client Base for Banks

7.5 There are three sub-components here.

- A more complete elimination of the non-payment phenomenon. As was emphasised above, and in the Technical Report (Chapter 3) non-payment is a cancer that must be removed as part of an integrated strategy for financial sector development. A good start was made on, for example, energy non-payments in 1999-2000 but the problem as a whole remains large (see Annex 2). Its removal is part of the process of eliminating the arbitrary and distorting elements of enterprise profitability which the present system sustains;
- a second set of actions motivated by the same consideration is the elimination of arbitrary tax privileges. These also confuse the informational signals to banks and NBFIs about how credit should be allocated. Again the reforms begun with the budget for 2000 have gone only part way to deal with this (Annex 2).
- the third is the systematic reduction of the regulatory burden especially on small and medium-sized enterprises. This has not been the subject of this present Report but the steps needed have been articulated in other

Bank studies. An important complementary step – again not analysed in this report – is the raft of measures to increase Ukraine’s worryingly small volumes of foreign direct investment.

- 7.6 There is no magic formula for producing a large credit-worthy population of productive enterprises but all three of these steps are needed to move in this direction. Ukraine cannot achieve a modern and growing financial system of any significance until these steps are taken. What is required is a commitment to gradually change the culture and expectations regarding the granting and receiving of hidden subsidies. Standards for reasonably prompt payment of all obligations using recognised (not surrogate) money must be established. Specifically, it is recommended that the strategy should begin with a concerted attack on tax privileges/exemptions with the target being their virtual elimination within a very short span of time. This has to be accompanied by actions to wholly phase out tax payments using barter and offset mechanisms. The government should match these actions on the tax front (and so help to make them more palatable) by an equally principled commitment to make all its own payments by monetary means and eschew the use of barter and related devices. These actions which are closest to government control need to be accompanied by the campaign to *cap* the levels of non-payment (the stock of arrears) in a targeted group of mainly larger enterprises. Above all this would help to resolve the problem of arrears due to power companies and so enhance their own compliance with their own tax obligations. These various actions also need to be supported by actions to mitigate the main negative side-effects of the new payments discipline. This is to dilute some of the political case against that discipline. The correction of the non-payments problem involves the unavoidable but painful reality of accelerated closure of significant numbers of loss-making enterprises. But soundly based banks and NBFIs cannot be expected to work effectively until these actions are taken.

Component 2: Lowering Externally Imposed Costs on Banks

- 7.7 Actions in this second area of reform should be politically more straightforward. The agenda has already been presented in some detail in Table 2 in Section 3 above. That table identifies at least eight ways in which the government itself contributes to the exceptionally high costs of banking in Ukraine. These include the consequences of the government’s unreliability regarding its own debt management; its complicity in tolerating high levels of barter and non-payment; its out-dated system of taxing banks at the branch rather than the consolidated level; its excessive tolerance of failed and failing banks and its maintenance of a complex and arbitrary system of state subsidies. It also incorporates a number of ways in which the NBU itself could strengthen its performance to help lower costs in banks. These include greater efforts to re-establish functioning money including inter-bank markets; the establishment of supportive institutional arrangements such as improved pledge registries to help banks avoid poor credit risk; a program to gradually reduce the burden of the high reserve requirement; and a series of actions to force through a more rapid consolidation of the banking system in order to increase the market share of those amongst banks which can operate at the lowest costs. Finally, it identifies remaining gaps and weaknesses in both the legal system and other parts of the institutional infrastructure which impact on bank costs. The responsibility for remedial action in these areas is broadly diffused across a range of government agencies including the Ministry of Justice, the NBU, and the Ministry of the Economy.

Component 3: Regulatory Improvements for Commercial

Banks

7.8 In this third area considerable progress is already evident at least in relation to commercial banks. In particular, the NBU has made significant progress since 1997 in the further development and strengthening of its supervisory function. Further work is now needed to eliminate those practices inimical to the more rapid development of banks and above all to speed the consolidation of the sector. This is an area dealt with in detail by the Basel Core Principles Assessment undertaken by the IMF-MAE in January 2000. The recommendations presented there should form the basis of the strategy in this component area and do not need to be repeated in detail in this present report.⁵⁷ The recent approval of the new Law on Banks and Banking Activity should make this part of the work significantly easier. The further actions should be motivated by the need to produce in the nearest future a robust and reliable banking sector and one that can also achieve the sustainable growth anticipated in Section 4. A score card on the elements where progress in this regard is good and others where it is unsatisfactory is presented in Table 11. The robustness indicators shown there are those proposed by the Bank for International Settlements (BIS). The marks shown in the 'Score' column indicate the amount of further progress still needed to increase the resilience of the banking system to unanticipated shocks and to improve its efficiency.

⁵⁷ The assessment found that Ukraine is in full compliance with 3 of the 25 Core Principles and largely compliant with 12 others. It is materially non-compliant with five principles and non-compliant with five others

Table 10. Robust Banking System Indicators

Category	Score	Indicator
Market Structure	FS	- Open to qualified new entrants, including from abroad
	U	- Share of foreign participants in total assets
	PS	- Financial sector concentration ratios
	HU	- Liquid inter-bank money and capital markets
	PS	- Regulations permit full range of financial instruments
	PS	- Sound/effective payment and settlement systems
	FS	- Share of banking systems assets held by public sector fin. institutions
	PS	- Effectively enforceable exit
Supervisory/Regulatory Authority	PS	- Independent from political interference
		- Power to force disclosure, impose penalties, impose corrective issues
	FS	- in principle
	FS	- in practice
	PS	- Adequate off-and-on-site supervision resources
	PS	- Conducts supervision on a consolidated basis
	PS	- Verification of information on risk management and internal control systems and on asset quality by regular examinations or external audits
		- Adherence to norms established by international consultative bodies (BIS, etc.):
		- in principle
		- in practice
		- Measures to address particular types of risks:
	PS	- Evaluation of risk management systems
	PS	- Connected lending
	PS	- Risk exposure and loan concentration
PS	- Attention to foreign currency/interest rate risk management exposure	
PS	- Scrutiny of asset quality/cap. adequacy in face of sharp price moves	
	- Addressing financial insolvency:	
	- Prompt corrective actions effectively enforced	
PS	- Effective exit policy in principle and practice	
Design of the Safety Net	NA	- Explicit deposit insurance paid for by the banks
	PS	- Appropriate allocation of losses among stakeholders
	PS	- Stringent conditionality for the use of public money
Stakeholders Oversight/ Governance and Institutional Capacity	PS	- Capital adequacy
	PS	- Effective screening of ownership
	U	- Adequate oversight/governance by boards
	U	- Replacement of management for poor perf./enforceable legal liability
	U	- Adequate institutional capacity, including financial and risk management
U	- Pervasive use of effective risk management / internal control systems	
Legal and Juridical Framework	PS	- Well-defined property rights/contract law
	U	- Market contracts easily enforceable in practice
	PS	- Ability to pledge and seize collateral
	U	- Well-developed bankruptcy role
Accounting, Disclosure and Transparency	PS	- Loan valuation/asset classification/provision practices reflecting sound risk assessment
	PS	- Regular (FS) and effective (PS) external auditing mechanism
	HU	- Information on banks' creditworthiness publicly available on a regular, frequent basis
	U	- Timely publications of relevant aggregate financial data (macroeconomic indicators, reserves, banking sector statistics, etc.)
	HU	- Availability of impartial credit-rating/credit information facilities

FS-Fully Satisfactory; PS-Partially Satisfactory; U-Unsatisfactory; HU-Highly Unsatisfactory; NA – Not Applicable

7.9 Based on this and the IMF's recent evaluation, we suggest that the priority actions to be included in the reform strategy for the sector fall under six main headings. They are:

- markets – actions are needed to greatly improve the liquidity of inter-bank, other money and capital markets;
- governance of banks – actions to greatly improve the duties and responsibilities of bank boards including better definition of the responsibilities *vis a vis* executive management; and much better arrangements to replace and sanction poor managers;
- operational management of banks – especially actions to enforce the pervasive use of effective systems of risk management and internal control;
- legal and judicial – including the points relating to contract enforcement

already include in the first two components of strategy listed above;

- disclosure and transparency – development of sound system of impartial credit rating and other credit information systems including agreed standards for the allowable delays in payment. This item also embraces much more timely and usable public information about the creditworthiness of individual banks as well as all relevant financial data (the target should be full Ukrainian compliance with the IMF’s Data Dissemination Standard); and above all
- exit strategy – a far more pro-active NBU approach to the consolidation of the banking sector around a smaller number of higher efficiency/lower cost banks. This will imply the end of the policy of tolerance towards failing banks especially where their cost bases provide little hope of long term viability in a competitive environment. It will be a politically difficult part of the agenda given the high political profile and influence of some of the weaker banks. Hence the prior actions included in Component 2 are critical to get more banks working more efficiently to absorb the business of those banks which have to exit the sector.

Component 4: A New Approach to Non-Bank Financial Institutions

7.10 The recommendations here involve a considerable intensification of the existing legal and regulatory efforts in order to avert the numerous potential dangers which institutions in this sector face. The specific actions recommended include:

- elaborate and adopt an integrated *Strategy* for Ukraine’s NBFi development aimed at creating favourable conditions for the development of the NBFi sector as a whole;
- to this end, establish an *Integrated Legislative Framework* for all NBFi activities. This needs to be a two-tier legislative structure covering (a) the framework legislation to define basic principles of operation of all NBFis and (b) special legislation governing individual types of NBFi. Parallel legislative changes on issues such as the taxation of NBFis is also called for. A diagrammatic representation of how the different parts of this recommendation translate into a program for legal reform is shown in Figure 8 above.

7.11 This new structure should in particular embrace all those points listed in the Conclusions to Section 6 above. The early steps in the action plan include:

- re-examine existing (including draft and partly approved) legislation on individual types of NBFi and amend in line with both the proposed Framework Law and with the priorities of the strategy priorities. This re-examination is likely to lead to the adoption of amendments to the existing normative acts related to the existing types of NBFi, as well as legislative support for the possible creation and functioning of new NBFi types;
- rationalise and integrate the operations of the various bodies, which currently have some responsibilities for supervising NBFis of different types;

- Set up, in the nearest future, a new and separate Authority that would supervise the activities of all the NBFIs, including joint investment institutions and insurance companies. This new agency would be able to ensure the enforcement of an integral holistic state regulation policy and supervision of the non-bank financial institutions. This is extremely important because of the strong interrelationship and integration of the various types of NBFIs in practice. Equally, the very small scale of all the existing NBFIs in Ukraine would not justify a great deal of separated and specialised supervision.

7.12 An overall structure for the new system of regulation and supervision is set out schematically in Figure 8 in Section 6 above. This schema includes the proposals about where the new laws and institutions should be positioned relative to the existing arrangements. Again the emphasis is on an integrated approach and the ending of the ineffective piece-meal approach of the past.

Component 5: Should Government Promote New Financial Institutions?

7.13 It is a Ukrainian instinct to periodically advocate the creation of new financial institutions to try to solve specific problems in the sector. This tendency is well represented in the Presidential Decree of July 2000. This refers among other things to the development of new institutions to support mortgage and housing finance; a Land Mortgage Bank; a Ukrainian Bank for Reconstruction and Development; and new institutions for credit and guarantee facilities for business.

7.14 Although there is an obvious case for all of these, the evidence from past government initiatives *vis a vis* both banks and NBFIs is that there the prospects for the success of these initiatives are small. This is because all successful financial institutions need high levels both of capitalization and good governance neither of which Ukrainian governments has been good at providing. In the future, it is recommended that the authorities should establish clear and demanding standards against which to judge any new proposals for new financial institutions using public funds. The over-riding consideration in judging new initiatives in the future should be whether they are able to raise private capital and whether they can be constituted as independent and sustainable commercial organizations. It will make no sense at all for institutions of this type to be established with a long-term dependence on capital from the state, and on political favors. The record on this is clear – the state of Ukraine at the present time cannot honour its existing obligations to existing institutions: the backlog of government unpaid obligations to banks alone is well in excess of Uah 1.2 billion. This amount includes significant non-paid capital contributions to the two state-owned banks. While this situation persists the government is strongly advised against creating new institutions dependent on state capital. Additionally, the analysis in Section 4 shows how difficult it is for state-owned and even former state-owned banks to establish the conditions for their long term sustainability. Doubts about the long term futures of 2 of these banks in particular are already real and immediate. The same variety of direct and indirect interference which handicaps these large banks, would surely compromise the prospects for success of any new state-created institution.

7.15 However, the state may a role in relation to this aspect of the policy agenda in two

respects. First, many of the supporting institutions of finance will need an accommodating legal framework as well as the general support of the authorities if they are to get established and succeed. New supportive institutions such as credit-rating agencies and pledge registries are clear examples of this. But here the role of the state is one of *support* rather than *ownership*.

- 7.16 Second, it is emphasized again that the strategy for NBFIs development has to have a longer term horizon: 7–10 years. What will be done to provide the ‘missing’ products and services to the public and the enterprise sector during this extended period? The answer is that some of the gaps in the institutional structure could be filled quite quickly through politically courageous actions by the government designed to ‘buy-in’ certain missing services from abroad. In the area of private pension provision, for example, it will take 10 years or more to develop the activity to a reasonable level if present arrangements continue: existing pension companies are unreliable and have no assets in which to invest (Annex 5). Instead, the government should seriously consider invitations to reputable foreign fund-management companies to enter Ukraine to establish a wholly new private pension and life insurance system. It might also – for a number of years – allow these organizations to invest a significant part of the funds they raise in high quality investment vehicles issued by strong overseas governments and blue chip companies⁵⁸. As the domestic debt and securities market develop and mature, these management companies would gradually be expected to invest a rising proportion of these funds in local issues. Such an initiative might in any case be a useful element of the authorities’ offer regarding the General Agreement on trade in Services (GATS); itself part of the ongoing WTO negotiations.
- 7.17 This is but one of several examples of how Ukraine could shorten its transition to effective banking and finance by ‘buying-in’ services and products from mature markets and institutions in other countries. This recognises that there are inevitable sequencing problems with financial reform. The consolidating actions discussed in Section 4 could probably radically change the shape of banking in 3-5 years: many of the important foundations for this are already in place. But in the case of NBFIs institutions, the authorities need to recognise that they have not even built the basic foundations. Hence there will be a delay of many more years before this type of activity can get deeply and effectively established in the country. In that interim many of the benefits of having the services available could be obtained through the ‘buy-in’ strategy which is here proposed. This need not abort the emergence of home-grown Ukrainian institutions in time so long as a properly sequenced strategy is clearly articulated at the outset with the eventual phase-down of overseas dependence made clear to all concerned.

⁵⁸ This would obviously be a more palatable remedy politically if the reforms proposed here and in related documents were such as to produce a greatly increased flow of foreign direct investment into Ukraine.

Annex One

The Macroeconomic Environment and Performance, 1990-2000

Post-Independence Instability

1. The main body of this Report has focused considerable attention on the extremely difficult environment in which banks and NBFIs need to operate. An important element of this difficult environment has been the macro economic instability which has characterised much of the post-Independence era. This Annex explores some aspects of these macroeconomic problems.
2. In the first part of the 1990s, unstable money was directly attributable to budget deficits: these were at least two to four times the maximum set for European countries by the Maastricht Treaty.¹ At this stage relatively large volumes of bank credit to finance the productive sectors were provided in parallel with official deficit financing – much of it to subsidize loss-making industries, and this contributed to money supply growth rates of more than 1,000 percent per annum by 1993. The associated nominal demand stimulus arising from this and the monetary overhang from the Soviet era, led to near hyperinflation in 1992-94.² The public sustained heavy inflationary losses on accumulated savings during this period and consequently sharply lowered their desired and actual real holdings of money balances. This intensified monetary and price instability which in turn was a major factor contributing to economic decline in the early years of Ukraine's independence. Among other things, it made profitable production and investment almost impossible. Periodic financial scandals involving investment trusts and NBFIs intensified the collapse of confidence. As a result, financial depth in Ukraine as in most other FSU countries declined dramatically through the mid-1990s – the ratio of bank deposits to GDP for example declined from over 70% to less than 10%. This story is developed in greater detail in Section Two of the main report and Figure 2 in that Section provides an overview of this decline from 1989 to the present.
3. Today, the damaging legacy of this initial period of instability still awaits a resolution. Its main manifestation is that Ukraine still has one of the smallest banking and monetary systems in the world relative to GDP. Until this situation changes it will be impossible for the sector to provide the credits and other financial support services to the productive sectors on the scale that politicians expect and that the economy ideally needs to effect its transformation.

Compromised reform after 1994

¹ Total deficits including directed credits exceeded 20 percent of GDP in 1992-93.

² Specifically, between the end of 1992 and the end of 1994 prices increased by almost 500 times

4. A large number of important stabilization and structural reforms have been undertaken since the Fall of 1994. Superficially these reforms seemed sound enough and seemed likely to provide the liberal environment in which a modern financial sector could be expected to operate with reasonable efficiency. A degree of macroeconomic stabilization was quickly achieved through tighter monetary policies as were important structural reforms: initial price and trade liberalization; the curtailment of credit subsidies to loss-making enterprises; and the launch of the successful small scale and mass privatization programs. Damaging enterprise subsidies channelled via banks were replaced in large measure by direct subsidies through the budget.³ By September 1996, two years of responsible monetary policy had rendered the domestic currency sufficiently stable to justify the delayed launch of the new national currency – the hryvnia. One year later, the local currency having been stable for nearly two years, there were clear signs of recovery of monetary balances and an associated reduction of the velocity of circulation and thus inflationary pressures⁴. During this period too prospects for a return to growth began to brighten. Unfortunately, this period of stability was sharply interrupted by the August 1998 crisis of which more later. In particular this opened a period of volatile but generally declining value for the hryvnia. But in spite of this, by end-1999, it seemed likely that inflation was stabilising at around 10-20%; that the cash deficit of the budget had been reduced successfully to around 2% of GDP and that the decline in GDP was bottoming out.

5. However, behind the scenes and increasingly in the period 1995-2000, a number of things were going on which had the effect of compromising the gains which the macroeconomic and structural reforms should have generated. These factors together have damaged the environment for the operation of financial institutions:
 - Large quasi-rents generated in key industries (metals, chemicals, gas); from the re-sale of gas imports; from Forex speculation; and from various budgetary subsidies in the **early** years after independence set the tone for an ongoing scramble for such easy profits. The incentives motivating this scramble have not been eliminated by the post-1994 liberalisation and other structural reforms. Indeed these incentives have persisted and taken on new forms as described in Annex 2. They remain today as a more important influence on behaviour than those deriving from competition in the realms of real production, innovation and a genuine search for improved productivity.⁵ Privatisation per se has been a disappointment in that it seems not to have created the incentives to dislodge the rent-seeking culture and motivate serious industrial restructuring.⁶
 - Powerful economic groupings established up in the country during the early pre-

³ By 1994 these had surged to 34 percent of total spending, pushing the budget deficit to about 9 percent of GDP. Direct budget subsidies were themselves reduced starting in 1995, and other reforms were put in place to further limit budgetary deficits and monetary expansion.

⁴ The lower inflationary pressures also eased pressures on the exchange rate, which appreciated in real terms by about 60 percent during its two year period of nominal stability. This process was abruptly reversed by the 1998 crisis and the sharp fall of the currency.

⁵ Anders Aslund estimates that the quasi rents earned on commodity exports alone amounted to more than \$4 billion or 20% of GDP in 1992. However, price stabilisation and some more transparent processes gradually reduced this percentage to single figures and so reduced the total pickings though not to the attractiveness of these to the relatively limited number of so-called “clans” that hope to lay claim to them. It is claimed that Pavlo Lazarenko who was Prime Minister in the period 1996-97 and who is now remanded in San Francisco personally siphoned of as much as \$ 700 million mainly via his association with important energy companies. See *Kyiv Post*, June 8th 2000.

⁶ Part of the explanation for this lies in the fact that by 1997, newly privatised firms were owned to the extent of 46.2% by their former managers and 15.3% by their employees. These are higher percentages than in Russia and most other FSU countries and imply lower proportionate roles for outside and maybe strategic investors.

reform years have continued to exert pressure through a variety of corrupt practices which embrace senior government officials, deputies elected to the Supreme Rada, and significant parts of the business, including the banking, community. This dynamic has resulted in an unhealthy form of competition in which political influence, including the ability to influence the granting of official favours such as tax exemptions and the discretionary application of regulatory requirements, has partly displaced the healthy forms of competition based on relative economic efficiency and associated profitability. This factor partly explains the disconnect between enterprise efficiency and enterprise after-tax profitability referred to earlier. The strong likelihood that some banks are complicit in, and dependent on the process of political favours undermines their chances of transforming into Western standard banks even further. The struggle between oligarchic influences and genuine reformers remains as an ongoing tension in Ukrainian policy making.

- Ukraine has institutionalized a part-way reformed socialist economy elsewhere labelled a “hybrid” economy. In this hybrid many important activities including parts of banking retain a serious dependence on the state. However, the state plays its role not via visible policies but via ubiquitous and mainly non-transparent special arrangements for large numbers of “deserving” enterprises and farms. These arrangements include tax privileges; waivers or deferred payments of taxes; the connivance of the authorities in the barter settlement of tax obligations⁷; the write-offs of budget loans and tax debts; and insider access to public procurement. Insofar as these ad hoc practices are **not** motivated by corrupt intentions, they are often associated with the legitimate motive of wanting to revitalize failing enterprises. In practice they have rarely succeeded in this objective. Honest politicians may take comfort from the attempts that they make to preserve jobs and incomes and these attempts have undoubtedly permitted many failing activities – including some banks – to survive a bit longer than might otherwise have been the case. But the cost to the economy has been high since the numerous hidden subsidies inevitably drain resources from other potentially viable firms (see also Annex Two).
6. The main mechanisms for this insidious process of dumping high costs on sound enterprises is as follows. Sounder firms are required to pay unreasonably high taxes and exceptionally high interest rates on domestic capital—if they can get it at all. As Annex 2 indicates, some tax rates in Ukraine could be almost halved if tax exemptions were to be eliminated. The very high rate of loan losses in most banks necessarily increases the margin which banks need to achieve on their lending to “better” clients. The banks until April 2001 were also implicated in another way since through the Kartoteka 2 system, the banks have become efficient agents of the State Tax Administration – enterprises with healthy bank balances have little or no prospect of questioning or avoiding tax however unreasonable. The response has scarcely been surprising. Enterprises have tried to avoid large positive bank balances and so the tax burden which would result from this evidence of their “success”. The banks for their part pay the price by having far fewer resources to intermediate than might otherwise be possible.

⁷ Although tax revenues were reported to be around 30 percent of GDP, actual tax collections in cash are now only 18-19 percent of GDP. By allowing failing enterprises to remain in operation and “pay” their taxes with barter if at all, the government has helped create a large virtual economy that operates in addition to the shadow economy.

The 1998 Financial and Banking Crisis

7. The collective damage done to the financial sector by the factors considered above were magnified hugely by the crisis which unwound in 1998. This arose as follows.
8. The apparent macroeconomic stability after 1996⁸ encouraged a deepening of the country's official debt management beginning with the introduction of the Treasury Bill market in the latter part of 1995. Regrettably this was an inauspicious time to launch the market since inflation was still very high – monthly CPI rates in the range of 5–10% in most months. Hence the volumes of TBills sold into the market were initially small and the nominal yields needed to achieve these sales were high: in excess of 20%.⁹ However, the market developed significantly and the government became much more dependent on it through 1997. By the middle of that year, monthly issues in excess of Uah 500 million (\$210 million) were becoming routine). This was the equivalent of almost a quarter of the total government budget and was also in excess of 8% of GDP. In other words, TBills by 1997 had become the dominant source of financing for the still-large fiscal deficit. This was of course consistent with the IMF monetary program and the insistence of the Fund on minimizing the monetary financing of the deficit.
9. At that stage in late 1997, most TBill auctions achieved their target sales without much if any reliance on sales to the National Bank (NBU). Indeed, since by then inflation was below 15% per annum and declining, TBill yields of around 25%, and falling, proved sufficient to compensate holders both for inflationary expectations and for the, then small, risk of default. Substantial foreign interest in the Treasury Bills began to develop as more evidence accumulated of sustained monetary and exchange rate stability.¹⁰ By the early part of 1998, it was estimated that about 50% of all TBills then outstanding were held by overseas institutional investors: implying a cumulative portfolio inflow, mainly in 1997, of about Uah 3 billion (\$1.5 billion). At that time this was almost the only form of portfolio inflow into Ukraine. Commercial banks by end 1997 were also holding about Uah 2 billion of TBills – a figure which compared with about Uah 5.5 billion of outstanding domestic currency credits to the enterprise sector.
10. But the dangers in this quite rapid build up of domestic and international debt were already evident in the facts. The yields on the securities, although declining, were still in excess of 20% in mid-1997 while inflation was down to about 12-15%: implying a significantly positive real rate of interest. But the real growth of the economy was negative with the inevitable consequence that government revenues were also very sluggish. So even at the yields prevailing in September 1997, the debt build up implied unhealthy debt dynamics: a higher and higher proportion of Government revenues committed to debt service. Relatively low inflation and fiscal deficits at that time were illusory. The situation worsened sharply after the October 1997 financial crises in various Asian economies. That crisis rapidly led to higher interest rates on Russian GKO's in order to achieved the necessary large rollover of maturing issues. The Ukrainian yields

⁸ Inflation fell to only 10% by 1997 and was about 20% in 1998. The exchange rate remained fairly stable in nominal terms through 1996, 1997 and the first half of 1998 at close to the launch level of the hryvnia namely Uah 1.82 = \$1

⁹ Specifically, the monthly sales through the last months of 1995 were typically around Uah 30 million and only in 1996 as inflation moderated through mid-year did sales rise to an eventual monthly level of around 300-400 million. Foreign interest was virtually non-existent.

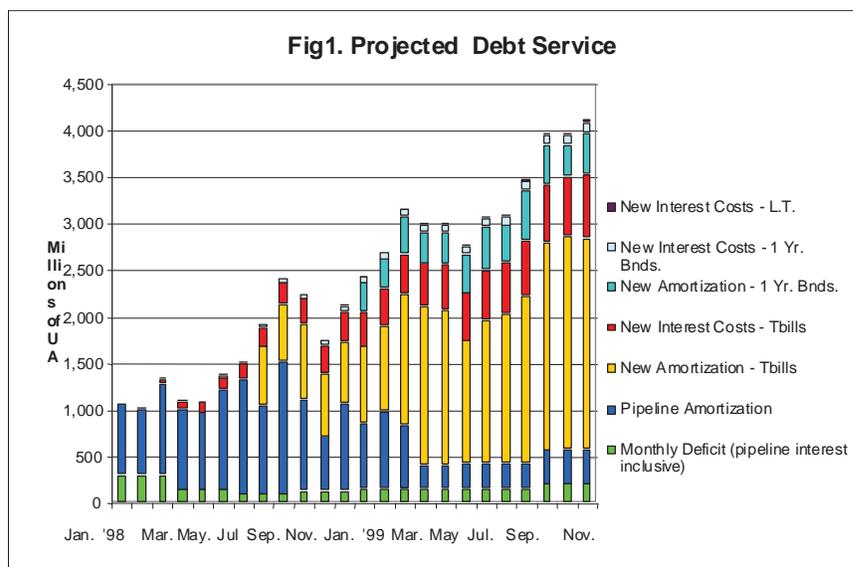
¹⁰ The new currency the Hyrvna was introduced in September 1996 and for a period of around 18 months after that displayed a high degree of stability at around Uah 1.85 to 1.95 per \$1US

had to follow promptly and by the end of the year yields of around 50 percent were being paid. However, the volumes of TBills auctioned did not decline. As Table 1 indicates, there was in that period both an increase in the volumes auctioned and the yields that had to be paid.

Table 1. Treasury Bills and the 1997 Asian Crisis

Date	Amount Raised Uah '000	Effective Yield (%)
Sep-97	277,699	21.72
Oct-97	395,052	26.97
Nov-97	272,086	39.87
Dec-97	592,59	49.42
Jan-98	606,466	45.69

11. At this point, a committed fiscal adjustment might just about have averted the extremely serious problems that followed. However, Parliamentary elections in March 1998 precluded this and by the end of March the pre-existing IMF Stand-By program broke down. At the same time, the problems in Russia and East Asia intensified and the pressures on TBill yields already indicated also intensified. Although small moderations in yields occurred, rates generally rose and yields of around 80% became necessary when the Russian crisis came out in to the open in May/June of 1998. Of course **this completely destroyed any real hope of sustainable debt dynamics** in Ukraine given the economic facts discussed earlier. Indeed, it was obvious even before the summer that Ukraine faced an explosive domestic debt problem which, if unchecked would rapidly consume ALL of government revenues. Figure 1 below shows the monthly pipeline of debt service which the Government faced through the period 2000 (viewed through the lens of the Bank's Debt Sensitivity Model as run in January 1998). Each monthly number should be compared with the average monthly budgetary revenues of circa Uah 800 million.



12. This episode and Ukraine's general experience through 1998 revealed the fundamental weakness of a macroeconomic stability based on tight monetary policies but juxtaposed on an overly relaxed fiscal stance and a still-thin financial market. The implied borrowing

costs associated with ongoing fiscal deficits were far too high relative to a very fragile revenue situation. After the August 1998 crisis in Russia, Ukraine found it impossible to roll over its large TBill debt, much of which had been sold to foreign investors. Those investors, having witnessed the problems in Asia and Russia, became wary of all emerging markets—particularly risky ones like Ukraine, where future debt service obligations now accounted for an awesome share of government revenues. Long before any formal debt restructuring began in the Fall of 1998, TBill investors from abroad began repatriating their investments in hard currency as the bills matured, drawing down Ukraine's foreign exchange reserves in the process. Once the TBill debt could no longer be rolled over, even at real annual yields exceeding 70 percent, Ukraine was forced to restructure TBill debts in amounts of nearly Uah 2 billion.¹¹ Later it also restructured Tbill and other debt due in 1999 and in March 2000 restructured the year 2000 and 2001 maturities of Eurobond and other external issues.¹²

The Period 1999-2001

13. Ukraine like Russia achieved a relatively rapid recovery from the 1998 crisis. The significant real devaluation of the currency turned out to be helpful to the main productive sectors. But because of a strong commitment to the IMF program agreed in September 1998, the devaluation did not precipitate any big increase in inflation which remained in the 10 and 20 percent range, despite ongoing fiscal problems. These in turn were greatly eased by the government's successful re-negotiation of its major Euro bond debt which shifted the peaks of loan repayment by around 2-3 years on average relative to the amounts shown in Figure 1 above. The Cash deficit of the general government was reduced from 5.6% of GDP in 1997, to 2.8% in 1998 to 2.4% in 1999 and to less than 2% in 2000. Tighter expenditure controls, greatly reduced budget offsets, and cuts in tax privileges and social subsidies all contributed to this improvement.
14. Political events were broadly supportive of these improvements at least through the early months of 2001. After his decisive victory in the presidential elections in November 1999, President Kuchma appointed a Prime Minister and a cabinet largely populated by officials with a progressive track record. In addition, for the first time in years parliamentary factions were able to coalesce into a pro-Presidential majority, which withstood some initial tests, such as the passage of a strong budget and the endorsement of the pro-reform Government Program. But the long term survival and success of the reformist coalition was never assured. There were ongoing questions regarding the extent of the mandate from president Kuchma to Prime Minister Yushchenko, particularly when the reform program started to bite into the vested interest of the more powerful oligarchs, who have deep connections within the legislative and the executive.
15. The successes translated also into the bottoming out of the GDP decline: a 3% decline recorded in 1997 was followed by a 1.7% decline in 1998, and an even smaller 0.4%

¹¹ As a part of the 1998 restructuring, Ukraine had to pay foreign investors 20 percent of the restructured amounts in cash. This, plus the repayment of major fiduciary loans in foreign exchange, severely depleted the nation's international reserves. During 1998 the central bank lost nearly all its \$3 billion in reserves repaying debts and defending the exchange rate. At one point reserves were down to just a week or so of import cover. In the end, after losing reserves equal to about one-third of the entire stock of medium- and long-term external debt, the pressure for devaluation became irresistible: the dollar appreciated against the hryvnia by about 80 percent over the course of 1998.

¹² After debt service payments in the first two months of 1999, reserves were again down to about one week of import cover. Reserves were rebuilt under the umbrella of the Fund's Extended Financing Facility as approved in September 1998 but periodic further devaluations of the hryvnia occurred regularly thereafter bringing the nominal rate to more than UAh 5.5 = \$1 per end-1999.

decline in 1999. The year 2000 saw the first positive growth of GDP since independence at the impressive rate of 6% and this has continued into the early part of 2001. The recovery in 2000 was based on the continued revival of industrial production (mainly metals and metallurgy) and some recovery of agricultural production after a very weak output performance during 1999. Land reform in 2000 was a factor in this improvement.

16. Despite these various and welcome improvements, the macroeconomic situation continued to be fragile. The main difficulties continued to come from fiscal and debt management. Fiscal deficits, higher on a commitment than on a cash basis continue to generate significant budgetary arrears and create inflationary pressures. Money creation to pay arrears, in the wake of the presidential elections, jointly with a relatively flexible exchange rate, generated higher inflation rates in the early stages of the new government.

Some Consequences for the Financial Sector

17. The various points discussed above and in the main Report explain the manner in which the general operating environment for banking and other financial sector activity deteriorated or remained inhospitable even after structural reforms began in 1994. The further discussion of the 1998 crisis referred to developments that created specific additional problems for most types of financial institution. This section discusses selectively some of the overall consequences especially for banks.
18. Let us note first of all that the banks and NBFIs are not merely innocent victims of the negative influences described above. On the contrary, some of the country's banks and other financial institutions are deeply implicated in the political-relationship and hybrid economics described earlier. This means among other things that:
 - some manifest only a qualified commitment to a more open and transparent system.¹³
 - some of the banks, because they serve the private interests of large power brokers, still represent important sources of personal enrichment even when their own capital and liquidity positions seem parlous when judged by Western standards.
 - the commitment on the part of NBU and other regulators to establish "sound banks" has almost certainly been compromised by the pressures from pervasive coalitions of business and political interests which have little genuine interest in sound banks. In particular, NBU interventions to liquidate insolvent banks and to take tough remedial actions especially against larger well-connected banks have been compromised adversely from time to time by this fact.¹⁴
19. As regards the consequences of the 1998 crisis, the local banks and some other financial institutions were impacted in at least **four** main ways by the events surrounding this.
 - The direct losses on T-Bills holdings impacted negatively on both liquidity and

¹³ In spite of a reasonable record since 1996 on regulatory reforms and technical reforms within banks, many of the small "pocket banks" established in the early 1990s and some at least of the large descendants from the Soviet monobank such as Oschadny Bank and Bank Ukraina still have agendas which transcend the legitimate aspirations of commercial banking in well functioning market economies.

¹⁴ The failure to respond promptly to the evident insolvency of Bank Ukraina and, before that Grado Bank, are merely two of the more dramatic examples of this point. In the first case in particular, the NBU itself stands to lose an amount equal to about 30% of the total liabilities of that bank because of its permissive attitude.

earnings¹⁵.

- After the T-Bill write-down there was no longer an asset in the system that could be regarded as truly “safe”. This fact has adversely affected the technical management of liquidity positions in most financial institutions. The volatility of markets is now impossibly high for successful liquidity management (see Figure 2 for some evidence on volatility and Box 2.1 for an up-date on the current situation in the T-Bill market).
- A number of banks took significant foreign losses on their uncovered foreign exchange borrowings (though never on the scale of Russia).¹⁶
- The adjustment to the 1998 crisis required deflationary policies, including belated fiscal adjustment through 2000 which further deepened the already serious recession and further damaged the health of already weak loan portfolios.
- A fifth potential source of damage was a run on deposits. Such a run materialized in the immediate aftermath of the major run on the Russian banks and a 10% reduction in household deposits occurred very quickly. But this was quickly reversed as it became evident that the banking problems in Ukraine were really not on the same scale as in Russia.

The Effects Overall and the Impact of Policy

20. The contribution of the banking system to the economy passed through a number of stages as a result of the various influence referred to in this Chapter. Some aspects of this are summarized in a simplified manner in Figure 3 below. The figure illustrates several important points including

- the banking system as a whole, including the NBU was never able to get total credit to the economy (including to the government) on a rising trend. Indeed the ratio of total banking credit outstanding to GDP remained between 10 and 20% for the whole of the period we have considered¹⁷.
- the NBU itself became and remained a very important part of the total credit supply. The figure shows that the NBU credits to government (including in later years the purchase of TBills) rose from around 20% of total banking system credits outstanding in 1993 to a level well in excess of 50% of the total by mid-1996. After the crisis of 1998 the NBU’s large share was explained increasingly by the NBU’s role in absorbing TBill issues for which there were no longer any

¹⁵ The restructuring of the approximately \$5 billion of domestic debt involved the exchange of old securities for new ones having lower yields and longer maturities. At the time, Standard and Poors categorized this transaction as a default (although it was never presented as such by the authorities), and some foreign holders contested it in the courts. Domestic holders of Treasury securities and especially the commercial banks volunteered a restructuring of their own holdings in September 1998 but nonetheless had to swallow a substantial degrading of both their income and their liquidity positions.

¹⁶ Unofficial Bank estimates indicate that by July 1998 Russian banks had build an exposure to non-residents in excess of \$22 billion. This is a figure which was far larger than Russian foreign reserves at the time and which reflects the more developed state of the Russian banking system and the greater interest of Western – and especially German – banks in working with Russian partners. By contrast the Forex liabilities of the Ukrainian banks was only around \$500 million which was a figure far below the pre-crisis level of foreign reserves. This latter fact is partly explained by the efforts made by NBU regulators from late in 1997 to monitor and control the un-matched positions of the local commercial banks.

¹⁷ It is of course arguable that this failure to increase the credit aggregates was a blessing in disguise given our assessment of the limited ability of banks to intermediate credit funds in an effective manner. For the future the ability of the banks to intermediate funds effectively and their access to larger volumes of funds should go hand in hand as the large menu of necessary reforms identified later in this report are implemented.

other purchasers.

- The latter part of the period has been characterised by the very considerable increase in importance of the state issue of securities including to the NBU and the commercial banks). These remained equivalent to over 50% of the figure for banking system credit through the period of the crisis and until the TBill restructurings of 1998 to 2000 began to pull down the totals.

Box 1.1 The Treasury Bill Market

The Treasury bill market in Ukraine has not recovered from the 1998 crisis, when the government was forced to reschedule some Uah 840 million of outstanding bills. The rate of discount at auction varied between 25 percent and 35 percent during 1999, and given the government's recent record of repayment, the banks do not consider that this represents adequate return for the risk involved (note also that many banks also hold under-performing loans to, or guaranteed by, the government – see Annex 5 for details).

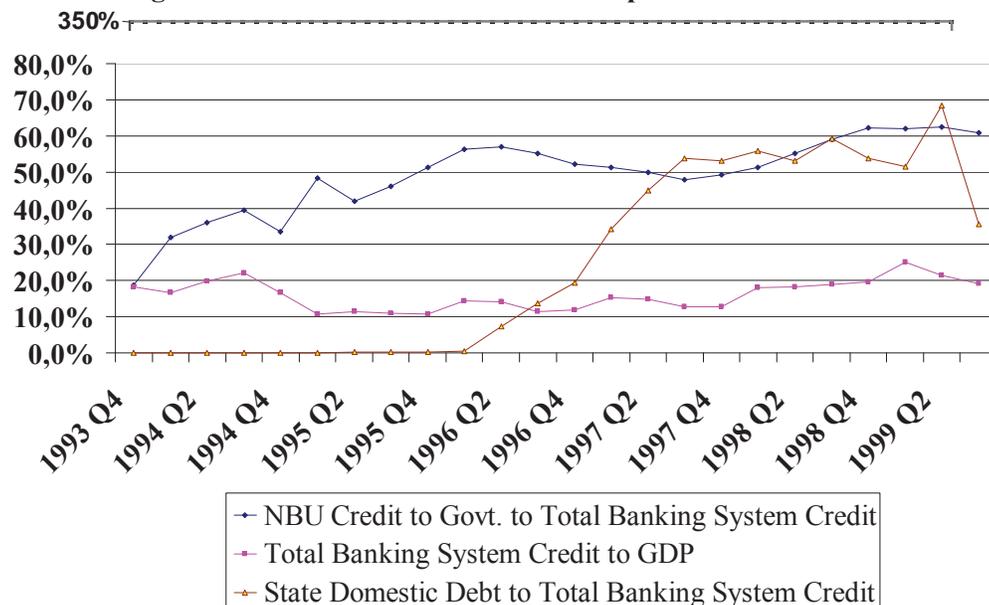
During 1999, the majority of new Treasury bills issued were sold to the NBU, either on the primary market (until June 22, when primary market purchases by the NBU were banned under the new NBU law) or on the secondary market. In practice these "secondary market purchases" account for virtually all the bills allocated in the primary market auctions, and usually occur on the same day as, or within a few days of, the auction. At the end of September 1999, the NBU held Uah 8,473 million of the total stock of Uah 8,924 million outstanding, in addition to some Uah 715 million of the rescheduled bills.

The low level of Treasury bills outstanding to market holders is having a detrimental effect on the money market more generally. It limits the amount of collateral available to commercial banks for transactions between themselves, and for collateralizing refinancing transactions with the NBU. This inhibits the provision and movement of liquidity within the hryvnia market. It also means that the funds available to the NBU for refinancing purposes are limited because much of the headroom under the NDA ceiling is taken up with treasury bill expenditure.

The recent introduction of the NBU's own CDs will address some aspects of the problem in the short term, providing the market with lower-risk assets yielding close to market rates. However, it would be undesirable for NBU paper to be taking the role of government paper, and there is no intention that this should happen.

The inability of the Government to fully honor its veksel liabilities to the banks in 1999 and the restructuring of T-bills in 1998, undermined confidence in the Government's ability to honor its financial promises, exposed banks to larger risks and led to further deterioration of banks' assets. Government debt plays an important role in the financial system of every developed country. Government bonds are used as a broadly risk-free asset against which other financial instruments are priced. They are counted as part of banks' capital, and prudential regulations often require pension funds to hold a minimum share of their assets in government securities. Central banks also use government securities in open-market operations to influence interest rates. It is therefore of paramount interest that government paper regain the confidence of the public in Ukraine. This will require an extended period of very prudent fiscal financing incorporating a longer term strategy for government domestic debt management.

Figure 2: Volatility of portfolio consisting of 5 instruments.
Figure 3: Main Trends in Sector Development:1993-1999



21. Pulling some of these ideas together, it can be argued that political and fiscal influences over the development of the sector have taken three main forms.
- The direct issue of state securities to levels outstanding which, after 1996 grew to match the total credit of the banking system taken as a whole. This initially provided banks and NBFIs with a highly profitable and “safe” asset which inevitably displaced the inherently riskier alternative assets – including lending to productive enterprises – available to the banks. Later, the default/restructuring of these securities directly impacted the earnings and liquidity of the banks and substantially complicated their task of liquidity management.
 - A variety of politically-motivated direct interventions with banks including systematic direction of lending at least through 1996 and the failure of the state to comply with its duties to capitalise and otherwise support the two large state banks namely Ukreximbank and Oschadny. Non-performing assets in banks associated with this point are conservatively estimated at Uah 800 million currently¹⁸. Deficient capital contributions are around Uah 400 million. Against this background all new proposals for the state to create new state banks – specialised or universal – need to be treated with extreme caution.
 - Indirect influences over the relative profitability of the potential enterprise clients of banks exercised through a wide variety of interventions which collectively and arbitrarily distort the post-tax profitability of different enterprises. These interventions are identified and discussed more fully in the main Report and in Annex 2. Their elimination represents one of the more important but also the most difficult aspect of necessary future reforms for the sector.

¹⁸ Data in and K.M.Sultan and D.G.Mishev, set the total much higher at Uah 1.6 billion. See, *Banking System in Ukraine: Sector Analysis and International Comparison*, HIID, Kiev, February 2000

Annex Two

The Impact of Barter and Non-Payment on the Sector

The Problem

1. The Ukrainian economy is characterized by levels of barter payment, non-payment, mutual offsets and the use of other money surrogates (collectively referred to as veksel) which would be unprecedented were it not for the similarly large volume of such activities in its nearest neighbor namely Russia. Alternative monies of one type or another are now used on a very wide scale in making payments in the Ukrainian economy. In January 1999, for example, only 35 % of shipped industrial products were paid for in cash. A similar proportion of total sales was accounted for by barter transactions and the remaining 30 % approximately of total sales were “financed” by veksel and other forms of non-payment and offsets. In the past two years, the settlement situation has somewhat improved. For example, cash revenue for the shipped industrial products rose to 48.2 % by January 2000, and to 64.0 % by January 2001. But there is evidence that the improvements have been achieved in part by shifting the problems to alternative forms of non-payment: certainly the systemic correction of this corrosive problem has not been achieved.
2. In purely numerical terms the dominant item has been the accumulation of inter-enterprise credits (see Table 1), which by the beginning of 2001 stood at Uah 185.3 billion (receivables) and Uah 258.4 billion (payables). Some of these are not arrears in a formal sense (see below) and some net out when enterprises as a whole are consolidated across the whole economy: i.e. they do not represent a net injection of credit. But this is not the case with two specific types of arrears which have both strategic and political importance. They are:
 - The outstanding payment arrears to electricity power companies
 - The outstanding tax and other arrears due to government.
3. These mechanisms together have provided large informal alternatives to the formal credit which the banks themselves are able to provide. They have also ensured the institutionalization of barter modes of trade which have highly damaging consequences for financial sector development as discussed below. The total of outstanding arrears easily exceeds the country's GDP and compares with total credits provided by commercial banks to economic entities that by 2000 stood at only Uah 19.1 billion (see Figure 1)¹.
4. In most recent studies of Ukraine's financial sector, this extremely high incidence of alternative monies has been noted and some of the dangers identified.² This present

¹ Alfandari and Shaffer (1996) note that in some countries the amount of commercial credits that enterprises extend to each other, exceeds the total banking sector credit. Amounts of commercial credits are constants, and the level of outstanding commercial credit usually varies from 30 to 60 percent of its overall amount. See: Alfandari, Gilles and Mark E. Schaffer. “Arrears in the Russian Enterprise Sector”, *CERT Papers*, March 1996.

² The main recent examples are Financial Markets International, *Financial Markets Development in Ukraine*, Ch.11, January 2000 and K.M.Sultan and D.G.Mishev, *Banking System in Ukraine: Sector Analysis and International Comparison*, Section 4, HIIID, Kiev, February 2000

report goes further by identifying the high level of these alternative monies as the major symptom of a systemic malaise and mal-function of the economy: the other main components being a prolific but arbitrary system of tax exemptions and a wide variety of other special supports to, or penalties imposed on particular enterprises or classes of enterprises. The consequences of this malaise for financial sector development include:

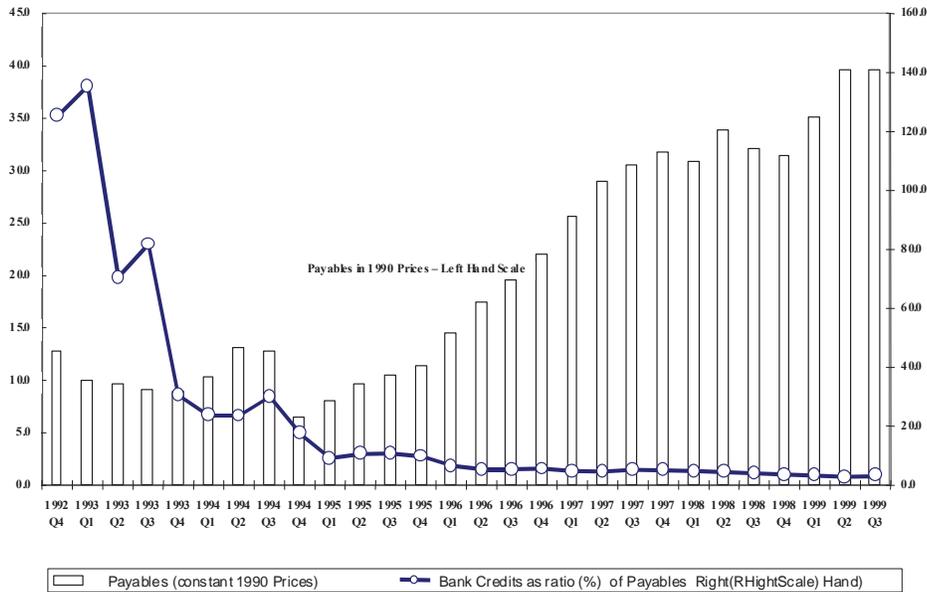
- a) chronic economic inefficiencies associated with barter and the failure to make universal use of a single standard monetary means of payment. These inefficiencies arise from the additional transactions costs involved and from the multiplicity of prices for certain commodities that are caused by present arrangements;
 - b) a serious disconnect between enterprise efficiency and the reported levels of enterprise after-tax profitability. This is a fatal informational flaw for the banks since they need sound enterprise profitability data to make their credit allocation decision. It is also damaging for economy-wide efficiency given the erroneous allocation of investment resources to which this disconnect gives rise; and;
 - c) large volumes of often cheap (to some users), and wholly unregulated alternatives to the more conventional payment and credit arrangements provided through banks and other financial institutions.
5. The purpose of this Annex is to describe and analyze the nature and origins of alternative monies and tax privileges in Ukraine and then use this analysis to elaborate the basic propositions just described. The central hypothesis is that various government interventions in the economy bear most of the blame for the high level of utilization of alternative monies at the present time. Barter and non-payment are **not** spontaneous developments that can be blamed on the self-serving activities of private market participants. These agents are responding to incentives that are largely the creation of policy. The analysis concludes that a complete strategy for the recovery of the financial sector needs to include the elimination of the problems associated with (a), (b) and (c) as central components. That strategy must certainly include the removal of the government interventions that contribute to the problem.

The Scale of Parallel Payments in Ukraine

6. There are four main types of non-conventional “payments” arrangements in use currently. These are:
- barter – where sales transactions are paid for with goods or services rather than money
 - outstanding arrears – where a payment for a transaction is merely deferred or, in some cases, never made. This case differs from the first and third in this list in that the transactions concerned do not involve any identified *quid pro quo* for the goods that are sold. In some instances veksel or barter arrangements may be instigated at a later stage in order to achieve “payment”

- veksels – where transactions are paid for initially, or eventually, by the issue of various forms of financial IOU (or “veksel” to use the German/Russian term). The main issuers in practice are enterprises, banks and the government
- offsets (or “vzaemozaliky”)³ – where two or more transactions are combined in order to enable the arrears/veksels built up in one transaction to be used to settle obligations arising from a completely different transaction(s). A common example is the use of veksels issued to a creditor being later used to settle or partly offset debts to the State Tax Administration. But similar arrangements

Figure 1: Enterprise Payables and Bank Credit, 1992-1999



between enterprises are also quite common.

7. The use of these arrangements involves government at all levels; major state owned enterprises, and especially energy utility companies; and many of the country’s privatized enterprises. Households and smaller scale enterprises seem to be implicated more as **victims** of the non-monetary payments rather than as instigators. Systematic and complete data on all of these are not readily available. However, an overview of the main totals is in Table 1 and Figure 2. below.

The Problem in Detail

8. The next five sub-sections of this Annex describe this situation in greater detail.

A. Non-Payment in the Industrial Sector

9. **Barter.** Barter transactions had a long history in the Soviet Union. But by 1992 just after

³ Offsets are widely used not only in settlements between the state and enterprises, but also in performing foreign economic relations. Thus in 2000, there was an offsetting of the debt of US\$ 1,099 billion between Russia and Ukraine. (Analysis of the Execution of Ukraine’s Budget over the first six months of 2000. K.: Audit Chamber. Issue 15. 2000).

Independence, barter transactions in Ukrainian manufacturing amounted to only 6 % of total industrial production. At that same date payments arrears were insignificant. However, 6 years later by 1998, the barter percentage had risen to a remarkable 43 %.⁴ In value terms, industrial barter transactions were worth Uah 32 billion (30 % of GDP) by 1999.⁵ Using barter arrangements, Ukraine's industry sold in 1997 Uah 28.3 billion worth of products⁶, equivalent to 42.4 % of all shipped products. In 1998 these numbers amounted to Uah 32.1 billion (42,5 %) , in 1999 - to Uah 32.3 billion (32.7 %) , and in 2000 - to Uah 22.6 billion (17.0 %).

⁴ data are from the State Committee of Statistics and a draft paper by Olexander Shchur and Igor Zhilyayev, "*Barter in the Ukrainian Industrial Sector*"

⁵ Some independent studies indicate an even higher overall ratio of barter to sales. For example, D.Kaufmann and M.Marine, "Disorganization, Financial Squeeze and Barter", *Working Paper* No. 165, William Davidson Institute, July 1998, reports a ratio of 51 % of sales for a sample of 55 Ukrainian firms in 1997. Discrepancies arise because of certain features of national statistics.

⁶ The Derzhkomstat of Ukraine obtains data on the volume of barter transactions and product sales revenue using the 1-П (monthly) form which is filled out by enterprises and structural units of enterprises of all forms of ownership. Under this form, the "Sales" line concerns the shipped products in current wholesale enterprise prices without account of the VAT and excise duty. Therefore, it would be more correct from the methodological standpoint, to refer to the shipped produce and differentiate this indicator from the sales indicator, used in the national finance statistics. In 2000, state statistics began using the term "shipped products".

Table 1. Scale and Trends of Non-Monetary Settlements in Ukraine

	1997	1998	1999	2000
Barter, % share of the shipped products:				
· industry	42.4	42.5	32.7	17.1
· agriculture (state sector)	23.4	26.2	27.1	18.6
· export of goods	10.5	7.5	3.8	1.5
· import of goods	10.0	7.1	3.0	1.4
Non-monetary domestic budget settlements, % of revenues⁷:				
· state budget	24.3	16.9	10.2	0.1
· local budgets	28.3	23.1	28.0	1.7
Outstanding arrears-to-GDP %:				
· receivables	77.1	75.9	76.2	55.6
· payables	110.1	108.5	106.5	71.4
Outstanding domestic inter-enterprise debt, Uah billion*				
· receivables	51.4	56.3	75.5	80.2
· payables	70.0	82.1	105.5	103.0
Outstanding external debt of Ukrainian enterprises, USD million*				
· receivables	835	824	292	253
· payables	1450	1852	2622	2676
Outstanding arrears between Ukrainian enterprises in veksel-to-gross industrial product, %:				
· receivables	0.5	1.3	1.1	0.6
· payables	0.7	1.8	1.9	1.1

Sources: This table is updated from Ihor Zhyliaev, "Surrogate money in the Ukrainian economy: the scale and the dynamics" in Ukraine Economic Trends, March 1999. Data are from Derzhkomstat Ministry of Finance, Ukrainian Economic Trends (various issues).

* end-of period in current prices, except for small enterprises and institutions funded from the budget

Source: State Committee of Ukraine for Statistics (Derzhkomstat), I. Zhilyaev's Estimates

Notes: Statistical reporting on arrears on receivables and payables between Ukrainian enterprises is available from the state statistical agencies beginning from January 01, 1993, in respect of the arrears fallen-due component – and since January 01, 1997 for the debt of Ukrainian enterprises resulting from foreign trade operations. Statistics on industry branches is kept since October 01, 1997

10. **Arrears.** In addition to barter, all sub-sectors of industry experience significant "sales" of products which are not paid for at all within a reasonable period of time and where "arrears" are therefore the mechanism effectively used for payment. Under Ukrainian law, receivables and payables are only "in arrears" if they are not paid within 30 days (this is the definition used in Table 1 above). The past three years have seen an increase in the absolute size of the arrears problem as thus defined despite occasional claims to the contrary. Accounts payable in industry alone have risen from Uah 37 billion (as of October 1, 1997) to Uah 87 billion (February 2000). The corresponding increase for accounts receivable has risen from Uah 21 billion to about Uah 64 billion. Total payables exceed already the annual output and are close to being equal to total nominal GDP.⁸

⁷ Government estimates are given over 1999 and 2000 (See. Report on the Progress of Implementing the Cabinet of Ministers of Ukraine Action Program "Reforms for Welfare", March 2001). According to other estimates, non-monetary budget settlements are significantly greater than shown here. Thus, T. Vakhnenko estimates the volumes of "revenue mobilization" in the 1999 Consolidated Budget at Uah 10.03 billion, or 35.6 % of revenue in money form. Over the 9-month period of 2000, non-monetary Consolidated Budget revenue, as estimated by this researcher, was 12.7 % of monetary revenue, or 3.4 % of the GDP – much higher than is shown in Table 1 (T. Vakhnenko, "Non-monetary Budget Execution Forms: Evaluation of the Current Situation and Analysis of Economic Implications", Trends in Ukraine's Economy. UEPLAC. October 2000).

⁸ Although these amounts are large, it needs to be remembered that they are stocks not flows. Hence, comparison with the data on barter requires that they be placed on a first difference basis. This in turn shows a broad similarity in the monthly flows of financing effectively made available through the two routes of barter and arrears – around Uah 2.5 billion monthly in recent times.

Payment in cash, in many sub-divisions of the sector such as Energy Products and Construction Materials has been an infrequent occurrence in some recent periods.

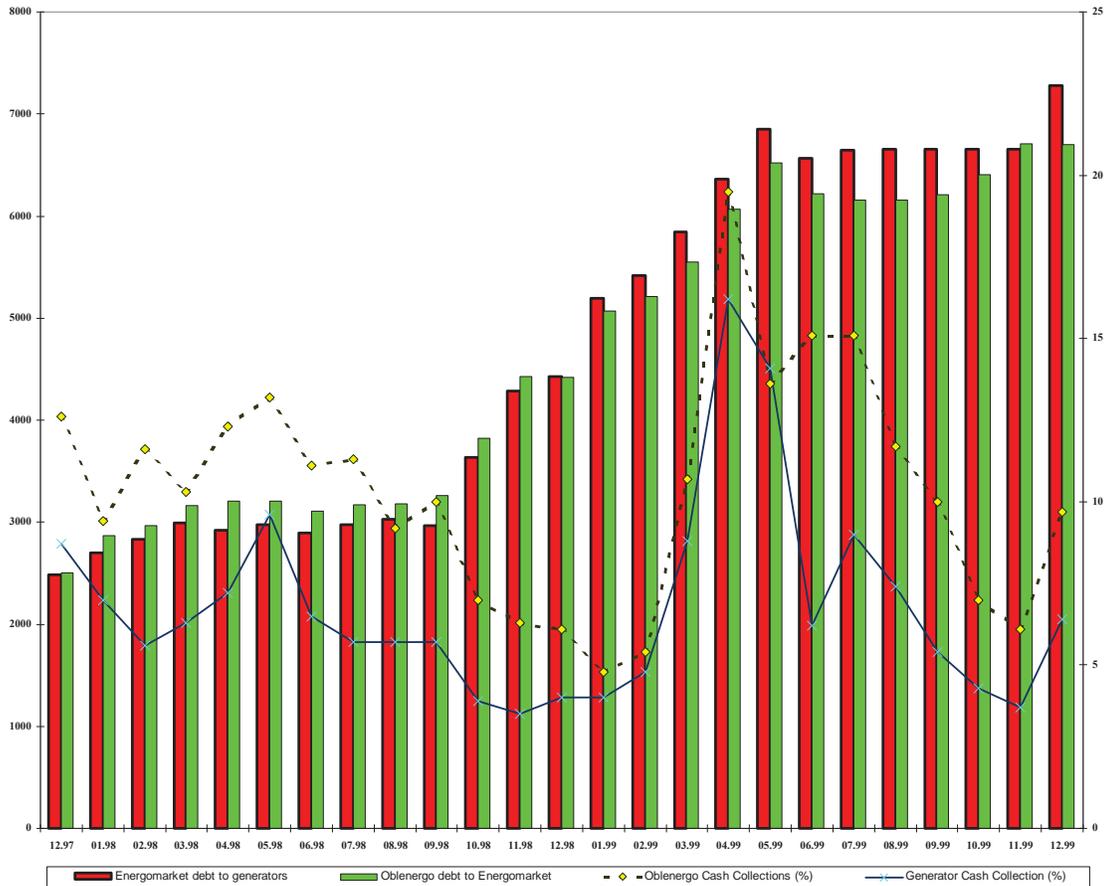
Table 2. Accounts Receivable and Payable in Ukraine *, Uah, million

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Accounts receivable									
Total	22	1049	5113	22864	51396	77182	107924	170273	185277
Index of Annual Change	-	47.3 times	4.9 times	4.5 times	2.2 times	150.2 %	139.8 %	157.8 %	108.8 %
including: between Ukrainian enterprises	17	993	4904	22250	48018	74085	102976	163450	178176
Accounts payable									
Total	22	1399	7593	32421	76806	107747	153561	229234	258401
Index of Annual Change	-	62.2 times	5.4 times	4.3 times	2.4 times	140.3 %	142.5 %	149.3 %	112.7 %
including: - between Ukrainian enterprises - with the budget	19 ...	1276 ...	6834 ...	30543 ...	73168 8211	102506 8218	137613 13283	196364 18856	222431 21148
Index of Annual Change	-	100.0 %	161.6 %	142.0 %	112.1 %
* By period-end, in current prices, except for small enterprises and institutions funded from the budget Source: Derzhkomstat of Ukraine									

11. Important insights about the causes of barter and non-payment can be derived from the fact that the percentage of sales financed on a barter or arrears basis varies widely as between different sub-divisions within the industrial sector. These are greatest (cash payments lowest) in the sub-divisions of fuel and construction materials. In the former case, the total of barter sales attained a level of 60 % in 1998 and in the latter case, 67 %. Both these numbers represented an increase over the corresponding 1997 figures. What do these main offenders in terms of non-payment have in common? In general industrial sectors which are populated mainly by larger enterprises and which continue either in direct state ownership or under some high degree of indirect state control, show up as those where the incidence of barter and non-payment are greatest. Industrial sectors, which are more evidently private in nature and populated more by smaller units, seem to have a much lower incidence of barter and non-payment.
12. The strong and systematic differences in the non-cash percentages across sectors is consistent with the view that there are **instigating** sectors as far as the emergence and growth of industrial sector barter and arrears is concerned. Instigating sectors are those that have allowed their own financial positions to be undermined by non-payment or inferior forms of payment such as barter. In Ukraine as in Russia this dubious responsibility has clearly fallen on the Fuel and Energy Sectors and to a lesser extent on the sector of Construction Materials. In this Report we have not examined the hypothesis that the barter arrangements have been imposed mainly on the most solvent enterprises, rather than weak (insolvent) ones. This view has certainly been advanced in respect of Russian enterprises.
13. Either one of these propositions is consistent with the viewpoint that the continued presence of barter and non-payment in the economy depends on government policies turning a blind eye to these arrangements if not openly encouraging them. Ukraine has never had an explicit government policy in favor of barter: i.e. a coherent well thought out strategy. But there certainly has been an **implicit** government policy sustaining barter and non-payment. This implicit policy involves a variety of separate and uncoordinated

decisions by a number of different organs and layers of government having some degree of residual influence over particular industrial enterprises (see also Box 2.1). This contrasts with a convenient popular point of view that barter and non-payment are inventions of private sector agents motivated by considerations such as tax avoidance.

Fig. 2: Electric Power Collection Rates(%) and Debts (Uah million), 1997-2000



B. The Special Problem of Energy Arrears

14. Most types of barter and other non-monetary transactions create credit between enterprises but these transactions cannot manufacture credit for the enterprise sector taken as a whole. That role of injecting net credit for the productive sector as a whole has to fall either on the banking sector or on the state sector broadly defined. We know from the analysis in the main Report that the banking sector itself provides only limited amounts of credit. It is likely therefore that the ongoing infusion of credit into the system – the infusions needed to sustain the large overall increases that we see - has depended very much on the support and the injections of **state accommodation/credit** of one form or another. A crucial role in this infusion has come from the power sector in the form of enterprise and others debts to the oblonergos and, from there in the form of the rising energomarket debts to the power generating companies. (see Box 2.1 for one explanation of the history behind this). In this context the parallels with Russian experience are clear and alarming. Commander and Mumssen in a recent EBRD paper have shown that

- overdue receivables in the electricity sector of Russia rose from the equivalent of 0.7 % of GDP in 1994, to over 3 % by 1996 and to more than 6 % of GDP by 1998. In the case of Ukraine, the oblonergos debts to the energomarket amounted to about Uah 1.5 billion equivalent to about 2 % of GDP in 1997 but by end-1999 these debts amounted to Uah 6.7 billion which is equivalent to around 6 % of GDP – see the left hand scale of Fig. 2 above.⁹
15. The new government appointed in December 1999 made a serious and concerted attack on this problem. In particular, it achieved conspicuous success in increasing the cash element of payments for electricity. For example the ratio of obloenergo cash collections to their total sales rose from less than 10% in December 1999 to over 50% by mid 2000 and further rises from that point were also sustained through the Spring of 2001. The requirement of the 2000 budget that local authorities settle their claims to energy companies mainly in cash, has caused some decline in cash payments for other purposes including wages. But even so the cumulative balance of outstanding arrears of energy payment continued to rise albeit at a slower rate. By March 2001, the total outstanding to the obloenergos exceeded Uah 10 billion: the equivalent of 5.7% of estimated GDP for the year 2000. So in spite of undoubted improvements through 2000-2001, the arrears now accumulated in this sector are still of the same order of magnitude as the credit injection into the Russian economy represented by arrears in their power sector. By any standards it is a huge number in both countries. In Ukraine it compares closely with the amounts which the domestic banking sector has been able to make available to the enterprise sector (see Section 2 of the main Report). Bank credits to the enterprise sector in some years have been less than the credits provided by the infusions of money from unpaid electricity bills. This means that the rising volumes of arrears in the power sector have created a parallel credit circuit which in absolute terms rivals the credit coming from banks¹⁰.

C. Barter in Agriculture

16. Information on barter and non-payment in agriculture is less widely discussed but several useful studies are now available.¹¹ It is well known that a significant proportion of Ukraine's agricultural producers are effectively bankrupt and so have limited ability to make payments for supplies in a timely fashion (see Table 3). They are constrained in terms of both their liquidity and their access to credit¹². This results in a high incidence of dependence on barter and related forms of non-cash payment in the sector. These problems are probably most acute in the large agro-processing enterprises which are

⁹ The right hand scale of that same figure 2 indicates the percentage cash collections achieved by the obloenergos and the generators respectively. Prior to 2000, these cash collection rates were typically about 10 % of total sales.

¹⁰ It would follow that the one-shot eventual correction of this problem of arrears – often misrepresented as a narrowly-based technical problem - would in reality be the equivalent of a major credit crunch of the type caused by a huge percentage decline in available bank credit.

¹¹ See for example, D. Van Atta, D. Newbert, I. Plakhotnik. "Barter in Ukraine's Agriculture" *Ukraine Economic Trends*. UEPLAC. March 1998; Bilyk Yu.D. "Barter: Causes, Problems, Ways of Elimination" *APK Economics*. 1998.; I. Zhilyaev, "Fiscal and Pricing Policy in the Unsteady-Price Economy (Using Agriculture as an Example)". Research-Analytical Materials. GIMR. January, 1999; Shtrive L., Sh. von Taubadel. K. Sirin. "Financing the Agrarian Sector: Status and Ways of Overcoming the Existing Problems" *Advanced Research*, no. 15 *Agrarian Reform*, ICAS, January, 2001, et al.

¹² Prior to the 1999 reforms some 15 % of farm land in Ukraine was cultivated in individual or family farms and most agriculture remained effectively collectivized despite the new organizational forms (joint stock companies, limited liability partnerships, collective enterprises and co-operatives) that emerged after 1992. There were about 38,000 small purely private farms but these accounted for only 2 % of all agricultural land. Source: World Bank, *Review of Agricultural Restructuring Experiences*. May 1999.

included in the statistics for the industrial sector, and in the state farms (kolkhoz). In the case of the kolkhoz, the development of barter dependence appears to have followed broadly the same time pattern as in industry (see Table 1 and Box 2.1). One difference is that since the Soviet times, collective agricultural enterprises (CAE) operated almost without money - i.e. mostly using barter arrangements. The state would commandeer the agricultural produce of the CAEs and would then supply them with machinery, fuel, fertilizers, etc., within contracts based on administratively set quotas and prices. The state would also write off CAE debt to the state annually. Individual collective farmers would also be paid mostly in-kind. All this testifies to the persistent and traditional existence of barter arrangements in the agricultural sector.

17. In publicly-owned agriculture, the share of total sales executed on a barter basis rose to 23.4 % by 1997 and then again to 26.2 % by 1998.¹³ In addition, a sizeable share of agricultural produce is made available to the population on a barter basis as part of the payment for work and the property right transfer mechanism - for greater detail, see later sections of this Annex. These various arrangements combined suggest that between 50-75% of some individual agricultural products were “sold” using barter arrangements during the period of 1996-2000.¹⁴ The recent agrarian reform has not injected any new cash into the sector – it has largely involved vouchers and paper transfers. (in the year 2000, 11,700 or 99.5% of CAEs, were reformed, and 14,700 new agricultural entities came into being). So the extent of barter in agriculture remains high. According to Derzhkomstat data, in the first 11 months of 2000, agricultural enterprises bartered 38 percent of the total sunflower seed sales, 33 percent of sugar sales, 27 percent of grains, 18 percent of sunflower oil. In January through February of 2001, these numbers were 22 percent sugar, 13 percent grains, 11 percent sunflower seeds, and 10 percent of vegetable oil, respectively.
18. A major economic problem arising from the continued use of barter trades is the **distortion of pricing** that occurs. Because large volumes of agricultural produce are bartered at prices divergent from market ones, price structures typically involve large elements of arbitrariness. In 1999, for example, the country-wide prices of the bartered vegetables, flax, and wool, were 40 to 60 percent lower than the prices at which these commodities were sold to procurement organizations, while the prices of livestock and poultry, potatoes, melons and gourds, oil-bearing crops were 8-14 percent lower, and for sugar beet, milk, grapes, and tobacco they were 5-7 percent lower. Moreover, the large amounts of produce transferred to farm workers as in-kind wages had a value in most cases, 10 to 60 percent lower than the procurement price.
19. Official data report the share of barter sales in agriculture generally accounting for between 16 % of all sales in the case of livestock rising to 54 % in the case of sunflower seeds. The World Bank’s 1999 study on Farm Restructuring show even re-organized farms as having accounts payable equal to 11 % of their 1998 total liabilities and equity (up from 6 % in 1996).

¹³ More specifically, in 1998 barter accounted for 33 percent of grain crops, 54 percent of oil crops, 46 percent of sugar, 56 percent of potatoes, and 17 percent of vegetables.

¹⁴ Equally, the state controlled parts of the agricultural sector comprised as they are of larger units of production are also the most implicated in the parallel credit provided by fuel and power companies. A variety of special laws and decrees have added to the problem of non-payment in agriculture. For example, the May 1997 Law On the Suspension of the Decline of Agricultural Production and Foodstuff Provision, deferred the repayment of arrears of agricultural enterprises for a period of 5 years. A 1998 Presidential Decree cancelled fines and sanction for late payment to the budget, the Pension Fund and Social Fund accrued as of January 1, 1998.

20. The total debt of Ukrainian agricultural enterprises is extremely large in spite of frequent write offs of the part of that debt due to state organizations. Prior to the writing down the state debt, the cumulated amount of debt incurred by agricultural enterprises over recent years has equaled or exceeded the total value of the annual sales of these enterprises. Even after the write offs, the outstanding arrears of these enterprises to the state stood at about 8 percent of the GDP in 1999, and at 7.2 percent of the GDP in 2000.

Table 3: Debt Burden of Ukraine’s Agricultural Enterprises, Uah ‘000

	1996	1997	1998	1999
Average CAE debt	603.4	848.9	1 137.1	1 236.7
Average CAE debt balance after writing-off the debt to the state	429.2	562.3	676.8	763.7
Average debt per ha of plough-land	228	332	455	496
Average debt per ha of plough-land after writing off the debt to the state	162	220	271	306

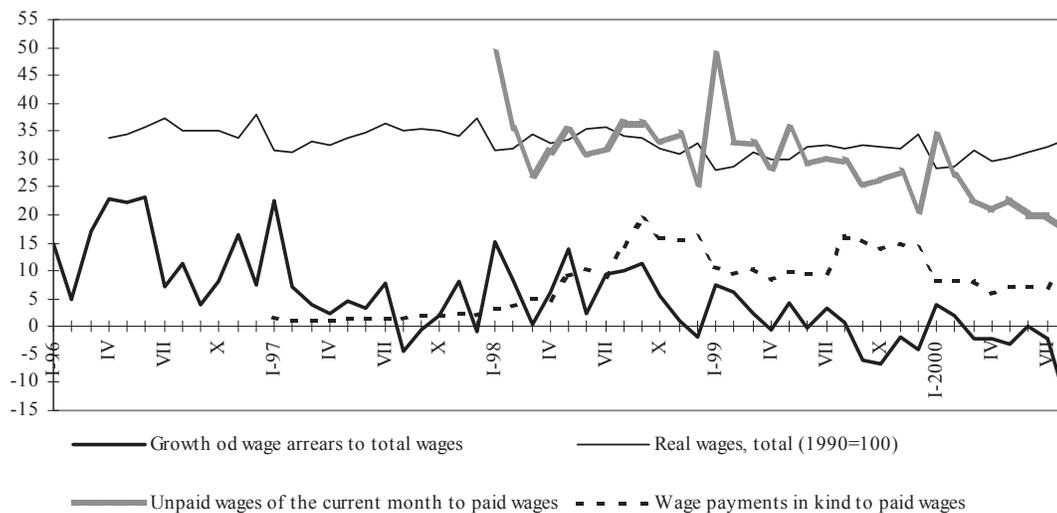
Source: L. Shtrive, Sh. Von Kramon-Taubadel, K. Sirin. Financing the Agrarian Sector: Status and Ways to Overcome the Existing Problem, Advanced Studies (Perspektivni doslidzhennia). № 15 “Agrarian Reform”. ICPS (MIPII). January, 2001

21. Until two years ago one common form of barter involved the trading of certain types of agricultural exports. Specifically, the future delivery of export receipts were pledged against the up-front provision of key inputs such as seeds and fertilizers. Large international agro companies such as Cargills and Monsanto were the main sources of this credit. However, unlike domestic arrears where the credit source is, for example, a local enego, these international barter deals face an obvious credit limit – the willingness of the foreign suppliers to continue to provide new-season credit when payments for early season loans have not been re-paid. In fact of course the routine interference of oblast and other officials in commercial export transactions has resulted in recent years in a high level of non-payment of these international credits. In the 1998 crop season this precipitated the withdrawal of the large foreign suppliers from the Ukrainian market. In the 1999 crop season, alternative domestic financing of the inputs was arranged via the state – some of it via the direction of credit through Bank Ukraina and other large banks. The undesirable consequence of this is that the pledging of future production to the state as the security for these up-front credits looks to all intents and purposes like the re-establishment of the state-orders system which was supposed to have been abolished in 1996.¹⁵ Given the poor repayment record of the borrowers this is also an obvious burden on financially weak banks such as Bank Ukraina.

D. Wages in Kind and in Arrears

22. In spite of recent government efforts to reduce the large backlog of wage arrears, the actual level of those arrears has also remained high (see Figure 3). Through 1999 and 2000 the situation seemed to stabilize but even so the total by year end was still in excess of Uah 5 billion. The government has been directly implicated in this major social problem. For example, in 1999 the government’s own arrears of wage payments amounted to almost Uah 3 billion with a further Uah 1 billion of arrears of social insurance payments to households. Financially distressed Ukrainian enterprises and farms (or enterprises claiming such distress) have shown a high propensity to delay or default

¹⁵ The dismantling of the state-orders system in agriculture was one condition of the World Bank’s Agriculture Sector Adjustment Credit which was approved in 1996.



on wage payments or to deal with such obligations by resort to barter – paying wages in kind.(see Figure 3)¹⁶ In 1997 in-kind wages amounted to 6.2% of wages paid in industry and agriculture and this percentage more than doubled to 12,6 % in 1998 before dropping slightly in 2000 (Table 4).

Figure 3: Changes in wage indicators in Ukraine, 1996-2000 , %

Wages calculated and paid

23. Through the 1990s, wages non-payment or payment delays became *another de facto* mechanism to achieve the reduction of real wages of the population in the process of economic transformation¹⁷. The 14% decline in real wages between 1995 and 2000 was mirrored in wage arrears which were typically 20% or more of the total wages actually paid¹⁸ and in-kind wage payments which were typically around 10% of that total. Between 1995-2001, a sizeable proportion of all employees continued to make some use of the wage delay mechanism.¹⁹ The largest volumes of arrears on wages were recorded in June-August, 1999, when the total amount of arrears exceeded Uah 7 billion (equal to almost three months wages). Wage payment delays have even been argued to have been a key element of the country's "financial stabilization"²⁰. It is also noteworthy that there has also been a persistent seasonal and political pattern to the wage arrears increase relative to wages actually paid.
24. More than two thirds (Uah 3313 m) of the total current (January 2001) wage debt is attributable to enterprises, institutions, and organizations **not** in the state sector. Of these, about one third are joint-stock companies. During the year 2000 arrears on wages

¹⁶ Numerous normative and legal acts establish employer responsibility for wage arrears and provide for a compensation mechanism for an employee which should mitigate delays in the payment of wages and other social benefits. Under the Regulation of the Cabinet of Ministers of Ukraine of 12.20.97, #1427 (with changes and amendments introduced by the Regulation of 04.23.99, #692), in paying out arrears on wages, enterprises and organizations shall also pay the workers a compensation for the loss of a portion of wages due to delay in its payment. The Law of Ukraine "On the Compensation to Citizens for the Loss of the Portion of their Income Due to the Violation of the Terms for the Payment of the Latter" has established a procedure for the compensation to citizens of a part of debt on those social benefits that will form after January 01, 2001.

¹⁷ See: "The Concept of Wages in the Context of Ukrainian Economic Reforms", *Ukrainian Economic Trends*, Ukrainian-European Policy and Legal Advice Center. Quarterly Issue March 2000. P. 42 - 47, Internet (www.ueplac.kiev.ua)

¹⁸ Paid out wages are defined as the current month's wage payments plus the retirement of arrears in that month of previous period wages.

¹⁹ State statistics agencies conduct the monthly recording of arrears on wages starting from September, 1996.

²⁰ V. Muntian. Economic security of Ukraine (Економічна безпека України). К.: 1999, p. 228

decreased by about 20% in state-owned enterprises as one element of the generally greater state discipline regarding payments. However, as Figure 3 illustrates, changes in wage arrears have been prone to influences coming from political events. For example, there was a significant pay-down of wage arrears through much of 1997 in the period prior to the last Parliamentary elections. A similar pay-down is evident in the period leading to the Presidential elections in 1999. But the new government after October 1999 was the first to sustain these reductions. There is also a significant seasonal dimension to the wage element of arrears. The highest levels of outstanding wages relative to wages actually paid is observed in January, and the lowest level is observed in December. This is largely due to the increase in December wages owing to one-time payments based on the year-end performance and to the seasonal increase in work hours. Finally, it can be noted that the budget as well as individuals suffers significantly from the widespread use of wage delays. According to the calculations of the Audit Chamber, Olivier-Tanzi type effects of delays in the taxes associated with late payment of wages costs the budget almost Uah 322 million²¹ in lost revenues in 1997.

	1996	1997	1998	1999	2000
Real GDP (1995 = 100), %	94.0	94.0	91.0	90.0	94.7
Average nominal wages (1995 = 100), %	171.0	193.8	207.8	241.2	286.9
Real wages in the economy (1995 = 100), %	94.9	92.7	90.0	85.1	86.7
Wages share of GDP, %	50	53	49	46	47
Arrears on wages % of GDP	4.6	5.3	6.4	5.1	2.8
Wage arrears change (December to December), times	6.5	1.2	1.18	0.98	0.77
Arrears as % of paid wages.	18.0	20.4	25.5	21.7	12.5
In-kind payments to paid wages, %	4.7	6.2	12.6	12.3	9.0

Note: by period-end
Source: Derzhkomstat of Ukraine and UEPLAC calculations, I. Zhilyaev's estimates

Table 4. Characteristics of Work Payment in 1995-2000

Wages paid in-kind

25. In Ukraine today wage payments in-kind have come to be regarded as one of the simplest ways to contain arrears on wages. In 1998-99, for example, one in eight hryvnia paid out in wages was in the form of a “commodity” payment. To a great extent, the sharp jump in this commodity payment element since early 1998 (see Figure 3). is what has made it possible to improve the previous negative dynamics of arrears on wages. Of particular relevance here are non-cash wage payments in agriculture. In 1999, workers of agricultural enterprises received almost Uah 2 billion, or 56.8 %, of the wage bill in the form of agricultural produce. The barterization of employer-employee relations also covers the social sphere - pension payments, and other social benefits - on an ever increasing scale. In particular, commodity provision is widely practiced in paying pensions. In 1999, pensions paid in kind amounted to Uah 627 million.²² Over the first nine months of 2000, pensions paid in kind amounted to Uah 174.5 million.²³ Supporting this system is a network of almost 8,600 shops and shop departments where goods are

²¹ Analysis of the execution of the State and Consolidated Budget of Ukraine in 1997. Audit Chamber, 12.10.98.

²² Sotsialniy zakhist, 2000, № 2, p. 18

²³ Pratsia I zarplata, 2000, № 41, p. 10

- provided to individuals against the repayment of wage and pension debt^{24 25}.
26. Arithmetically, it was the increase of pensions paid in kind that allowed the reduction of pension arrears in the run up to the election in 1999. Specifically, the volume of pensions paid in kind in 1999 was equal to the volume of the reduction of pension arrears. In 1999, pension arrears dropped from Uah 2013 million to Uah 1359 million, or by Uah 655 million.
 27. Another recent novel event that further evidences the institutionalization of non-payment was the 2000 land reform. This resulted in new types of barter payments to the rural population. Specifically, the reduction of the wage debt to agricultural workers of Uah 520 million in 2000 was achieved by adding part of this debt to the notional property shares of individuals which they acquired in the process of the reform of collective agricultural enterprises. Barter sales to peasants were also made to cover lease payments for their land plots and property shares.²⁶
 28. The social-and-psychological effects²⁷, and the reactions of different groups of workers to the fact that wages and social benefits are paid in goods are complex but also important. Most workers and pensioners prefer payment-in-kind to the long delays of payments (with many premonitions and doubts, whether these payments will occur at all). The authorities are less happy since the state knowingly loses real tax revenue from individual income tax.²⁸ This affects especially local budgets, to which almost 2/3 of this tax accrued in recent years. In terms of amounts, this loss is comparable to the aggregate annual income of an “average “ oblast like Cherkassy.²⁹ In addition, in using such approaches to wage and social benefit payments, local authorities run into big problems of receiving cash payments for the communal and housing services they provide to the population: if the public receive no cash wages they can hardly be expected to make payments in cash for services received. Problems arise also because the propagation of this practice causes both a drop in the quality and the padding of the prices of the goods and services with which settlements are made to workers. In these ways, enterprises shift their own financial problems (and sales costs) onto their workers. Particularly irritating for the population is the inferior quality of the barter goods and their overpricing. Economic reform is adversely impacted because a large new quasi-state and anti-market system for the “rationed redistribution” of essential goods and commodities has emerged.³⁰ The authorities seem to have given little or no thought to the substantial

²⁴ A relevant list of 25 goods' groups, that shall not be subject to in kind wage payment, was approved by the Regulation of the Cabinet of Ministers of Ukraine Regulation of 04.03.93, № 244 (amendments and changes were introduced by the Regulation of 04.03.96, # 400). It is important that included in the list have been such types of goods, as foodstuffs (except for sugar) and non-food essentials, construction materials and timber, etc. This list is largely ignored by enterprises, and the authorities often “close their eyes” to violations of these Regulations. However, the authorities make no haste in aligning these regulations with the changed requirements of the time and economic conditions.

²⁵ Uryadoviy kurier, 24.09.99

²⁶ On the social and economic situation in Ukraine over January - February, 2001. K., Derzhkomstat Ukrainy, 2001. p. 38

²⁷ See Gordon L. Когда психология важнее денег. Социальное и социально-психологическое значение задержек заработной платы и пенсий в России 90-х годов (When Mentality is More Important than Money: Social and psychological implications of wage and pension payment delays in Russia // Mirovaya ekonomika I mezhdunarodniye otnosheniya, 1998, №№ 3 and 4

²⁸ Assuming that workers who receive wages in goods are not paying tax on income, whose average 1997-99 rate was 1/8 of the wage bill, and taking into consideration that the amounts of barter wage payments stood at Uah 3624.3 million in 1999, one can conclude that these losses equal roughly almost Uah 400 million.

²⁹ The Cherkassy oblast income in January - December, 1998 (without taking into consideration the funds obtained through offsets and subsidies) was Uah 403.5 million.

³⁰ Using special points-of-sale network, a pensioner or worker will be forced to accept a certain line of goods or services at administratively set prices or rationing norms.

economic costs incurred in the creation and operation of such as infrastructure. Overall, the policy of encouraging barter payments to the population shows that the state, while trying to solve a crucial problem of large social arrears, has created a variety of negative side effects including lost revenues and various social tensions as well as new types of economic inefficiencies

E. Government Arrears and Mutual Settlement

29. As has been argued above, several dimensions of the barter and non-payment problem are accounted for in part by some pressure or tacit involvement of the local and, to a lesser extent, the national governments. But obviously the main evidence of official involvement in these pervasive practices is the direct participation of the state itself. This has two main dimensions. First, the government has been actively involved in the growth of arrears both on the payables side (mainly wages and pensions) and on the receivables side of the account (mainly tax arrears). Second, the government particularly at the local level has increasingly allowed the settlement of tax payments to be made in-kind either directly (by accepting actual goods in lieu of cash) or indirectly (by accepting the veksel issued by some third party as the means of settling tax obligations). Governments came and went promising to eliminate wage arrears, non-payments, barter, and offsets. However, none has succeeded fully³¹. The practice of non-monetary settlements between economic entities and budgets at all levels proliferated at least until 2000. In 1998, for example, they accounted for almost 30% percent of revenues in Ukraine's consolidated budget, or 9.2 percent of GDP.
30. Financing the State Budget of Ukraine via non-monetary operations has continued to employ many of the following arrangements:
- small-scale offsets pursuant to special Government decisions involving budget-supported institutions and Treasury veksel for the settlements of tax liabilities, and the funding of, for example, coal sector enterprises which provide coal for state needs;
 - early redemption of domestic and external state bonds contingent upon the fulfillment by economic agents of their state budget liabilities (Regulation of the Government of 11.20.2000);
 - reimbursement of VAT obligations at the expense of meeting the budget creditors' debt from the budget (Regulation of the Government # 2215 of 12.07.1999);
 - netting operations on "extrabudgetary items" (state budget revenues and expenditures of these items are not shown in the budget plan targets and the budgets of state budget-funded institutions). Article 60 of the Law on the state budget for 2000 provided for the netting operations to repay debt for energy resources, water supply and water drainage, as well as the debts of the armed services for military property purchases and works performed for or services provided to them. The action of this Article applies to payables that arose as of January 2000 and to current operations of energy resource suppliers. Article 71 of this Law also provided for the repayment of coal enterprise wage arrears of Uah

³¹ For greater detail see: Barter economy: non-cash operations in the budget sector of Ukraine. K. Harvard International Development Institute (HIID), 2000

1.5 billion. According to the State Treasury Department data, under Article 60, by the end of 2000, the State budget of Ukraine had performed transactions worth Uah 7.5 billion, and under Article 71 transactions worth Uah 328.7 million. The non-cash State budget settlement habit also applies to local budgets.

- completion of non-monetary transactions on the accounts of budget fund managers began in 1999 (pursuant to the Government decision of 02.18.2000, # 91);³²

Box 2.1: The Barter of the Bankrupt

In the days of the Soviet Union barter arose from repressed inflation and the inconsistencies between production and credit plans. Essentially barter in those days was a function of the inadequate purchasing power of the partitioned money (e.g. qualified access to enterprise “own funds”, bank accounts and cash) made available to Soviet enterprises. Given the dominant status of production, producers were typically excused for using barter methods to achieve the inputs needed to meet plan targets. Price liberalisation in 1992 was widely expected to eliminate this form of barter.

In its place in the main post-Soviet republics of Russia and Ukraine has emerged a new form of barter referred to by David Woodruff in his book *Money Unmade* as the Barter of the Bankrupt. It evolved in the following stages.

1. Price liberalisation combined with efforts to tighten money (later in Ukraine than in Russia) initially met strong resistance from the “directors corpus” of large SOEs arguing for the unlimited printing of money to maintain their out-moded enterprises. In Russia after June 1992 and more obviously in Ukraine this lobby group initially won the day. So subsidies to enterprises came via money creation thereby diminishing the need for support at oblast and lower levels.

2. Huge price increases, 1992-94 arose from trade between large SOEs with no determined equilibrium price (given universal soft-budget constraints). Following Soviet practice, these trades were funded via automatic inter-enterprise credits under the “payments order system” and accumulated under the Kartoteka 2. The production-oriented mind-set of most lobbies saw non-payment of these balances as evidence of the need for more monetary injections - not arguments for bankruptcies of non payers. But reformers in Russia generally rejected “debt-clearance” operations.

2. The next stage was when accumulating non-payment, especially when money started to be tightened (1993 in Russia, 1994 in Ukraine) created huge enterprise problems in making payments in cash (especially wages) and fiscal problems in that non-

4. By mid-1993 in Russia and late 1994 in Ukraine the willingness of enterprises to absorb increased debt was undermined laterally (failing belief in an eventual debt clearance to compensate them for unpaid credits) and vertically (government’s increasing unwillingness/inability to offer the necessary subsidies as an alternative to debt clearance, including cheap money/seignorage).

5. From 1993 in Russian and late 1994 in Ukraine, non-payments for electricity and fuels started to accumulate to become eventually the dominant element in rising non-payments. Initially the power companies’ ability to deduct direct payment from customers’ banks (the card-payment system) ensured high rates of collections. But from early 1993 in Russia and 1995(?) in Ukraine, many large enterprises had exhausted their bank accounts as they failed to sell large parts of their outputs. Disconnection was not a seriously considered option for (i) companies that were thought to have prospects or (ii) were large in the local area and whose closure (the logical consequence of losing access to electric power and/or gas) was ruled out by strong local political pressures. The local political pressures defending non-payments by distressed enterprises was critical at this stage.

6. Alternative “payments” arrangements developed. These were in effect price concessions provided by power companies via their increasing willingness to accept *over-valued barter* or non-payment. Actual price reductions were ruled out by administrative and rigid price setting partially influenced by rules from the State Tax Administration. The downward price rigidity of un-wanted manufactured products also encouraged manufacturing enterprises to barter these away especially where *over-valued barter prices* were available.

7. Major recipients of barter goods faced major problems in disposing of these given the apparent problems in lowering prices below the accounting prices set by administrative authorities. (essentially cost-plus mark-up pricing). This stimulated the proliferation of second stage barter and credit deals which served to obscure the real selling prices. See also Box 2.2.

8. Power companies were and remain easily milked by local administrations anxious to save bankrupt local enterprises. This is because (a) collective action against them was easy (the directors corpus) and they had few obvious political allies, and (b) because these companies were perceived as resilient to even seriously eroded financial viability

³² T. Vakhnenko. “Non-monetary Budget Execution Forms: Evaluation of the Current Situation and Analysis of Economic Implications”, Trends in Ukraine’s Economy. UEPLAC. October 2000.

(e.g. social protection in cold winters remains a key political imperative and so is a key part of the barter/non-payment syndrome).

9. Equally oblasts administrations saw no political advantage in expediting the exit of large local bankrupt enterprises. The ability to see the advantages of such exit resided, if with anyone, with those capable of seeing the big national picture i.e. central administrations in Moscow and Kiev. This local perspective also accounts for the gradual oblast acceptance of more tax payments in kind once the bank accounts of bankrupt enterprises were empty and could no longer be directly accessed by the tax administrations.

10. Around 1995, sectoral elites (supported often by international agencies) increasingly demanded relief from the effects of barter practices originating with de-centralized local decisions. This then led to the multiplication of surrogate monies – vekselns of various types – and to the increasing involvement of national governments and agencies in what started as a local problem. See also Box 2.2.

31. The good news of the period since late 1999 is that the situation as regards the payments arrears of government (both payables and receivables) have shown a significant improvement: particularly as regards social obligations such as wages and pensions. The situation is summarized in Table 5. below.

Table 5 Government Arrears of Payments and Receipts (Uah billion)

	1996 Q1	1996 Q4	1997 Q1	1997 Q4	1998 Q1	1998 Q3	1999 Q4	2000 Q4
Arrears by Government								
State government	2.2	4.0	3.9	3.7	3.4	3.3	3.0	n.a.
Local government	4.0	9.5	11.8	12.7	12.2	14.2	n.a.	n.a.
Consolidated budget	6.2	13.5	15.8	16.4	15.5	17.5		
Of which Wages	1.2	3.2	3.7	2.3	2.3	2.8	0.5	0.3
Arrears to Government								
Taxes	3.0	4.0	5.0	6.9	8.3	22.4	11.8	10.3
Of which Enterprise Taxes	2.2	3.1	3.5	4.0	5.0	13.1	8.0	7.1
Pension Contributions	2.2	4.3	4.9	6.9	8.2	9.6	1.3	1.3
Total	5.2	8.3	9.8	13.8	16.6	32.0	13.1	11.6

32. Several points are apparent from this table.

- The most significant expansion in the state's arrears of payables, at least through end-1998 came from local government³³: the total increase at least through the end of 1998 being very substantial and the total arrears at that stage being equal to over 40 % of the total budgeted expenditures.
- Budgetary institutions have been significant beneficiaries of the non-payment to power and heating companies referred to earlier. The absolute size of that non-payment increased relatively slowly, and was almost eliminated by 2000.
- There has been a significant net credit extension by the government to the enterprise sector. Even considering just the tax arrears attributable to the enterprise sector, the total rose to over Uah 13 billion by end-1998 (Uah 7 billion by 2000) and unpaid pension contributions (most of which are attributable to enterprises) added a further Uah 10 billion. The total of these items was the equivalent of circa 20 % of GDP and, as in the case of the arrears of enterprises to power companies, is an amount which is high relative

³³ One of the underlying causes has to do with non-money state budget settlement with local budgets. Thus, in 1999, overall receipts of local budgets were Uah 16.1 billion, while the state budget has provided subventions to local budgets of Uah 3.7 billion, including treasury vekselns of Uah 3.4 billion, and money funds of the total of Uah 230.5 million (Analysis of the execution of the State budget of Ukraine in 1999. K: Audit Chamber, Issue 18. 2000)

- to the formal credit provided by banks to enterprises. Hence the elimination of these arrears as begun in 1999 would also constitute a major credit crunch on the enterprise sector.
33. The bad news is that the data to substantiate some of these developments is far from robust and reliable. This applies in particular to arrears as between enterprises and the budget where data is compiled both by the State Tax Administration (tax revenues); by the State Committee for Statistics (using balance-sheet data) and by the NBU (using payment documents). According to the NBU,³⁴ in January 2001 more than 156,000 enterprises had some sort of debt still outstanding to the budget. The amounts they record are almost **five times** the level recorded by the STA (as shown in Table 5) and more than twice the amounts recorded by the Statistics Committee. Similar but less dramatic differences are apparent in the data for amounts payable by the budget. This suggests that a statistical reconciliation exercise is a necessary pre-cursor of any systematic attempt to resolve the remaining problems of budgetary arrears. The other negative news is that the successes of the past two years are associated with increased resort to non-payment devices other than arrears.
34. As regards the mutual settlement of tax debts this is a phenomenon of just the last 5 years since when these debts have become endemic with over 10,000 transactions a year taking place.³⁵ As Box 2.1 clarifies, it is mainly a phenomenon associated with sub-national governments. In 1998 the authorities collected 29.2 % of their tax revenues in this way.³⁶ Then as part of the IMF agreement in the last quarter of 1998, there was a ban on the further use of mutual settlements and they declined to only about 20 % of local tax revenues by early 1999. But this decline was short-lived - by mid-1999, the percentage was back over 40 % and this increase provoked a new 1999 decree prohibiting the use of veksels in mutual settlements. The situation now is that mutual settlements seem to be tolerated provided that they are not institutionalized in the form of veksels – something that is not absolutely essential in any case. Periodic prohibitions are unlikely to solve the problem because they fail to go to its root causes.
35. These arrangements of arrears and mutual settlement subsidize enterprises in several ways. A first example arises from the frequent over-statement of the prices used in mutual settlements relative to market prices (see below for more details). A second example arises from the periodic write downs of arrears of payment which the government seems prepared to accept. Ihor Zhylyayev notes that significant amounts of enterprises' arrears to the state have been written off and restructured in most recent years, e.g. Uah 5.4 billion (5.8 % of GDP) in 1997 and Uah 3.8 billion (3.7 % of GDP) in 1998. Who are the main beneficiaries? Pinto and others put forward an interesting proposition for Russia which is almost certainly valid also in the case of Ukraine.³⁷ This is that the biggest providers of implicit subsidies through non-payment namely the energy companies get their recompense in the form of the greatest leniency in terms of tax arrears or favorable deals on tax offsets. This also explains (credibly) why the government has and will continue to have major problems in enforcing tax discipline:

³⁴ See: Natalia Lapko, Tetiana Lukianova. *Reduction in Arrears of Budget Payments. Some Aspects of the Problem.*// Herald of the NBU, #3. 2001. P. 41-43.

³⁵ Audit Chamber reports 13,500 separate transactions in 1997. No firm data are available for later years.

³⁶ In the first six months of 1999 the ratio of mutual settlements to total tax revenues varied between 53 % in the Rivnenska oblast to 5 % or less in Zaporizha and Odessa oblasts. The average across oblasts was 26 %.

³⁷ Brian Pinto and others, "Dismantling Russia's Non-Payments System: Creating Conditions for Growth", World Bank Memo, September 1999.

how can it succeed when the greatest offenders are also doing the most to provide the implicit subsidies to failed enterprises?

Explanation – Why have these transactions become so important?³⁸

36. A variety of explanations can be put forward to account for the large absolute importance and increasing role of non-traditional payments in the economy. Since these are collectively damaging to the prospects for the emergence of a larger and sounder formal financial sector, these underlying **causes** (not just symptoms) need to be addressed directly as part of a broader strategy for the sector. The conventional wisdom in Ukraine strongly links the non-payment phenomenon to the avoidance of tax. Local authors have been critical of foreign studies which have down-played this explanation.³⁹ The evidence reviewed for this report and especially the historical evolution of the problem (see Box 2.1) leads it also to argue **against** the tax avoidance argument as the main explanation.⁴⁰ Instead, and more worryingly, the phenomenon seems to arise from the present structural situation of Ukraine and especially from the continued existence of large numbers of mainly bankrupt enterprises which have achieved sufficient political influence (mainly at the local level) to avoid closure. Much of the barter and non-payment documented above derives from this basic fact.

Loss-making enterprises and the absence of a bankruptcy discipline

37. The most important and generic of the explanations is the absence of a working bankruptcy system⁴¹ combined with the political and social pressures to keep many of the country's largest loss-making enterprises alive. The reluctance of the state to force through the fundamental restructuring of value-subtracting state enterprises conspires with the inability of private creditors to achieve and enforce bankruptcy settlements on either private or state companies. It is probably the absence of a political will to enforce bankruptcy systematically rather than the quality of today's bankruptcy legislation which is the key factor in this equation. The consequence in any case is a large population of surviving but value-subtracting enterprises which have neither the wherewithal or the incentive to fully meet their obligations to other enterprises, to government, or to their

³⁸ An interesting examination of some of the main hypotheses pertaining to this is to be found in Viktor Lysytsky, "The Reality of Fictitious Value or How Much are Our Mutual Debts?" in NBU Herald, June 1999

³⁹ See for example, Serhiy Pivnenko in an unpublished paper entitled, "Economics of Barter" who criticizes the point of view argued by Commander and Mummsen. The essence of the argument is that the rules on barter taxation are based on the concept of *zvychainy* (normal prices). In Ukraine there are at least four different definitions of *zvychainy* issued respectively by the Rada, the CabMin, the Presidential Administration and the State Tax Administration. He argues that this gives participants in barter deal a great deal of scope for manipulating their results and their tax burdens.

⁴⁰ There is a great deal of evidence, once barter, mutual settlements, veksels etc. become an accepted part of the scene after 1995, that innumerable practices emerged which had the effect of using these arrangements to avoid or reduce tax obligation and to achieve "illicit" profits of one sort or another. But the existence of these dubious practices does not prove that they constitute the initiating motivation for the parallel payment practices. See Box 2.2 for examples.

⁴¹ The Supreme Rada approved a new law On the Restoration of Solvency of the Debtor or Declaring it Bankrupt, in 1999. This was a significant step forward instituting as it did a clear set of arrangements for the reorganization of insolvent companies rather than their liquidation. However, the potential inherent in this new law has yet to be put into practice and there are numerous practical problems to be resolved including the legal interpretation of certain clauses (including the tests to establish bankruptcy that the courts need to consider) and the training of adequate numbers of bankruptcy practitioners.

work-forces. Some **victims** of the resulting non-payment, or qualified payment, paradoxically often have quite strong incentives to accept the losses and inconvenience that they themselves suffer as a result of this failure of the enterprise restructuring process. This is true where the alternative to accepting, say, barter payment may be the exit of the partner enterprise (the debtor) and the loss of all prospective business with that enterprise. In the case of households and their arrears of wages, payment in the form of goods which may be more or less saleable is often preferable to no payment at all. Other victims may be less willing to accept barter or similar “payments” but are politically pressured to do so and have insufficient bargaining power to resist these pressures.⁴² The suggestion above is that electricity power companies may be the most important example of this phenomenon. (see Box 2.1)

Substituting for credit and explicit subsidies

38. A second but related reason for the proliferation of alternative payment, or non-payment arrangements, could have to do with one of the macroeconomic successes of the mid-1990s namely the phasing out of direct fiscal subsidies to sick enterprises and the generally very tight stance of monetary policy referred to in Annex 1. There is clear evidence that as these policies began to bite and cause cash flow difficulties – either through the cost or the availability of credit – the enterprise response has been to wriggle around the resulting constraints by resorting more and more to informal financing. Figure 4, for example, shows the relationship between the levels of inter-enterprise arrears and the real interest rates on commercial bank loans. It is evident that the increasing tightness of the formal fiscal and monetary policies coincided with increased usage of informal means of payment from 1995 and onwards. But this does not make these formal policies the **cause** of this development – it would **not** have been possible if the normal discipline on enterprises found in properly functioning markets had also been operating in Ukraine. Equally, in spite of a tight monetary stance in most recent years, the growth rates of the main monetary aggregates in real terms have been quite sufficient to more than match the real growth rates of economic activity. (e.g. M2 grew by more than 125 % in nominal terms and more than 50 percent in real terms between December 1996 and October

⁴² For example, from the standpoint of **government**: (i) it may be preferable to go along with the non-receipt or barter-payment of taxes from an ailing enterprise rather than having to acknowledge the zero receipts (or even government payments) which would be the direct result should the authorities exercise their right to close such enterprises; and (ii) the overvaluation of goods in barter transactions which is a well-documented feature of barter in the region³, provides significant opportunities to dispense hidden, and uncontested, subsidies to sick enterprises. For the same reasons it provides a significant window of opportunity for corrupt officials to enrich themselves by negotiating an excessively high value.

From the viewpoint of **households and the government**: (i) the incomplete receipt/payment of pensions, other social benefits and wages may be preferable to hearing/announcing the reality that the authorities can no longer afford payment of benefits and wages at their present levels and that some need to be cancelled in their entirety and (ii) the non-receipt or barter payment of wages by an ailing enterprises may be preferable to having to acknowledge the true reality that the enterprise is non viable, needs to close and so cannot pay any wages in future.

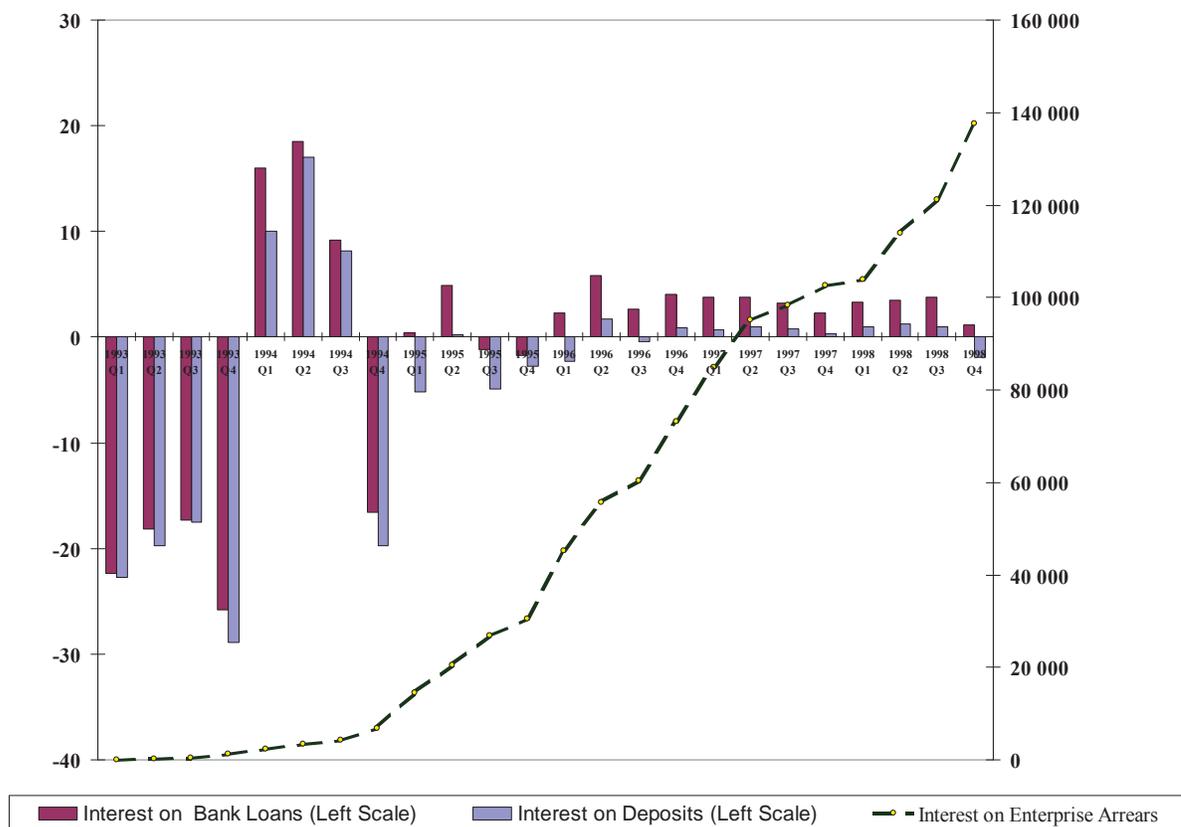
From the viewpoint of **enterprises**: (i) it may be preferable to go along with a barter-payment, or even a long-lived receivable, from an ailing customer rather than having to acknowledge the decline in the long term flow of business from that enterprise that would be the likely consequence of initiating bankruptcy. In a technical sense the alternative to barter is the extension of credit to the sick enterprise. But this opens up the creditor enterprise to considerable risk especially given the limited but expensive procedures for pursuing claims through the courts: (ii) the mutual acceptance of receivable/payables as between two or more of ailing enterprises may be preferable to the alternative of hastening the demise of either one by the other. This is especially true where both enterprise parties to a transaction are quasi monopolies in their own fields and so very dependent on the other in terms of either sales outlets or input supply; (iii) the over-valuation of goods in barter transactions can help some enterprises inflate the true magnitude of their total revenues and costs and so strengthen their potential bargaining position vis a vis government – larger enterprises being harder both to close and also to tax aggressively; and (iv) Once a barter/non-payment system gets as deeply entrenched as it seems to be in Ukraine, it becomes hard for any enterprise to defect from the system and insist on full cash payment for all goods and services which it supplies. Defection in such circumstances may seriously undermine the company's competitive appeal in the eyes of the other enterprises with which it seeks to do business.

1999).⁴³ Lysytsky and his co-authors make it very clear in their own analysis that the explosion of arrears cannot be seen primarily as a monetarily-caused phenomenon although it obviously has monetary consequences.

Deepening the Non-Payment Phenomenon: the Veksel Stage

39. The securitization (or vekselization) of the non-payment phenomenon can be argued to represent the maturing of that phenomenon and also to provide a mechanism – a set of marketable securities – which could provide the basis for the eventual elimination of a large chunk of the accumulated debts. In reality, as in Russia, this securitization seems instead to have multiplied the volume of effective alternative monies. At the same time it has increased the opportunities and the range of devices through which potential economic rents based on the existence of non-payment have been able to increase yet further. By so doing **it has entrenched the vested interests that benefit from these rents and added their political influence** to that of the legion of Ukraine’s distressed productive enterprises that were the initial beneficiaries. Consequently the phenomenon is much harder to dislodge. See Box 2.2.⁴⁴

Figure 4: Real Interest Rates and Accumulating Arrears



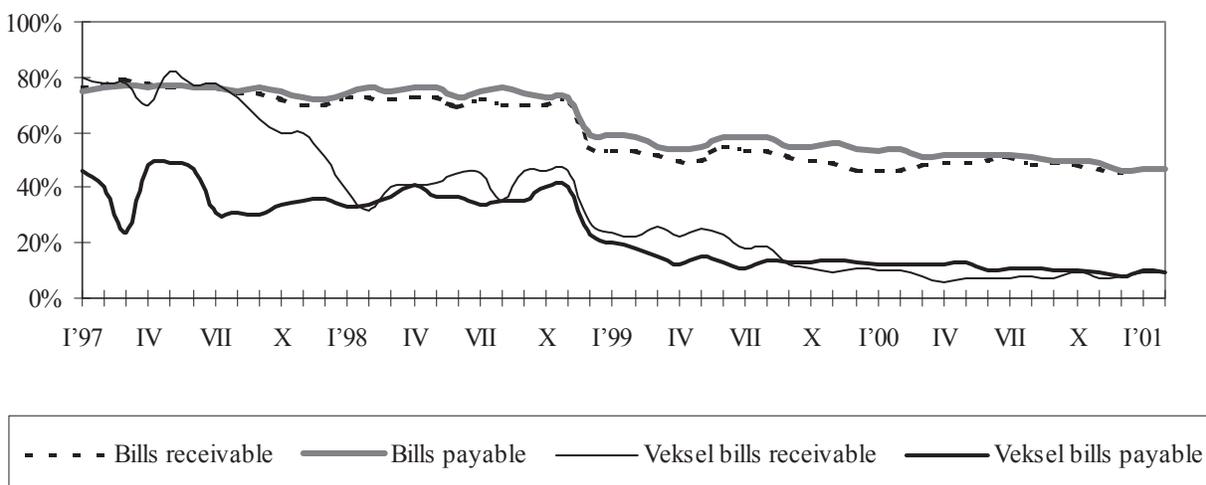
⁴³ this point is discussed more fully in V. Lysytsky, O. Rudnev and I. Lysytsky, “Money and Debts in the Economy of Ukraine” *Herald of the National Bank of Ukraine*, December 1999

⁴⁴ The materials in Box 2.2 are heavily reliant on David Woodruff, *Money Unmade*, Chapter 5, which provides a very detailed discussion of the Russian experience with veksel. Ukraine’s experience differs mainly because of the lesser importance of commercial bank-issued veksel. This is probably traceable to the early 1996 collapse of Tveruniversalbank in Russia. This bank was both a pioneer and a huge issuer of veksel. Its early demise enabled Ukrainian banks and their regulators to see and avoid some of the pitfalls which finished Tveruniversalbank

40. However, it must also be acknowledged that the veksel debt treatment of inter-enterprise arrears has helped to mitigate the payment crisis to some extent. We say this because:

- a) Using this approach has allowed a significant reduction of the outstanding debt share in the total arrears (see Figure 5⁴⁵). Thus, between January, 1997, and January, 2001, the outstanding debt share in total bills receivable and bills payable dropped from 75 to 47 percent, and for the veksel debt this reduction was much greater. During this period, for outstanding bills receivable this share dropped from 80 to 9 percent, and for outstanding bills payable - from 46 to 10 percent. In other words, where veksel bills have been used, the payment-settlement discipline of Ukrainian enterprises seems to have been better than under usual conditions.
- b) When using veksel bills, one can observe shorter payment delays as between enterprises. Thus, for example, in one large enterprise (Makeyevugledobicha) in 1999-2000, the repayment period for normal receivables increased from 212.5 to 339.2 days (+127.1 days), but the repayment period for "veksel" bills receivable dropped from 133.3 to 72.6 days (-60.7). This pattern seems to apply more generally. The period needed to repay normal receivables rose by 140 days simultaneously with the reduction of "veksel" bills payable by 31 days (22 %).⁴⁶

Figure 5. Outstanding Debt Component of Total Ukraine's Interenterprise Arrears, %



Further Selected Consequences

41. The evidence presented in this Annex shows quite clearly that barter and other non monetary means of payment have become institutionalized within most parts of the Ukrainian economic system. Many Ukrainian companies now employ specialized

⁴⁵ Source: The Derzhkomstat of Ukraine. I. Zhilyaev's estimates

⁴⁶ Bortnikova N.F. Analysis of the Influence of Using Veksel Bills as Settlement Tools on the Financial Cycle of an Enterprise, Financy, Uchet, Banki. Collection of Research Papers of the Donetsk National University. Issue 4, 2000, p. 196-201.

prices are below some of the wholesale ex farm prices. Ex-farm prices also differ depending on who is taking the goods from the farm – employees, for example, “paying” far less than the state procurement agencies. The barter price is also above the normal retail price. If this arbitrariness of price structures is replicated across most of the products and sectors participating in the barter/non-payment syndrome then it is evident that the accounting profits reported by enterprise in the economy will also be largely arbitrary – **if not random!**

45. These price distortions in turn impact government and fiscal sustainability very seriously. There is plenty of evidence that the government’s willingness to receive taxes in kind (mutual settlement) results in an over-statement of tax revenue and an implicit profit (tax saving) for the tax paying enterprises. This is because under Ukraine’s present system of public accounts, mutual settlements are treated as cash. Furthermore, the accounting value of the goods offered for tax payment are determined by their accounting value rather than their prevailing market values. For most goods which are used in this way, the administrative accounting values exceed the present market values which are closer to distress-sale levels. Cases where accounting values are double prevailing values are not unusual. The results are that the government attributes too much cash-equivalent value to the goods, over-states its own receipts and provides the tax payer with some hidden profit. Recent research by the HIID team in Kiev indicates that the elimination of mutual offsets would cause a down-valuing of the tax revenues that sub-national governments report that they now collect of about 18%.⁵² Similarly wage payments in kind cause tax revenue losses for the reasons outlined earlier.
46. Finally, the propagation of non-monetary settlement schemes brings about an across-the-board change in the organization of markets that have adapted to this new settlement mode. There now exist special market forms of enterprise adaptation to transition economy. These include a business organization type that performs activities in a vertically or horizontally integrated business group with legally separated financial and production components. There has also emerged a broad network of traders or intermediary firms that take care of supplying enterprises with inputs and selling their finished products. Because traders thus assume enterprise commercial risks, they claim a relevant reward for this. The wide network of barter stores to deal with the barter claims arising from wages and pensions is another institutional innovation provoked by the situation.

Tax Exemptions – The Additional Ingredient

47. As the final element of this story, we consider the question of tax exemptions⁵³. These exemptions are obviously **not** a part of the non-payment syndrome. However, this report puts a bracket around the topic of tax exemptions and the topic of non-payment since both are devices whereby special advantage can be conferred on particular enterprise, groups and sectors through discretionary policies. Additionally tax exemptions definitely conspire with the barter/non-payment syndrome to intensify what we perceive to be a huge overall distortion of the after-tax profitability of Ukraine’s productive sectors

⁵² W. Thirsk, P. Ricoy and others, “How Much is a Hryvnia of Mutual Settlements Worth?” *HIID Policy Seminar Series*, December 1999. They also calculate the size of the necessary adjustment of the fiscal capacity indicator of each oblast (as used in formula- based transfer system now proposed for local governments) associated with this correction of the revenue estimates.

⁵³ Currently, consolidated budget receipts depend on a very narrow group of tax payers. Thus, 1.3 % of tax payer enterprises ensure almost 75 % of total Ukraine’s budget revenue and create 80 % of tax arrears. (Analysis of the execution of the State Budget of Ukraine over the first six months of 2000. K.: Audit Chamber. Issue 15. 2000).

relative to that which would be seen in an economy where these peculiarities were not present. Finally both are eminently well adapted to serve the interests of a system characterized by wide-spread corruption.

48. Tax exemption/ privileges currently take many forms in Ukraine and a recent study of this subject has identified some 200 separate categories.⁵⁴ The budgetary cost of the exemptions granted through budget year 1999 was high⁵⁵. Overall the revenues actually collected amounted to only 50 % of those that could have been obtained in the absence of all exemptions. The detail on this is in Table 5.
49. There is now a general consensus amongst expert opinion, and a strong pressure from the IMF, to halt and reverse the proliferation of tax exemptions. In the limited number of cases where exemptions are retained or are newly introduced, they should be subjected to rigorous assessment. Tax privileges designed to promote investment in clearly identified economic opportunities, including job creation in areas of high unemployment, need to be carefully targeted and subjected to stringent performance criteria and monitoring. It is rightly argued in this context that these aids frequently cost a great deal of public money and achieve little in the way of measurable benefits. Downey cites the examples in Ukraine of the Arsenal Works⁵⁶ and the Kyiv motorcycle works which finally ceased production of its outmoded unreliable motorbikes in May 1999. Both companies finished up with large inventories of virtually unsaleable products. Additionally, it is pointed out that state aid is not compatible with the establishment of the common market and the that the European Union is very quick to take decisive action against countries engaged in the practice of granting tax breaks and privileges. This has to be an important consideration as Ukraine develops its strategy for EU accession.

⁵⁴ This section relies heavily on Maurice Downey, "Tax Breaks in Ukraine. The case for and against their withdrawal", *Ukraine Economic Trends*, UEPLAC, December 1999. The major examples most of which are applied selectively include: Vat exemption on imports; VAT exemptions on sales of goods such as drugs and medical goods; Import duty exemptions; VAT zero rated sales on electric power, coal and peat briquettes; Exemptions from enterprise profit tax; Tax exemptions on profits from sales to identified persons; Customs privileges for identified groups of individuals; Excise exemptions for some Ukrainian manufactured goods; Accelerated depreciation for selected industries e.g. space; Indirect local manufacture support through special import tariffs; and Special economic zones where relief from almost all taxes is allowed.

⁵⁵ The total amount of tax breaks provided in 1999 was Uah 39.7 billion, or 1.2 times the actual consolidated budget revenue. Direct budget losses were Uah 19.6 billion. (Analysis of Ukraine's Budget execution in 1999. K.: Audit Chamber. Issue 18, 2000). The equivalent amount of incentives provided to tax payers in the first quarter of 2000 exceeded Uah 10 billion. Almost 85,800, or 11.7 % of registered tax payers have realized their right to tax breaks under the effective legislation. (Analysis of Ukraine's Budget execution over the first six months of 2000. K.: Audit Chamber. Issue 15, 2000).

⁵⁶ This is an aided factory that used to produce advanced precision optics for military use switched production to photographic cameras but these have design faults.

Table 6. Losses From Major Tax Exemptions

UAH millions	1998	1999	2000 budget 31.01.00
Enterprise profit tax	23	595	1,874
VAT	6,469	9,976	2,586
Land tax	898	1,054	1,146
Local taxes and fees (2000 budget not available)	24	9	0
Excise	3,151	1,777	671
Payment for road-building	134	134	134
Personal income tax	415	818	945
Other	985	37	91
Totals losses from tax breaks	12,100	14,401	7,374
Total budget income	11,51	15,989	26,516
Tax break losses as a percentage of budget income	105%	90%	28%

Source: the State Tax Administration and the budget estimates for 2000

50. Downey notes that tax breaks are just one part of the structural and design faults that plague the Ukrainian taxation system. But when these exemptions are put alongside our earlier comments about the distortions coming from barter and non-payment, then an additional reason for their elimination emerges. In particular that reform would signal as forcefully as anything can, that the government is committed to the elimination of its own involvement in manipulating the effective after-tax profitability of different business activities. It will need to go much further than that by also committing to the, much more complex, reform involved in the elimination of barter and non-payments. But the elimination of tax exemptions as begun in the 2000 budget is an important first step. It begins to establish the principle that profitability should be a function of the efficiency of enterprises and not of their relationship with the country's power brokers. Once this principle is credibly established it becomes more likely that a sound financial system can start to be built.

Conclusions and Solutions

51. The huge level of non-payment in the economy represents a cancer which is damaging many aspects of economic performance and which certainly creates a huge impediment to the successful reform of the financial sector. It does this first by allowing thousands of enterprises and individuals to operate inefficiently with alternative means of payment rather than by making payments with a standard monetary instrument. It does it secondly by causing a major degradation of the information available to banks about the quality of different potential credit prospects. This is a degradation which cannot be corrected merely by adopting international accounting standards at the enterprise level although this is of course desirable. It does it thirdly by erecting a large and unregulated competitor for many forms of banking operation. For these two reasons, non-payment is a cancer that must be removed as part of an integrated strategy for financial sector development.
52. But this will not be an easy operation. As this Annex has attempted to explain, the beneficiaries of the present system are numerous and the various non-payment practices are deep-seated because they bring considerable economic advantage to many vested interest groups. Hence **the periodic "banning" of various practices linked to non-**

payment cannot succeed. Past experience in both Ukraine as well as Russia provides obvious testimony to this point. The vested interests will fight hard and probably “dirty” to avoid giving up on the easy money they make from the continuation of the practices. Additionally, even if it were possible, it is no longer desirable to try to deal with the whole backlog of the problem (the “stock” aspect) in a one-shot corrective operation. This would precipitate a huge credit crunch equivalent to demanding the immediate repayment of all outstanding bank credit by all debtors. So this cannot and should not be done. Instead what is required is a commitment to gradually change the culture and expectations on this point. Standards for reasonably prompt payment of all obligations using recognized (not surrogate) money must be established.

53. The government itself has the clear responsibility – at all levels – to create and then guard those standards. It can begin, as it already has since the Presidential election at end-1999 – to phase out most explicit tax privileges. These are a part of the special pleading which arbitrarily favors some economic interests relative to others. A significant fiscal boost ought to come from this action.(see Table 6). One part of this “windfall” can be used to lower some rates of tax – an action which of itself should give some relief to the better quality enterprises, including many SMEs, which are undoubtedly over-burdened by taxation under present arrangements. A second part could be used to provide explicit budget support to some enterprises which for the moment are receiving implicit support via the non-payment mechanism. The government should match this action on the tax front by a equally principled commitment to make all its own payments by monetary means and eschew the use of barter and related devices. This could mean short term monetary injections but on a net basis this need not be overly damaging to inflation prospects.
54. This first and “easy” step needs to be followed by an explicit campaign conducted mainly at the oblast level to **cap** the levels of non-payment (the stock of arrears) in a targeted group of mainly larger enterprises which are the greatest offenders in terms of the past record of non-payment. It is likely that a few hundred main enterprises will account for a large percentage of the total of non-payment.⁵⁷ This will require above all an unqualified political commitment to remove government at all levels from all the non-payments mess.

Box 2.2: Veksels - Deepening the Barter Phenomenon

Early barter and non-payment transactions in Ukraine were confined in scope to transactions between two parties – a creditor (possibly an enterprise, a tax authority, or a wage earner) and a debtor (most often a distressed enterprise or government agency). While the process stayed like this, it restricted both the scale of the parallel monetary expansion that was possible and also the scope for profiting from intermediating in the process. But those restrictions inevitably exposed the two transactors to all the classic deficiencies of barter. Some escape from this was bound to be sought.

This process broadened out and embraced other transactors when some creditors began to do more than merely accept the second class “money” and in addition began to find ways of helping the debtor make a sale of those products which the debtor had on offer. One popular way to do this was for sound enterprises to partly pay their suppliers with claims on themselves (veksels) which could be used to buy their own, and more desirable, product (e.g. gas or power) or to expunge a tax debt. Being backed by the right to purchase a defined nominal value of some valuable product or service provided by the original creditors, these veksels were relatively easily re-sold, and were also frequently discounted (first stage recipients preferring to hold high grade cash rather than a

⁵⁷ The team preparing this present report was not equipped to do detailed and numerical work on this topic.

larger nominal amount of veksel). The repeated transfer of veksel and the implicit price-cutting involved at each stage supported barter/veksel chains. Eventually these chains could deliver discounted veksel into the hands of initial debtors as payment for their own and previously un-saleable products. Those veksel in turn could then be returned to the creditors to pay-off the initial debts.

Although these approaches effectively overcame the technical deficiencies of barter, they created instead a mountain of new problems. Above all by deepening the use of an alternative but inferior money, they invoked Gresham's Law – market

participants had every incentive to hoard higher grade cash wherever possible and to make payment using lower grade veksel. In particular financially sound businesses naturally tried to use discounted veksel to buy products (electricity) or pay taxes which they were fully able to pay using cash.

Since this decline in likely cash payments from sound organisations was obviously unacceptable to the creditors issuing veksel - tax administrations and sound enterprises - complex rules were developed to try to limit the circuits through which veksel could pass on their journey to their ultimate redemption for par. Also veksel where the use-value in purchase and the eligible users were defined and certain traded at smaller discounts than those where there was uncertainty (leakage) on these points.

In Ukraine at present, veksel are issued by the Ministry of Finance (State Treasury), by many local governments, by banks, and by individual enterprises. There are following examples of veksel and their prevailing discount levels.⁵⁸

- pension bills (discount of 20% to 50%) - payments to the Pension Fund⁵⁹
 - electric power bills (discount of 10% to 80%) - payments for electricity
 - railroad bills,
 - metallurgic bills (discount of 40% to 60%)
 - communication bills (discount of 30%)
- sugar manufacturers' bills, etc.

This deepening of the barter phenomenon appears to provide a solution to the so-called “liquidity” problem of weaker enterprises, Unfortunately it also undermines the use of conventional money for payments purposes. The implicit re-pricing of products which it also allows provides huge opportunities for new forms of unproductive rent-seeking. One example from the power sector makes this clear. At present some obloenergos receive payment from some final customers in cash. They can use part of this cash to buy heavily discounted veksel and then transfer these using their full nominal value to fully expunge their liabilities to the energo-market. The balance of the cash received remains as an unearned profit or rent in the hands of the obloenergos. Such examples proliferate in Ukraine where the notional restrictions on veksel use can easily be side-stepped.

55. The enforcement of this cap will have a number of positive but also negative effects which need to be countered by an explicit and well-prepared strategy – again at all levels of government. We here consider just a few of these. First, electricity companies ought to find their non-payment problems on **a flow basis** being reduced. This in turn will remove the justification for extending them new forbearance in relation to tax payments – so the tax take in cash also ought to improve. Second, the new payments discipline will create a multitude of demands for new special arrangements to help the enterprises that genuinely cannot pay because of the poor state of their finances. In most cases these enterprises will have to close – their overtures to have implicit subsidies associated with non-payment

⁵⁸ V.Yuschenko and V. Lysytsky note that “high discounts on veksel (60-70-85%) indicate that the fictive value is the market (real) value only in small share of its volume (reported in the balance of enterprises). Sensibly small amounts of veksel turnover and the lack of the transparent (stock) bill trade disallow using these discounts for the assessment of the reality of the fictive value at large for the national economy” (V. Yuschenko, V. Lysytsky. *Money: Development of Supply and Demand in Ukraine*. Kyiv, Skarby.2000. P.319).

⁵⁹ According to the Accounting Chamber data for 1998 and the first six months of 1999, the Pension Fund of Ukraine issued in notes arrears of enterprises in the amount of Uah 786,6 mn. Promissory notes were issued with medium discount: sugar plants - 30%, metal producers - 55,4%, coal and coke producers - 53,8%, timber - 46,4%. (Report on Accounting Chamber of Ukraine Activities in 1999. Kyiv, Accounting Chamber, 2000).

replaced by other forms of help need to be resisted. But this will be difficult – especially since those overtures will be addressed at local oblast and rayon officials who obviously have numerous devices available to “be soft”. These officials need to sign on to the political commitment referred to above. Hence, great vigilance will be needed and this will be easier if the authorities nationally can develop social-support packages that will help the most badly affected localities address the unemployment and other social downside of enterprise closures. This would be a good use of the fiscal “windfall” should one arise. It would also justify some short-term increase in the fiscal deficit because these social-support expenditures would in most cases merely be replacing larger amounts of *implicit* fiscal aid to the same regions transmitted through the non-payment for electricity and other goods and services. Third, the ongoing reform of sub-national government finances may be compromised to some degree by a serious attack on non-payment of the type we propose. Inevitably some regions will be more badly affected by the real enforcement of payments discipline than others: single company towns will be particularly hard-hit. This also should be the subject of explicit pre-planning and may require, for example, some additional transfers to some regions on a short term basis. Finally it is likely that this campaign to cap arrears could involve some short-term increase in rates of inflation. This possibility needs to be co-ordinated carefully with the macro-economic program and targets of the authorities.

56. Once the government has **set the example**, many other things will fall into place. In particular, enterprises unable to make payments of taxes because of the failure of their own-customers to pay them in a timely fashion, will be more likely to seek redress for non-payment. This change in the underlying incentives will need to be supported by appropriate strengthening and streamlining of bankruptcy and court-settlements to enable creditors to gain redress from their own delinquent clients. A variety of second stage reforms would be called for to accommodate to this. These might include the introduction of prompt small-claims settlements; the enforcement of sanctions on enterprise managers who allow their enterprises to persistently fail in making payments; and credit registers which would increasingly enable delinquent enterprises to be identified up-front by prospective new lenders.
57. Finally, if the political will to remove the non-payments cancer is truly established, then external adjustment assistance and associated conditionality might be discussed as one way to maintain momentum and mitigate some of the potential negative initial effects that might flow from these various actions. It is stressed that external conditionality is unlikely to be effective in initiating the reform – but it may be a useful complement to the authorities own efforts once they get established.

Annex Three

Survey Of Enterprises Regarding The Use Of Banking And Financial Services¹

Summary

1. This Annex presents the results of an enterprise survey conducted by International Center for Policy Studies (ICPS) on behalf of the World Bank. 11 enterprises in Kiev Region and 10 in each of Kharkiv, Donetsk, Odesa, and Lviv Regions were interviewed. The enterprises surveyed have various sizes and type of activities. In 1999, 69% of sampled enterprises used non-cash sales. The survey showed that for large enterprises with significant export activities the percentage of non-cash sales is lower. About 70% of respondents stated that they realized all their cash activities through banks. About 10% of respondents, and all large “exporters” mentioned traditional financial institutions as one source of finance that they use. However, the survey revealed also that most enterprises surveyed currently do not use traditional financial institutions as a significant source of finance: they prefer to draw funding from their day-to-day working activities. The respondents’ answers show that domestic payment orders, current accounts in national currency, and cash withdrawals can be identified as the banking services uniformly used by Ukrainian enterprises. Other banking services tend to be used by/given to large or medium-size enterprises with significant export activities. The survey revealed that most loans tend to go to large- or medium-size enterprises with significant export activities. Almost all respondents who answered the question regarding key factors influencing bank choice ranked “quality is better” and “prices are lower” as important, very important, or absolutely decisive. Large enterprises tend to pay more attention to “personal contacts with top management” and “dedicated servicing people in place” than do medium or small-size enterprises when choosing their banks. Fifty percent of respondents reported that they had received bank loans at some point in the past. The application procedure from initiation to eventual approval of the loan took the surveyed enterprises about 20 days on average. Among services provided by financial institutions insurance was the most widely used: 27% of respondents use insurance services. The survey revealed that the enterprises have a very limited use of other non-bank financial services. About 65% of respondents have plans to expand. Half of enterprises that plan to expand will try to raise additional financing.

Survey and Sample Description

2. The survey of 51 Ukrainian enterprises was conducted in May 4-19, 2000. Out of 51 enterprises surveyed, 11 were in Kiev Region and 10 in each of Kharkiv, Donetsk, Odesa, and Lviv Regions. In most cases, the answers to the survey questionnaires were given by the chief accountants of firms; in many cases, more than one representative of firm’s management was involved in the interview. It is important to report that the interviewers encountered some difficulties while trying to obtain the consent of some enterprises to

¹ The survey reported here was undertaken by the International Center for Policy Studies (ICEPs), a Ukrainian organisation based in Kiev.

participate in this survey since many found the financial topic very sensitive and refused to disclose their financial information. Overall, Kharkiv Region was the most difficult location. Many firms refused to be interviewed and some of those who agreed did not respond to many questions claiming that the issues involved were commercially confidential.

3. According to the World Bank requirements the sample of enterprises should have satisfied the following criteria:
 - each region should cover no less than 10 enterprises;
 - at least 10 enterprises should have sound exporting capacities (so called “exporters”) and be considered large or medium companies;
 - at least 20 enterprises should be considered large enterprises;
 - at least 30 enterprises should be fully private and be engaged in production or processing.

4. After allowing for non-response, the actual sample included²:
 - 18 large enterprises (4 in Kiev Region, 4 in Lviv Region, 3 in Odesa Region, 5 in Donetsk Region, and 2 in Kharkiv Region)³;
 - 21 large- or medium-size enterprises with significant export operations (6 in Kiev Region, 5 in Lviv Region, 5 in Odesa Region, 3 in Donetsk Region, and 2 in Kharkiv Region);
 - 29 fully privatized industrial enterprises (6 in Kiev Region, 6 in Lviv Region, 6 in Odesa Region, 4 in Donetsk Region, and 7 in Kharkiv Region)⁴;
 - 13 enterprises where the share of the state ownership exceeds 50% (4 in Kiev Region, 2 in Lviv Region, 2 in Odesa Region, 3 in Donetsk Region, and 2 in Kharkiv Region).
 - 18 large enterprises (with more than 1000 employees), 19 medium-size enterprises (with number of employees 100-1000), 14 small-size enterprises (with less than 100 employees)

5. Table 1 below displays the range, mean, and median of sales of the sampled enterprises as reported for 1999.

Table 1: Sample Coverage

Enterprise Size	Sales, Uah ('000)		
	Range	Mean	Median
Large (number of employees >1000)	4,840-242,653	54,628	23,429
Medium (number of employees 100-1000)	54-55,000	8,429	2,416
Small (number of employees <100)	21,6-10,762	1,696	350

² Note that certain enterprises can satisfy several criteria.

³ The number of large enterprises in the sample is lower than requested by the World Bank’s terms of reference since large enterprises were most frequently those who refused to participate in the survey. The sample, however, includes two firms – one in Kharkiv, the other in Kiev Region — with more than 800 employees – these are a close approximation to “large” enterprises where the definition is based on 1000 employees.

⁴ The sample includes less than 30 fully private enterprises. The requirement to have no less than 30 fully private enterprises was difficult to satisfy because large enterprises as well as enterprises-“exporters” which should have made up a significant share of the sample usually have some state-owned stake.

6. In 1999, out of 51 enterprises sampled 35, or 69%, used non-cash sales. Barter made up most or all of the non-cash sales of those respondents accepting payment in non-cash form. Among all sampled enterprises most non-cash sales were done by large enterprises: out of 18 large enterprises only 2 were not involved in non-cash operations. By contrast, more than half of small firms made no use of non-cash operations. Table 2 below represents the range, mean, and median of non-cash sales (as a percentage of total sales) reported by sampled enterprises in 1999.

Table 2: Non-Cash Usage

Enterprise Size	Non-cash sale, % of total sales		
	Range	Mean	Median
Large (number of employees >1000)	0-99.9	46.5	52.7
Medium (number of employees 100-1000)	0-100	36.7	33
Small (number of employees <100)	0-98	13.0	0

7. It is interesting to note that for large enterprises with significant export activities the percentage of non-cash sales is lower than it is for large enterprises as a whole: 42% average and 48% median.
8. The survey did not reveal any particular pattern in the main beneficiaries of barter. Although some respondents replied that the main beneficiaries of their non-cash sales were state-own enterprises, others reported private companies as the sole or primary beneficiary of non-cash sales. Among other important beneficiaries of non-cash sales also were mentioned agricultural enterprises (collective agricultural enterprises, farms, etc.).
9. Twelve surveyed firms reported that they sell their products for cash at the local market by-passing banks. For three firms, non-cash operations made up more than 99% of sales. About 6% of surveyed enterprises overall made virtually no use banking services or had very insignificant usage of them. At the same time, about 70% of respondents realized their cash operation only through banks.
10. Ten enterprises reported that they enjoy tax holidays: 3 in Odessa Region, 1 in Lviv, 3 in Donetsk, 2 in Kiev, and 1 in Kharkiv. All enterprises but one – a small-size enterprise in Donetsk Region – reported that they pay income tax and VAT. Among other taxes respondents most frequently mentioned profit tax, land tax, municipal tax, Innovation Fund tax, and automobile tax.

Banking Services Used by Enterprises

Enterprises' Sources of Finance

11. Thirty-three enterprises (8 large-, 14 medium-, and 11 small-size), or 67%, reported that they used their own savings as a source of finance, including working capital, in 1999. Another significant source of finance mentioned by respondents was buyers advance payment: 4 large-, 6 medium-, and 6 small-size enterprises, or 31% of respondents, used this source of finance. Only three large- and 2 medium-size enterprises, or about 10% of respondents, mentioned traditional bank credit as a main source of finance. Importantly,

all of these firms were identified as “exporters”. Only 4 firms – all large enterprises with state shares - indicated that they received any financing from state sources.⁵.

12. Among informal sources of finance mentioned by three different enterprises were Innovation Fund financing, funding from the state-owned enterprise Ukrzaliznytsya (what can be attributed to the state financing), and investors. One enterprise reported receiving a loan from the Regional Employment Center: this involved the obligation to double the number of its employees.
13. To summarize, the survey revealed that most enterprises currently do not use banks and other traditional financial institutions as a significant source of finance. Instead, they draw the major part of the funding from their every-day operating activities.
14. Nonetheless all respondents, even including those with no or minimal cash operations, reported that they have been making some use of banks. Two respondents in Kharkiv Region refused to name the banks whose financial services they use. Nineteen enterprises, or 37% of respondents use the services of more than one bank. Larger enterprises tend to use more than one bank. Most enterprises sampled are serviced by the largest Ukrainian banks, namely:
 - Ukrsotsbank provides services to 20 firms, or to almost 40% of respondents;
 - Prominvestbank provides services to 15 enterprises, or almost to 30% of respondents⁶;
 - Privatbank was mentioned by 4 large enterprises;
 - Bank “Aval” and bank “Ukraina” provide services to 3 respondents.
15. PUMB (First Ukrainian International Bank) is the most prominent among the regional banks: it services 5 out of 10 enterprises surveyed in the Donetsk Region.

Services Provided to Respondents by Banks in 1999⁷

16. All respondents with the exception of two small enterprises (one in Kiev, the other in Kharkiv Region) reported that they have current bank accounts in Ukrainian hryvnyas⁸. All respondents other than 1 small firm in Kiev Region reported that they used banks to perform domestic payment orders. All respondents except 2 medium- and 3 small-size enterprises use cash withdrawals. In other words, domestic payment orders, current accounts in national currency, and cash withdrawals can be identified as the banking services uniformly used by Ukrainian enterprises.
17. Moreover, the survey revealed that 12 (67%) large-, 9 (50%) medium-, and 4 (29%) small-size enterprises in the sample also hold current accounts in foreign currency. It is noteworthy that the total number of respondents with current accounts in foreign currency exceeds the number of respondents who reported significant export or import activities.

⁵ One small-size enterprise also reported the use of the state funding (credit). However, the share of this source was only 0.02%.

⁶ Ukrsotsbank and Prominvestbank provided services to respondents in each Region covered by survey.

⁷ One respondent (in Odessa Region) refused to reveal the information about banking services it uses. This sections of the report, therefore, does not account for this respondent.

⁸ The two enterprises that did not report the use of bank current accounts mentioned the use of domestic payment orders which would normally imply the availability of a banking current account.

This fact suggests that significant numbers of Ukrainian enterprises tend to hold foreign currency accounts even though they do not absolutely need these for their day-to-day activities.

18. One enterprise – a medium-size “exporter” from the Kiev Region – also reported the ownership of a term deposit in foreign currency and the purchase of treasury bills. Other respondents did not mention term deposits either in national or in foreign currency; nor did they report any purchase of treasury bills. This may indicate that Ukrainian enterprises (even those who are not much involved in non-cash operations) currently do not have much free cash that they could accumulate on term deposits or invest in treasury bills.
19. Short-term working capital loans in hryvnias were the types of loans most widely used by the respondents: 6 large-, 4 medium-, and 2 small-size enterprises, or 24% of respondents, reported that they had this type of loan last year. Importantly, in this cohort, all large enterprises and 1 medium-size enterprise are “exporters”. Furthermore, 3 large companies in this cohort also have short-term working capital loans denominated in foreign currency.
20. Revolving loans had been provided to 5 large and 2 medium-size enterprises. In this cohort 3 large enterprises and one medium-size are “exporters”. Overdraft facilities were reported by 4 enterprises (3 large- and 1 medium-size). But only two large enterprises benefited from long-term loans in hryvnias. To summarize, loans tend to be provided mainly to large- or medium-size enterprises with significant export activities.
21. The survey results support a general opinion that “exporters” are on average less involved in non-cash activities. This fact can explain the tendency of banks to make loans available to “exporters” more readily. At the same time, the survey revealed that most small-size enterprises do not use non-cash operations. However, only one type of loan – short-term working capital loans – were used by 2 small-size enterprises. In other words, both the prevalence of cash activities and also the size of enterprise seem to be important for banks’/enterprise decision to provide/take loans from banks.
22. Four surveyed enterprises – 3 large-, 1 medium-size, all “exporters” reported some use of discounted promissory notes. Only one enterprise – a large “exporter” – reported the use of factoring. Two large- and one medium-size enterprises reported the use of leasing.
23. Overall, the survey revealed that banking services, other than current accounts in national currency and related to it cash withdrawals and domestic payment orders, tend to be used predominantly by large or medium-size enterprises with significant export activities. Other banking-type services such as factoring, discounting of promissory note, and leasing are used only minimally even by companies who have access to other types of loans. This fact has two possible explanations: either banks offer a scarce supply of these services [a view which fits with the evidence in the main Report], or their clients are poorly informed about these forms of credit and are unwilling to use them.

Key Factors Influencing Bank Choice

24. Almost all respondents who answered the question regarding key factors influencing bank choice ranked “quality is better” and “prices are lower” as important, very important, or

absolutely decisive. “Personal contacts with top management” was also of great importance for many enterprises⁹. However, large enterprises dominated amongst responses that ranked the latter factor as important or higher: 10 (56%) large-, 6 (32%) medium-, and 5 (32%) small-size enterprises value this factor high. This same pattern can be observed in the way the enterprises of different size ranked the factor “dedicated servicing people in place”: 8 (44%) large-, 4 (21%) medium-, and 1 (7%) small-size firms ranked this factor as very important or higher. This pattern is likely to mean that the management of large enterprises that are usually better-known in the region and to a great extent determine the economic image of the region, have more possibilities to be acquainted with, and use influence over, bank managers and personnel. As a result, large enterprises pay more attention to these factors than small- or medium-size enterprises that are less known and whose possibilities to establish good contacts with banks are limited.

25. Respondents reported the following prices/fees they pay for domestic payment order: from Uah 70 per month, Uah120 per year, or from Uah 0.5 to 4 per payment. One enterprise (a large enterprise in the Kiev Region) reported that they have a special contract with their bank and pay no fees for payment orders. To analyze respondents’ responses to this question and thereby to deduce a pattern is difficult since the respondents used different types of measuring while reporting the price/fee they pay for domestic payment order.
26. Twelve respondents reported the annual interest rate they pay for 3-month loan in hryvnyas. The annual interest rate ranges from 7% to 60%, with 43% as the average. It is interesting to note that all loans provided to enterprises in Kiev Region had interest rates lower than the average. This can possibly be explained by greater bank competition and by better financial management of the enterprises in this main region.
27. Three enterprises reported the annual interest rate they pay for 3-month credits in foreign currency: 25% (large “exporter” in Kiev Region), 20% and 39% (large “exporters” in Donetsk Region).
28. The processing time for the execution of a payment order in domestic currency take usually less time than the execution of a payment order in foreign currency. The processing time for the execution of a payment in domestic order for ranges from 2-3 minutes to 7 days. Most respondents, however, mentioned processing times equal to several hours or 1-2 days. In most cases the processing time for the execution of a payment order in foreign currency equals to 1-2 days. The minimum time reported for this operation is 10 minutes, the maximum: 4 days. The analysis did not reveal any interconnection between the processing time and the location or the type of client.
29. Twenty-nine respondents, or 58%, reported that their banks offer them electronic banking services. However, not all enterprises use them. Some respondents complained that they cannot use electronic services because they do not have appropriate computers or cannot afford e-mail.
30. Overall, many respondents stated that they are satisfied with the banking services they use and did not mention any services that they are missing. Several respondents would like to take credits but only if the interest rates were to be lower. Among other missing services

⁹ The majority of surveyed enterprises are located in the largest cities of the Regions surveyed, in so-called regional centers. The enterprises located in regional centers usually have access to more banks than the enterprises in the region located outside the regional center. Therefore, we can expect that Ukrainian enterprises located outside regional centers have little or no options when choosing their bank: they just use the bank existing in their town.

were mentioned electronic services, timeliness of cash operations, the possibility to make money transfers not only in the daytime but also in the evening.

Receiving a Loan

31. Twenty-six (13 large-, 8 medium-, and 5 small-size enterprises), or 50% of respondents, reported that they had received at least one loan at some time or another. The application procedure from initiation to eventual approval took on average about 20 days. However this period varies substantially depending on the size of the enterprise. For instance, for large enterprises the application procedure took on average 30.5 days, for medium-size enterprises: 11.5 days, for small enterprises: 6 days. The possible explanation for this difference is that the larger enterprises are likely to apply for larger loans and larger loans require more time for approval, more documentation etc. Eleven enterprises (8 large, 1 medium-size and 2 small size) applied for and received extensions of their loans beyond the original maturity dates. The survey questionnaire did not include a question that could help to identify why certain enterprise did not apply for loan extensions. On the one hand, the enterprise could be in a position when it did not need the loan anymore; on the other hand, it could suspect that the bank might be unwilling to extend the loan anyway and so did not even apply. In other words, this survey does not allow us to identify what kind of enterprises banks look kindly on as regards the extension of loan maturities.
32. All but 2 out of 26 enterprises that reported receiving loans stated that the collateral was required. Fixed assets and finished goods were the most frequently used types of collateral.

Financial Institutions and their Services

33. Insurance companies were the most frequently mentioned non-bank financial institution used by respondents. Eight large-, 3 medium-, and 2 small-size firms, or about 25% of surveyed enterprises, reported that they used the services provided by insurance companies. Three large companies mentioned that they use the services of leasing companies. One large and one medium-size enterprises noted that they use the services of investment companies/funds. In addition, 3 companies (1 large and 2 medium-size) self-reported stock registrars as a type of non-bank financial institutions whose services they use.
34. Among the services provided by non-bank financial institutions, insurance products were the most widely used. Registration of securities, custody, and depositary services were the second most widely used by respondents: 6 large-, 4 medium-, and 2 small-size enterprises, or 24% of respondents, reported their use. In addition, 2 large and 2 medium size enterprises were involved in repurchase of others' securities from them. Other financial services were mentioned by no more than 3 surveyed enterprises.
35. It is significant that many companies did not answer at all or had difficulty answering when the question about which financial services are missing from the financial markets and that they believe should be offered by non-bank financial institutions. At the same time, some of those who responded to this questions mentioned general measures for the improvement of the financial sector (e.g. revitalization of the stock market, long-term investment, easy access to financial market, better information about activities of

financial companies) rather than new services. Some answers revealed the poor general understanding of financial markets and non-bank financial services. For example, as non-banking financial services some respondents mentioned “the sale of currency without delay” or “the decrease of National Bank’s refinancing rate”.

36. To summarize, this section of the survey revealed that the enterprises surveyed have a very limited use of non-bank financial services. Among those firms that reported the use of certain non-bank financial services large enterprises prevail. The survey also demonstrates that many respondents have a very limited awareness about financial market and non-bank financial services.

Enterprises’ Plans and Perspectives

37. About 65% of respondents (33 enterprises) have some plans to expand. It is worth noting that out of 14 small-size enterprises surveyed 12, or about 86%, claimed that they have plans to expand while out of 18 large enterprises only 10, or about 56%, have such plans. Furthermore, about 67% or 8 out of 12 small-size enterprises who plan to expand would like to increase their activities by 100%. Meanwhile, only 1 large and 2 medium-size enterprises claimed that they would like to double their activities in two years.
38. Sixteen out of 33 enterprises who would like to expand say that they will try to attract additional financing. Importantly, out of these 16, 6 are the small-size enterprises. As additional financing, small-size enterprises will try to attract bank credits and direct investments (including foreign). Large and medium-size enterprises will also try to attract this kind of financing. In addition, some of them plan to attract Innovation Fund credits and state financing (Ukrzaliznytsya).
39. Many respondents ranked banking and financial sector constraints (rather significant, significant or very significant) when answering the question about the major constraints for expansion of enterprise business activities. The table below summarizes the answers of respondents regarding the importance of financial and banking constraints for expansion of their business.

Table 3: Finance as a Constraint

Constraint	Number and percentage of respondents who ranked the constraint as rather significant or higher			
	Total	Large	Medium	Small
Lack of access to commercial bank lending	26 51%	11 61%	10 53%	5 20%
High cost of commercial bank finance	37 72%	15 83%	12 63%	10 71%
Lack of access to capital markets to raise funds	25 49%	10 56%	8 42%	7 50%
Low demand on capital markets for securities of the company	13 25%	5 28%	5 26%	3 21%
Lack of sound collateral to secure bank finance	20 39%	8 44%	7 37%	5 36%

40. Table 3 demonstrates that the lack of access to commercial bank lending and the high cost of commercial bank finance are perceived to be major constraints for expansion for most respondents. The relatively low percentage of respondents who ranked “lack of access to capital markets to raise funds” as a significant constraint does not necessarily mean that this is not a constraint for most enterprises. The analysis of respondents’ responses to questions regarding non-banking financial institutions revealed that they are not well aware about the role of capital market and its opportunities. Therefore, the lower percentage here is likely to reflect partly the low awareness about the issue rather than a genuinely low constraint to expansion.
41. Among other constraints to expansion the respondents mostly mentioned insufficient demand, high tax burdens, high cost of raw materials, inflation, and strong competition in the markets for their products.

Conclusions and Recommendations

42. Overall, the survey revealed that larger enterprises tend to use and have better access to both banking and non-bank financial services. Small-size enterprises make very limited use of banking both banking and other and financial services. As a rule, the services they use are limited to current bank accounts and related operations. The use of other banking and financial services by small-size enterprises is very uncommon.
43. At the same time, the survey revealed that an absolute majority of small-size enterprises plan to expand in the near future and that most of those who plan to expand would like to increase their activities by 100%. The percentage of large- and medium-size enterprises that want to expand that much is significantly lower. These findings draw us to the conclusion that in the near future enterprises with fewer than 100 employees will be in great need of additional financing. However, the analysis shows that small enterprises are also the least experienced in raising additional financing. To liquidate this mismatch, small-size enterprises need to develop the internal management capacity and skills that would allow them to be successful in attracting additional financing. These capacities and skills include good operational and financial management, the ability to develop effective business plan, and better knowledge about the banking and financial services available on the market.
44. The survey identifies several implications for the country’s banking sector. The limited use of banking services by small-size enterprises implies that these enterprises are poorly informed about service opportunities and/or banks use their scarce funds in ways that discriminate against them. When taking a decision about loans or proposing various services to commercial clients, banks need to pay more attention to small-size enterprises and not concentrate so narrowly on larger enterprises with significant export activities. Moreover, the survey reveals that small-size enterprise overall have the potential to be good borrowers because their share of cash operations is much higher than is the case with larger enterprises.
45. The survey revealed that respondents generally make very limited use and have limited knowledge of the role and opportunities of the non-banking financial sector. Among those few respondents who use non-bank financial services, large- and medium-size companies again prevail. Financial institutions, active in the Ukrainian market, and related government agencies need to develop better informational campaigns regarding

non-bank financial services and their use. For the reasons referred to above, enterprises employing less than 100 employees probably need to be the main targets for this campaign.

Annex Four

Money Market Malfunction and Volatility

Introduction

1. Government debt plays an important role in the financial system of every developed country. Government bonds are used as a broadly risk-free asset against which other financial instruments are priced. They are counted as part of banks' capital and prudential requirements typically require pension funds and similar bodies to hold a minimum share of their assets in such securities. Central banks also use government securities in open market operations to influence monetary conditions.
2. However, there is a pre-condition for the efficient introduction of these instruments. In order to have a sound primary market for this purpose; there must be public confidence in the securities. Otherwise the phenomenon of impaired confidence so well known in Ukraine will overwhelm most of the possibilities. Specifically experience in Ukraine is one where the rescheduling of government Tbill obligations has resulted in a situation where almost no one is prepared to hold these securities. As result the NBU has ended up doing what Central Banks should always try to avoid. Namely it has been forced to buy Tbills on the secondary markets a short time after issue and, in the process has effectively financed government budgets. This has left it with little room to maneuver in terms of managing the money markets and providing the normal range of facilities to the commercial banks.
3. Even before the 1998 crisis, the Treasury Bill and other components of the money markets in Ukraine had never progressed much beyond the embryonic stage. An early problem with inter bank lending associated with the mini banking crisis in 1995 installed an atmosphere of considerable caution in the use of this market. The more substantial crisis of September 1998 (see Annex One for details) fundamentally damaged the credibility and reliability of the Treasury Bill market. Consequently the range of instruments upon which the Ukrainian banks can now rely is extremely limited and still very unreliable. This fact has greatly raised the costs of liquidity management by banks by intensifying the volatility of prices in the underlying markets. The problem has been aggravated further by the authorities emphasis on the stability of the hryvna exchange rate with major foreign currencies as the main indicator of the country's financial stability. In this Annex we briefly explore this issue of volatility and the associated costs to the banks. It is concluded that the volatility of market prices needs much more serious attention than it has so far received if financial development is to progress.
4. Volatility and stability are closely related to risk. Market risk refers to the potential for changes in the value of a market participant's position resulting from changes in market prices. That is why the more frequent are the price changes in the market, the more risky the market is. This in turn is likely to affect the behavior of market players. Specifically, more risk is likely to encourage more speculative behavior by market participants and this in turn is likely to encourage short-term strategies and relatively limited amounts of long-term investments. A higher level of "stability" is clearly important for financial sector development. It should bring with it a transformation from speculative to more investment grade activities. It has been argued in this Report that the gradual achievement

of inflation stability from around 1996 contributed crucially to this transformation of behavior in this direction on the part of banks. But so long as instability persists in other components of the financial markets, that transformation cannot be complete.

5. In Ukraine the most developed of the money markets are the domestic inter bank money market and the inter-bank foreign exchange market. These markets both operate under the close supervision of the NBU but with the latter receiving most of the attention. (especially the US Dollar / hryvnia rate). In addition there are emerging securities markets (for both corporate debts and equity), and a limited inter bank loan market. Because the inter-bank markets are more liquid than other financial markets (securities, personal deposits and loans, etc.) and provide regular pricing, these markets should in principle serve as benchmarks for the other markets.

The Degree of Volatility

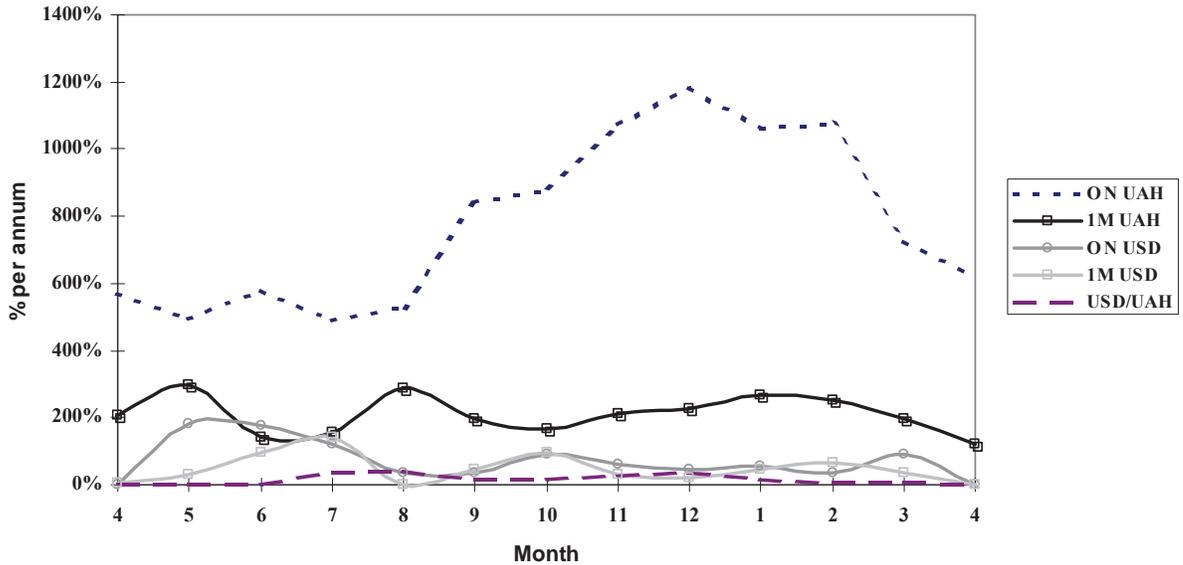
6. In what follows we measure volatility as the standard deviation of continuously compounded financial returns¹. It may be noted that this deviates from the implied understanding of stability accepted in Ukrainian financial markets. A typical comment on this point is that from the popular magazine Galytski Contracty². They say.....
... the major benchmark of stability established by the NBU is the official exchange rate of hryvnia to Dollar staying for two months at the level of ...
7. It is implicitly understood by most Ukrainian financial press and market participants that low interest rates (less than 10% p.a.) of yields in money market and a strong constant level of the hryvnia to US Dollar exchange rate indicates stability. By contrast high levels of exchange and interest rates denote non-stability and higher risk. This implicitly associates instability to the general situation of inflation – but as we noted above this is a seriously incomplete view.
8. Volatility measures(calculated as the standard deviation of financial returns for a 30-day period are presented below) for five instruments/prices namely:
 - overnight (ON) and 1-month (1 M) interest rate for hryvnia,
 - the rate for the US Dollar / hryvnia exchange rate
 - overnight, and 1-month interest rate for US Dollars in Ukrainian interbank market
9. These financial instruments were chosen because most Ukrainian banks need to close their positions generated by everyday business with customers in these inter-bank markets. The instruments listed are typically the only instruments available to the Treasuries of the commercial banks.
10. In 1993 most foreign exchange business was done on the Ukrainian Inter Bank Currency Exchange (UICE). Other markets started to develop in 1995, when banks began to trade between themselves in currencies outside of organized trade in the UICE. Inter-bank loans also started to emerge. Trade between banks at that same point in time was moved from the Boards of the banks to their dealing rooms and traders with respective delegation of

¹ Web site www.contingencyanalysis.com might be used for introduction to volatility and references..

² 'Market in expectation for further limitations on foreign exchange' Galytski Contracty N51, 1998

authority.

Figure 1. Volatility of interbank instruments, 1999-2000

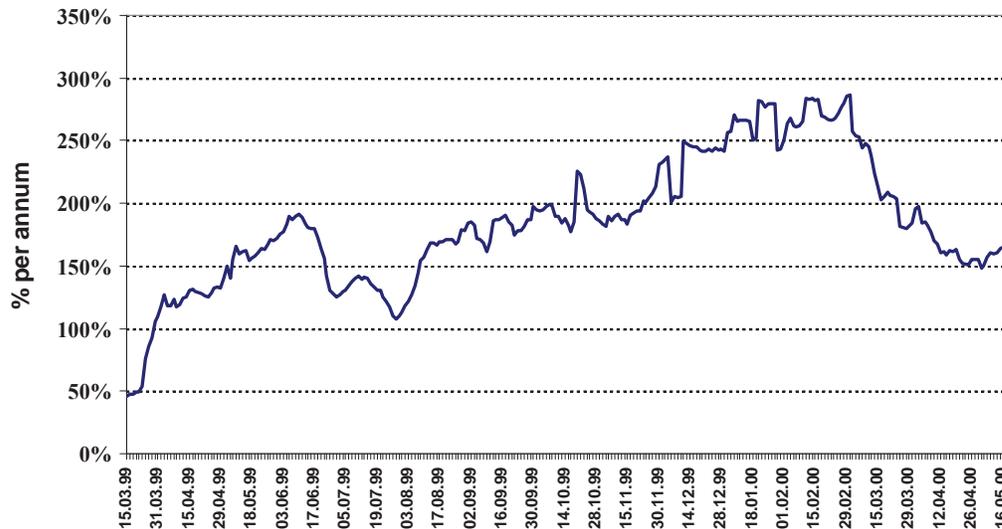


11. According to Figure 1, the **lowest** volatility is experienced in the US Dollar / hryvnia rate. The **greatest** volatility (some times greater than 1000% per annum) is demonstrated by the hryvnia overnight rate. The other volatilities fall between these two extremes. A partial explanation of these contrasts may relate to the regulation and monitoring of the inter bank foreign exchange market by the NBU. Overnight hryvnia rates are not regulated by the authorities to anything like the same extent as the US dollar rate. Hence the linking between the foreign exchange and the domestic money markets lead to an intensified excessive volatility of the money market rates.
12. To further explore the problems faced by banks we have also calculated the volatility of a hypothetical portfolio of assets consisting in equal proportions of positions taken in the five instruments listed above namely the overnight and 1-month hryvnia and US Dollar rates as well as the hryvnia/Dollar exchange rate to assess how risky or unstable the Ukrainian inter-bank market is as a whole. The relevant correlation between the different financial instruments was taken into account. This portfolio is not obviously associated with any one bank. But such a reference portfolio provides a reasonable indication of the conditions in the markets where Ukrainian banks need to operate.
13. The graph of portfolio volatility is presented in Figure 2. The average 150% volatility of portfolio value through 1999-2000 indicates the presence of very substantial risks. It means that with volatility constant at the level of 150% there is a 95% probability that during one year, the portfolio can increase in value by $150\%^3$ or to be reduced in its

³ $150\% * 1.65 = 247.5\%$

value to only of 0.1^4 of its original value. As we noted earlier, such huge possible swings in values seem certain to encourage speculative and short-term views among market participants. Certainly they are not likely to encourage investments in long-term capital.

Picture 2. Volatility of portfolio consisting of 5 financial instruments.



How much volatility is acceptable?

14. To provide some sort of answer to this question we compare data about the Ukrainian market with comparable data from a mature market namely the US Dollar / Deutsche Mark. The volatility measures of the US\$/DEM and US\$/hryvnia exchange rates are presented in Figures 3 and 4. The differences between these rates and their volatility is very easily visible. They are substantial not only in levels (a 10% average rate in the more mature market and double this in the US\$/hryvnia rate), but also in the variability around these averages.

Box 4.1: Liquidity Management in Banks

Commercial banks usually institutionalise the structure of their risk management in the form of an asset-liability management committee and assign ultimate responsibility for setting and reviewing liquidity decisions to the bank's highest management level. Liquidity needs are often determined by the construction of a maturity ladder that comprises expected cash inflows and outflows over a series of time periods. Liquidity management is related to a net funding requirement on a daily basis. Banks then meet these needs on the assets side of the account by either disposing of liquid assets or by decreasing their holdings on non-liquid assets. On the liabilities

⁴ $e^{(-1.65 \cdot 150\%)} = 0.084 \approx 0.1$

side they can fill liquidity gaps by increasing short-term borrowings/deposits; by lengthening the maturity of some liabilities and ultimately by raising new capital. Since liquidity management is usually a combination of actions in relation to both assets and liabilities, the instruments available to address the task is obviously a function of those instruments available in the economy and the liquidity characteristics of these instruments.

At one end of the spectrum of liquidity management are banks like GE Capital from the USA that do not even collect deposits. They can manage their liquidity needs by issuing their own instruments on the capital markets at interest rates well below the inter-bank rates. At the other extreme are countries such as Ukraine and Serbia where most saving by-pass the banking sector and where the banks have little choice but to rely heavily on standing re-financing facilities from the Central Bank or borrow from/lend to rather thin inter-bank markets.

The limited development of a standing re-finance facility in Ukraine is a prime source of the huge volatility discussed in this Annex. It is also a factor that contributes a great deal to the very high lending rates, which we still see. Banks must hedge their volatility in that they compensate for it in the pricing of their loans. A standing re-finance facility would have a soothing effect on volatility and also provide some stability to market rates generally. The base rate of a Central Bank would normally be accepted as the orientation level for establishing the price of funds in countries where market-economy type instruments are not available.

At the initial stages of the development of a financial sector it is usual to see, as in Ukraine, two types of re-financing facility: one for overnight and the other for distressed banks with deep structural asset/liability imbalances. The latter is usually referred to as the lender of last resort facility and is provided at prohibitive rates. At the next stage central banks offer a rediscounting facility for certain acceptable promissory notes and bills of exchange – the discount rate becoming the main orientation for the price of funds. At the next stage collateralized lending (using for example foreign exchange funds) and swaps are used. At the next stage still, open-market operations based on Treasury Bills or even Certificates of Deposit of the central bank are employed- often with repurchase agreements (REPOs).

Conclusions

15. The brief analysis in this Annex shows that it is not only the level of prices generally and inflation, which should indicate the economy's achievement of financial stability. If we wish to assess the motivations of banks and other market players we also need to give very serious consideration to the volatility of prices in key financial markets additional to those directly geared to general inflation. Such volatility remains very large in Ukraine (up to 15 times the international benchmarks) and is a very important dimension in the unfinished business of financial sector reform. As an obvious component of market risk, it also provides important information to regulators and society in general about market confidence, about the potential risks taken by banks, and about how to assess fully the stability required by the Constitution of Ukraine. This has been a serious gap in policy thinking so far and, as pointed out in the main Report, a gap which does serious damage to the costs of conducting banking business in the country.

Figure 3. Volatility USD/DEM

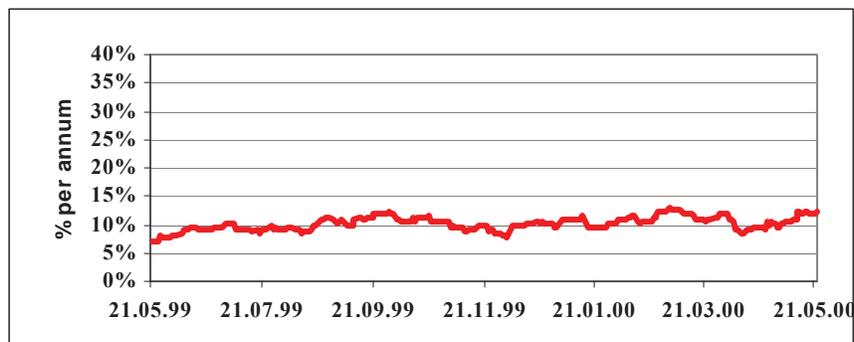
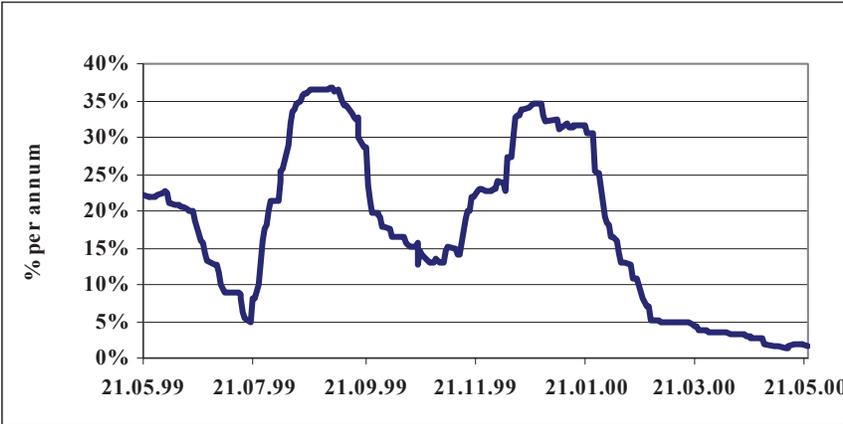


Figure 4. Volatility USD/UAH



Annex Five

Non-Bank Financial Institutions - Performance and Prospects

Introduction

1. There is a unanimous view amongst those who have studied Ukraine's situation that NBF development remains unsatisfactory, sluggish and largely chaotic. This situation is associated with a broad range of inter-connected problems preventing proper development of these institutions. The most important include the following:
 - a) an unfavorable macroeconomic climate: economic recession, currency and price instability etc.;
 - b) the absence of any purposeful long-term Government policy designed to build an efficient financial sector including efficient and reliable NBFIs;
 - c) the poor quality of the protection afforded to participants in the markets associated with the absence of a coherent framework of legislation regulating NBF financial operations, and the parallel absence of proper supervision;
 - d) the deep distrust of the public generally in any financial institution in the wake of the so called "trust saga" of 1994-1995, and similar scandals involving pension funds
 - e) the primitive nature of the professional environment associated with the unsatisfactory qualifications of many specialized personnel; the absence of good training arrangement to remedy this and the lack of qualification requirement to be met by these professionals.
2. These factors hold back the growth of all categories of NBFIs in spite of the enormous **prospective** demand for their services. The situation in individual categories of NBF can be summarized as follows.

Non-state pension funds

3. The urgency of creating a private pension support system in Ukraine represented by non-state pension funds (NPF) arises from the need to gradually reform the existing pay-as-you-go (PAYG) pension system and to introduce some elements of a funded system. This need is determined by a number of factors which are well rehearsed in the specialized reports on this topic.¹ This suggests that Ukraine has the possibility – given the correction of the factors listed above – to build pension fund assets to at least 4-5% of GDP within the medium term future. If achieved this would provide both an important source of medium term investment financing and at least one class of institutional investor to act as a countervailing influence on the powers of major enterprises. However, this will need well run and reliable institutions to establish the 2nd and 3rd tier elements of a sound pension system. It is unlikely in the extreme that this can be achieved on the foundations of the present private companies which are wholly unregulated and which inter-mingle their client-financed assets with the assets of their sponsoring organisations.²

¹ Ukraine's pay-as-you-go state systems for pensions is characterised by many well documented problems. These include very low benefits (below the poverty level of income in most cases); widespread evasion of contributions; too many retirees relative to the numbers of contributors; expensive administration; an arbitrary element in the allocation of pensions to different types of beneficiary.

² Financial Markets International Report of January 2000, pg 92

4. By sharp contrast with these evident needs and possibilities, the provision of private pension arrangements is tiny. At present, about 110 NPFs have been registered in Ukraine, but only about 20 of these are actually operating³. Of this number, 17 NPFs are confined to specific enterprises and collectives and only a few are open-end entities. Fifteen NPFs are integrated into the Association of Private Pension Funds created in December, 1996. The vast majority of the current NPFs are registered under the Law of Ukraine On Business Partnerships in the form of closed-end joint-stock companies, limited liability and additional liability partnerships. Most NPFs are founded and operated by commercial banks, trade unions and enterprises.
5. Of 90 non-active NPFs, almost 60 used to belong to the notorious “Oberig” scheme (a financial “pyramid” under the NPF guise that cheated 194,000 persons out of their money in 1995). Another 30 NPFs have registered but failed to start their operations or are awaiting a more benign legislative environment. Participants in the active funds include about 23,000 citizens whose contributions to these funds are equal to between 1 and 10 percent of employer-enterprise profits. The size of the additional pension which this provides varies between Uah 7 and Uah 300 per month relative to a state pension benefit of Uah 66 per month and the poverty line of Uah 118 per month. The NPFs use various pension schemes including lump-sum payment (30% of contracts), annual payments (30% of contracts) and annuity (40% of contracts). At the end of the year 2000 the total assets of the operating NPFs, according to NPFA data, were estimated to be Uah 22.77 million (in 1999 – Uah 15.11 million, in 1998 – Uah 10.52 million) while the sum total of pension contributions attracted during 2000 amounted to about Uah 3 million (another part of the NPF assets increase in 2000 is accounted for by the investment income obtained from the investment of earlier contributions). As was noted in the main Report this is only 0.01 % of GDP. The largest NPF at the present time is the Bank Ukraina fund that has 17,500 savers and 4,300 pensioners. Over the 4-year period of the Fund’s existence about UAH 2.0 million have been paid out in pensions. However, given the parlous state of this bank, the safety of these pensions must be in serious doubt.
6. Because financial and stock markets are so seriously underdeveloped in Ukraine, the opportunities to invest funds in reliable assets with a sufficient level of security, liquidity, diversity, yield and compliance with trust management standards, are extremely limited. Currently, these assets are basically limited to:
 - Treasury bills. These are now a poor quality asset due to the state’s deferral of payments in 1998/99 and the sharp decline in T-bill liquidity;
 - Bank deposits. These also have problems given the insolvency risks facing some major banks currently;
 - Real estate investments, primarily, housing. Again this is a difficult investment for the funds given the shallow state of the housing market; the significant fluctuations in housing values which are to be expected and the very low liquidity which it provides;⁴

³ PPFs typically will use something like the following scheme for their operations. A Fund concludes a pension agreement with an enterprise that remits pension contributions for its employees. All pension contributions accrue to the personal pension accounts of employees (fund participants) on instructions from depositor enterprises. The enterprise in turn signs contracts with its employees for additional pension fund contributions paid at the expense of enterprise funds. It is important to note that individual persons who are Fund participants cannot make their contributions independently since under a 1995 regulation, this is forbidden for them (regulation of the Verkhovna Rada of Ukraine of 12.22.95 “On Eliminating Abuse in the Process of Attraction of Citizens’ Funds by Economic Agents”)

⁴ the Decree of the President of Ukraine, #735/99, of 06.27.1999, and later the Law of Ukraine No. 1674-III of 04.20.2000

- Other assets including the shares of enterprises, insurance policies in major domestic or foreign insurance companies, deposit certificates in foreign banks, and hard currency cash. For a variety of reasons some NBFs consider these investments either not feasible or are too risky.
7. The consequence of this limited choice is that today the NPF investment portfolio comprises: bank deposits – 90%, State-loan bonds – 6%, shares, bank metals and real estate – 4%. Local expert opinion currently suggests diversified NPF investment based on the approximate ratios: T-bills - 25-30 percent; bank deposits - 50-60 percent in 5-10 banks; real estate - 10-15 percent. But this is far from being an adequate arrangement (either in terms of earnings, liquidity or safety of funds) to fuel the growth of pension business to the levels which might otherwise be possible.
 8. The logic of today’s situation as regards feasible investment outlets is as follows. If Ukraine wishes to achieve a satisfactory 2nd tier pension business (mandatory funded pensions) as well as improved 3rd tier arrangements (voluntary private funded pensions) then for some years the industry must be given the right to invest funds outside of Ukraine in carefully designated investment grade assets such as top-rated government debt and a limited range of overseas blue-chip equities.⁵ There is also some recognition in the industry of the need to allow foreign asset management companies access to the Ukrainian market in order to enhance the standards for fund management and custodianship and to re-build client confidence. In the absence of early improvement in the configuration of investment vehicles, this idea needs to be taken seriously. In the meantime, the perceived impossibility of creating reliable long-term PPF funds investment, and the low level of confidence in them caused by the 1994-1995 trusts and the “Oberig” scandals, substantially reduces the proportion of enterprises interested in sponsoring new NPF schemes for their employees. A recent survey put this at only 21.5 percent of enterprise managers.

Insurance Companies

9. Insurance companies have been one of the better performing categories of NBFIs during the past 5 years. But again they have a long way to go if they are to respond fully to the needs of the economy for the service they can potentially offer.
10. There were 283 insurance companies registered in Ukraine as of January 2001. However, only about 180 of these are really active including 23 companies having some foreign capital.⁶ The League of Insurance Organizations of Ukraine (LIOU) has 125 insurance companies as members. The regional distribution of insurance companies is non-uniform: Central region – 44 percent, Eastern region – 24%, Southern region – 21 percent; Western region - 11 percent. The distribution on the basis of size of insurance written is very concentrated. In 1998 for example, the 50 largest companies were responsible for 86 percent of all insurance premia and 93 percent of all insurance reserves. In 1999, the 72 largest companies (27% of the total number) accounted for almost 77% of the total amount of statutory funds, while 135 small companies (51% of

provides for an experiment on the basis of the “Kyivmiskbud” Holding company in order to streamline a mechanism for long-term investment of the pension deposits of natural and legal entities and the channelling of these funds to long-term credit for the construction of housing.

⁵ This is an idea advocated among other by the FMI report referred to earlier

⁶ 6 companies have a 49% foreign stake, 14 have 19-21%, 2 have 25% and 1 has a 35% foreign stake.

the total number) were responsible only for 12%. As of January 1, 2001, the amount of the insurance companies statutory funds was Uah 511 million, their own capital – Uah 1066 million, and the total assets amounted to Uah 1564 million (of which 29% – rights against re-insurers and 26% – securities seem to be income generating). The total reserves of Ukrainian insurance companies as of late 2000 amounted to Uah 959 million (176 million US dollars). This is approximately equivalent to the reserves of just one medium-sized Western insurance company. The structure of the insurance companies' reserves was as follows: unearned premia reserves – 97%, reserves against losses – 2%, and life insurance reserves – 1%. As indicated in the main Report, market volume is low, with accumulated premia at Uah 2136 million in 2000 (of which directly from insurers – Uah 1733 million, including Uah 253 million from individuals). This is equivalent to only 1.2% of GDP while in developed countries this indicator is typically 8 to 12%.

11. One result of these very small volumes is that only 10% of normally insurable risks have actually been insured to date (in developed countries the figure is typically around – 90 to 95%). The share of Ukraine in the total European market for insurance is only 0.05% as compared to the proportion of Ukraine's population in Europe which is about 7%). It should be noted that the Program for the Development of Ukraine's Insurance Market for the 2001 – 2004 period, approved by the Cabinet of Ministers of Ukraine Regulation of February 2, 2001, envisages that as of the year 2005 the amount of insurance premia will constitute 2% of GDP, with the amount of insurance reserves reaching Uah 3 to 5 billion. This is feasible but will call for substantial changes in the structure and practices of the industry.
12. There has already been a fairly rapid nominal growth in premia. during the past 6 years. Since 1995, annual growth rates have been 130%, 128%, 193%, 144% and 183%, respectively Altogether, the ratio of the amount of insurance payments for 2000 to the 1995 comparable indicator was 874% (without taking into account life insurance – 1160%). The factors accounting for this high growth include gradually improving professional standards; the lack of other viable financial instruments; and the greater interest/need in Ukraine's circumstances to hedge against risk. Additionally modern insurance services were unheard of until after independence and so the growth is taking off from a very low base.
13. The structure of insurance premia in the insurance sector in 2000 was as follows:
 - personal insurance (except life insurance) - 7.3 percent;
 - property insurance – 69.2 percent;
 - responsibility insurance - 9.5 percent;
 - Non-state obligatory insurance - 11.1 percent;
 - State obligatory insurance - 2.4 percent
 - Life insurance – 0.5 percent.
14. One important fact is that as of 1995, due to the considerable development of life insurance, personal rather than property insurance was prevalent in the overall structure of insurance payments. However, during the past 6 years, as a result of the macroeconomic situation and due to certain insurance market trends, specifically, the structure of payments has radically changed. The payment growth rates for the property insurance sector have exceeded 2000% over the past 6 years; for responsibility insurance these were almost 800%; for non-state obligatory insurance – almost 600%; and state obligatory insurance – close to 500%. By contrast personal insurance grew by only 180%

- due to a considerable decline in the amount of life insurance (the growth rates for the volume of personal insurance without life insurance exceeded 500% over the same period). In parallel with the change in the insurance market structure, the general level of premium receipts and payments has also changed.
15. The data presented above illustrate the present-day market situation in the insurance sphere. Looking ahead, non-state obligatory insurance has good prospects for development. For example, by 1999, responsibility insurance was leaving behind non-state obligatory insurance in terms of premium volumes – 16% and 13%, respectively. However, because of the lack of proper regulation and the uncertainties about the conditions for effecting these types of insurance, non-state obligatory insurance is actually developing at an unnecessarily slow pace. This applies in particular to the civil responsibility insurance of transport vehicle owners. The payments volume on class of this insurance, despite the huge market, was a mere Uah 49.0 million in 1999. To date, only 2.1% of transport vehicle owners have been insured.
 16. As regards state obligatory insurance, it would make sense to replace this gradually with direct compensation from the state budgets at the expense of funds envisaged for maintaining relevant state agencies.
 17. The re-insurance market in Ukraine is also seriously underdeveloped. As a consequence, only one-third of all insurance payments are re-insured and 50% of the re-insurance is written by non-resident companies. This is particularly the case for the coverage of substantial risks, such as those related to aviation, naval vessels and the space industry (aviation and sea risks, health risks for persons living abroad – amount to about 90% of payments, “autocar” risks – up to 60%, major property risks – up to 50%).
 18. Life insurance deserves special attention in the future. After medical and pension insurance, life insurance can be regarded as one of the highest priorities for the development of Ukraine’s financial markets. As is the case with pensions-business, life business provides for the accumulation of long-term investible funds and their channelling to the real sector of economy through the intermediation of financial and stock markets. However, statistics show that there has been a pronounced decline of this kind of insurance activity. Since 1995 to 1999, annual life insurance business has declined at rates of 55%, 55%, 69%, and 60% respectively, and only in 2000 was there a moderate increase in life insurance volumes (1999-2000 – 134%). However, annual premia in 2000 were only still 16.5 percent of the 1995 level. Consequently the share of life insurance in total insurance has declined from about 25 percent in 1995 to 0.5 percent at present (in developed countries, this indicator is typically 30 to 40%). With only 6 companies actually engaged in life insurance on the Ukraine’s market (with 12 companies having licenses for this type of insurance activities), Ukraine annually loses a potential US\$ 80 to 100 million as a result of the parallel activities of foreign insurers.
 19. An obvious reason for this low volume is the point made earlier that there are no reliable and profitable mechanisms for investing long-term funds due to the poorly developed domestic financial and share markets. In this connection, the League of Insurance Companies of Ukraine proposes that it be legally allowed to attract insurance payments and to retain life insurance reserves in foreign currency, and also to place them on foreign financial markets. However, such an approach does not find much support and

understanding on the part of the Government. There are fears that this approach may have an adverse implications for the stability of the national currency and result in a considerable outflow of investment resources from Ukraine. But in the absence of such radical action, it is difficult to see how the obvious demands for life insurance can be met by Ukrainian institutions.

20. Aside from the problem of appropriate investment vehicles, the two main problems for the sector at present are:

- **Protectionism.** The law adopted in 1996, maintains a 49% cap on the foreign ownership of Ukrainian insurance companies. This effectively gives local participants the ability to block decisions of the company's boards. The Ukrainian Insurance Organisations League (UIOL) which is a lobby of local market participants, has succeeded in convincing the Rada that the domestic industry is not ready for a foreign invasion. The draft law on amendments to the law On Insurance, which was approved in a first reading in May 1999, left the foreign ownership cap intact.

There is one more type of protectionism in Ukraine's insurance sphere – an internal one. Despite Article 42 of the Law On Insurance, which guarantees, on the part of the state, the conditions for free competition in exercising insurance activities, there are not infrequent breaches of this principle. In particular it is not unknown for central and local executive bodies to adopt ordinances that grant to one or a limited number of insurance companies a monopoly right to exercise certain types of insurance in a relevant territory. Such actions are seriously detrimental to the development of a competitive and effective insurance market in Ukraine.

- **Capitalization.** Capital requirements for insurance companies were fixed in 1996 at ECU 100,000 for companies formed by Ukrainian residents and ECU 500,000 for companies formed with foreign capital. The draft law On Introducing Amendments into the law of Ukraine "On Insurance" provides for establishing a minimum size of statutory capital for insurance companies (regardless of foreign capital involvement) in the amount of EURO 500.000, and for companies that are engaged in life insurance – EURO 750,000. In addition, The Program for the Development of Ukraine's Insurance Market for the 2001 – 2004 period provides for the possible introduction, starting with January 1, 2003, of new levels of statutory funds for insurance companies, namely EURO 1000.000 and EURO 1,500,000, respectively. The sector clearly needs to be consolidated and these new requirements would hasten the process. However, there remains considerable pressure from the industry against such changes.

Credit Unions

21. According to the estimates from the National Association of the Credit Unions of Ukraine (NACUU), about 650 credit unions (CU) have so far been registered in Ukraine and this number is growing continuously. The precise number is uncertain due to the fact that under the present legislation, the CUs are registered at the local level and there is no unified national CU register. The number of CUs actually operating is even less clear partly due to the absence of any specialized state agency to supervise their activities. However, NBU data indicate that in 2000 307 CUs reported some activity. Their total

assets amounted to Uah 36.8 million.⁷ The NACUU has implemented a system for monitoring the financial performance of its member CUs and it also applies self-regulating arrangements to these members. The NACUU reports that it has 106 CU members based in 24 separate regions of Ukraine and that it also provides some support to another 30 CUs that are prospective members. The overall membership in the NACUU member credit unions as of the end of 2000 was over 80,500 persons; total assets stood at over Uah 18.8 million; total credit turnover in 2000 involved some 100,000 separate loans totaling more than Uah 32 million. The total amount of membership fees at the same date amounted to Uah 16.72 million (of which 17 percent were share-type contributions, and 83 percent were deposit-type contributions). The nominal growth of business since 1995 has been rapid. Specifically, the annual asset growth rates of NACUU member credit unions in the past five years has been 219 %, 193 %, 186 %, 127 % and 147 percent, respectively. NACUU membership has increased by 5.5 times as compared to 1995.⁸

22. Given present legislation, a credit union may enlist only individuals sharing some common membership features (such as a common work place, affiliation with an NGO, the same place of residence, etc.). It can also offer services only to its members; and may perform only those types of financial and economic activities that are directly related to deposits from and loans to union members. However, each CU can independently determine the terms for services provision, and the policies for the creation of equity, liquidity and financial stability arrangements.
23. Although CUs are currently small in terms of their business and assets volumes, they represent one of the few financial institutions in Ukraine that can cater to the needs of small retail savers and borrowers. In accordance with the legislation, besides credit unions, only commercial banks may deal with individuals on the savings market. As of January 1, 2001, the deposits of individuals in the banking system were Uah 6,845 million or 36 percent of the total funds in the commercial banks accounts of enterprises, organizations and households (of which 82% at the banks that are members of the Deposits Guarantee Fund for individuals). However, at present, the overwhelming majority of banks, for this or that reason, are not actively involved in attracting deposits of individuals. Specifically, as of January 1, 2001, 3 large banks held almost 41% of all deposits of individuals (19.4 percent – Oshchadbank, 11.6% – Privatbank, and 10% – Prominvestbank). Most banks are interested in attracting large sums at relatively low interest. Currently those few banks that do actively seek household deposits pay interest rates from 2 and 20 % annually with minimum sums of deposits ranging from Uah 200 to 2000. By contrast the average credit union interest rates equal 36-48 percent per annum, with the typical deposit amount being Uah150-250 but in a range from Uah 10 to 10,000.
24. Similar contrast apply to lending. Most commercial banks do not offer credits to individuals, although the volumes of bank credit to this category of clients continues to

⁷ One can question these statistics since the NBU exercises no proper supervision of the timeliness, comprehensiveness and correctness of the submitted reports, nor does it perform obligatory regular inspections to prove the reliability of this information.

⁸ No corresponding data are available regarding those CUs that are not supported by the NACUU. This would suggest that the activities of some of them are dubious from the standpoint of both their statutory obligations and their safety. That suggestion is justified by a number of notorious cases of financial pyramid schemes that operated under the credit union label and were capitalizing on legislative uncertainty and lack of supervision. The best known is the case of the CU “Penguin” from the town of Bila Tserkva, in which around 10,000 citizens lost their savings in 1997.

rise. In 2000, the credit outstanding to the population amounted Uah 956.43 million. This is 40 percent higher than in 1999. However, 10 banks account for 54 percent of total amount of credit to individuals. These banks include Privatbank –9.2 percent, Oshchadbank – 9.1 percent). In this process, the banks typically target “larger” and “sustainable” borrowers. They also maintain stringent requirements to control their credit risks. The proportion of short-term credits in the total volume of credits issued to individuals in 2000 was only 9.1 percent. The average interest rates were 27 to 30 percent per annum; credits were normally issued on the security of real estate at a level of 50 to 70 percent of its assessed value, which automatically determines the minimum amount of credit at a level of around Uah 30 to 40,000). This state of affairs, in spite of the fact that bank credits are relatively cheap, excludes most individuals from access to bank credit. It also prevents the provision of credits to small and medium businessmen. A typical problem is the non-availability of credit to businessmen and farmers needing credits in the amount of Uah 1000 to 25,000 in order to replenish their working capital or purchase unsophisticated technological equipment.

25. Another category of financial institution that does provide credits to individuals is pawnshops. However, these are unable to cover even partially the existing niches on the credit market. There are presently estimated to be about 120 pawnshops operating in Ukraine, but they face no relevant special legislation and no supervision of their activities is exercised. Pawnshop credit that occupy the so-called “usurer” niche is characterized by high interest rates, onerous security requirements and short credit maturities. Most credits are extended against the pledge of precious stones and metals in the amount of 50-75 percent of their appraised amount at 250-500 annual interest with the maximum maturity of 45-60 days. By contrast, credit unions typically lend at 60-84% annual interest on credits, the average size of which is Uah 300-500 in the general range of Uah 50-50,000 for terms of between 10 days and 18 months.
26. The structure of the total credit portfolio of NACUU CU members in 2000 was as follows:
 - social credits – salary advance loans, medical treatment loans, preferential loans to individual socially vulnerable groups of population, etc. (5 percent of the general credit portfolio);
 - consumer loans - loans for the acquisition of household appliances, education loans, vacation loans, etc. (60 percent of the total credit portfolio), and
 - business loans - credits to private entrepreneurs and farmers (35 percent of the total credit portfolio).
27. In short, credit unions offer wide possibilities and good prospect for further development in these financial market niches. However, they have several problems that prevent their more rapid response to the obvious demand for these services. Foremost among these is the basic malaise of the economy including the instability of the national currency, which results in the devaluation of members’ savings, outage of a great number of industrial enterprises that are potential fields for CU, delays in the payment of wages and pensions that prevent savings and reduce borrowers’ ability to meet their obligations, etc. CUs also face the problems associated with the absence of a sound basis of legislation and the associated prudential supervision that is needed to ensure protection to actual and potential members. This is discussed in the main Report.

Leasing

28. Estimates of the potential demand for leasing services in Ukraine vary between \$12.0 and \$50.0 billion. These are theoretical numbers that take into account the level of depreciation and the need for replacement of fixed assets in different sectors of the economy. They are **not** indicative of the present capacity of the sector. Certainly the potential demand is very large and leasing services could be expected to be particularly important in sectors such as agriculture (90 percent of fixed assets are depreciated) and transport (60 percent of fixed assets are depreciated) and for SME development more generally. For example, it is estimated that in the agricultural sector alone fixed assets worth \$15.0 billion will have to be replaced over the next few years. Food processing industries will require another \$20.0 billion. There are also more than 100,000 SMEs operating in Ukraine and many of these would benefit from the availability of a leasing possibility to finance necessary equipment even if conventional bank credit becomes more easily and cheaply available than is the case presently. That number should also increase greatly (prospectively to 1 million plus SMEs) if the current regulatory burden on enterprise is reduced in the manner advocated by all commentators. At the present as we noted in Section 2 of the main Report, the banking system is unable to meet the financing needs of industry and especially the SME component.
29. Experts are reasonably agreed on the possible volume of leasing services during the next few years. IFC specialists evaluate such a volume at US\$ 367 million per annum. The Bank of Ireland estimates Uah 1.6 billion (\$300 million) by 2002. US\$ 300 million is very optimistic but even this will constitute only about 2 percent of the minimal potential requirement of the economy for such services.
30. How closely does the current actual volume of leasing operations in Ukraine approximate at least this indicator? There is no definite answer to this question, since there are no credible statistics on this issue. The situation is made worse by the fact that transactions that are *de facto* recorded using the leasing scheme are then formalised, because of the unfavourable legislative environment, as purchase and sale contracts under which payments are made on an instalment basis, or as various lease agreements (pseudo-leasing).
31. There are thought to be 40 leasing companies currently operating outside the state system, of which close to 20 are actually engaged in leasing operations. The survey carried out in 1998 by the IFC indicated that as of July, 1998, the total volume of leasing contracts of the 11 largest domestic lessors ("leasing providers") amounted to \$66.4 million. The structure of contracts at that time was as follows: trucks - 15 percent; cars - 10 percent; office and bank equipment - 29 percent; agricultural machinery - 14 percent; buses and minivans - 9 percent; other equipment - 23 percent. Preference seems to be given to relatively cheap, fast-payback, and liquid types of equipment and machinery that require no additional investment in the event of a probable dismantling upon leaser request. Contract amounts fluctuated in the range of \$10-950,000 with the average contracts equal to \$200,000. Prepayment is 25-30 percent, the average contract term is 2-3 years, and the leasing interest rate is 20-25 percent. Since 1998, the situation has not radically changed. As of end-2000, according to Ukrleasing Association estimates, the volume of leasing contracts was Uah 326.5 million (around US\$ 60 million), of which Uah 297.8 million falls on equipment leasing contracts (Uah 238.2 million or 80 percent

– international leasing) and Uah 28.7 million – real estate leasing contracts. Specifically, as regards the leasing of equipment:

- Prevalent among different types of equipment are machinery and industrial equipment (56 percent) and transport equipment (35 percent);
- Predominant among the leasing recipients categories are the agricultural sector (48%), private sector (32%) and industry and construction (14%);
- As regards the contract terms, contracts for 2 to 5 years prevail (72%), while contracts for up to 2 years constitute 20 percent, those from 5 to 10 years – 8 percent, and there are no contracts at all for a term longer than 10 years.

As regards real estate leasing:

- office buildings (35%) and hotel compounds (32%) were predominant among different types of real estate;
- as regards the contract terms, contracts of up to 8 years (92%) are prevalent.

32. It should be noted that although real estate leasing is possible pursuant to Ukraine's current legislation, it is not correct to regard it as financial leasing in the traditional meaning of this term.

33. Leasing operations in 2000 were performed by 22 companies, of which 15 were dealing only with equipment leasing, 5 – only real estate leasing, 2 – both equipment leasing and real estate leasing. Under the existing legislation, leasing operations may be performed by banks and leasing companies. However, the government also plays an active role. Thus, pursuant to the Cabinet of Ministers Regulation of January 1998, the State Leasing Fund was set up under the Ministry of Agriculture. This Fund was to be formed using budget funds and it was called upon to facilitate the renovation of the material and technical basis of agricultural sector. In April, 1998, 15 companies, most of which are enterprises involved in the state body "Oblagrotekhservice", obtained access to the Fund's resources on a competitive basis. The implementation of state leasing programs is basically concentrated in the quasi-state network of enterprises created on the basis of the former centralized supply system delivering machinery and equipment to kolkhozes. As of July 1, 2001, 9,7 thou pieces of machinery and equipment for the total amount of Uah 480 million were made available to collective agricultural enterprises and farms at cost of the State Leasing Fund. However, this approach is inefficient and is not market orientation. As a result, only 15 percent of the expected payments were obtained for equipment provided under this scheme by November of 1999, and as of January 1, 2001, a share of returned leasing payments constituted only 20,6%. The government response as of July 26, 1999 was to establish the State Leasing Enterprise *Ukragroleasing* (now, National Stock Company), which operates through the network of regional affiliates. It assumed the task of returning the funds that were previously disbursed from the State Leasing Fund, and channeling them into leasing circulation (the State Leasing Fund itself was not replenished in 2000 at the expense of budget resources). The Government has also attempted to create other specialized leasing companies with a government ownership stake.⁹ However, it proved impossible to ensure effective operation of these companies. This is yet one more example of the general proposition in this Report that the government is ill-equipped to operate as the sponsor and owner of financial institutions

⁹ This concerns the State Leasing Company (February 1998), whose 49 percent of shares were supposed to belong to 26 enterprises producing agricultural machinery, and the "Ukrtransleasing" Company (June, 1998).

be they banks or NBFIs.

34. Leasing companies are incorporated as joint-stock companies and limited-liability partnerships. Most have been founded by banks or by producer-enterprises. This is because it is virtually impossible for independent leasing companies to obtain the bank or supplier credits necessary to perform leasing transactions. In particular, banks either refuse to provide credits to the outside companies or offer credits on unacceptable terms (e.g. short-term credits at 60-70 percent compared to the typical rate for crediting leasing operations of 22 percent, with a credit term ranging from 3 to 5 years). As a result, the lion's share of international leasing operations which, as was noted, account for 80 percent of the total volume of equipment leasing operations, are carried out by foreign producer-enterprises (Volvo, Mercedes-Benz, Scania, etc.) via foreign leasing, rather than domestic leasing companies. Unlike domestic companies, foreign leasing companies face no serious problems while attempting to attract the required bank resources or to the bank guarantees and insurance services. Nor do they have any lack of proper business history or own capital. It seem likely that as the macroeconomic situation stabilizes and the legislation improves, their presence on the Ukrainian market will grow further.

Investment Companies and Funds

35. Investment funds and mutual funds of investment companies should be able to carry out an important function in terms of collecting small savings from the population at large and re-investing these in productive activities of various types. As the main Report shows, in some other transition economies, investment and mutual funds have been able to accumulate assets equal to 5-12 % of GDP as against less than 0.21% in Ukraine. There are several reasons why these institutions have not yet become a significant part of Ukraine's financial architecture.
36. The first is that of 252 investment funds and mutual funds of investment companies that operated at the end of 2000, 234 or 93% were of the closed-end type. The main function of these institutions was the accumulation of privatisation property certificates mainly from small investors (citizens of Ukraine), and the subsequent investment of these funds in privatised securities. As of January 1, 1999, closed-end investment funds and mutual funds of investment companies had attracted more than 19 million privatisation property certificates (PPCs), or 42% of the total amount of PPCs received by Ukraine's population through the Oshchadbank affiliate network. Other financial intermediaries attracted, respectively: trust companies – 17%, commercial banks – 2.3%, securities traders – 0.4%. In addition, between 1994 – 1998, and through their participation in certificate auctions and operations on the secondary securities market, investment funds and mutual funds of investment companies created blocks of shares of enterprises in the amount of 5 to 25 percent of the total. This helped to achieve a certain concentration of blocks of shares of privatised enterprises. However, the “mass certificate privatisation,” for the servicing of which closed-end investment funds and mutual funds of investment companies were actually created, reached its peak during 1996 – 1997 and was practically completed as of end-1998. At the same time, only a relatively small number of investment companies and funds managed to re-orient their activities towards systemic work with portfolio investors.¹⁰

¹⁰ During the period of investment fund or company operation in Ukraine, the regulator namely the State Property Fund has removed the permits of over 150 funds and companies.

37. A second point is that the completion of certificate privatization in 1998 coincided with the crisis in the Russian and Ukrainian financial markets which seriously compromised activities on the country's stock markets and the liquidity of the underlying securities. Since then most joint investment institutions have been virtually unable to obtain profit from active security transactions. It should be also noted that the absence of "controlling" and "blocking" stakes of privatized enterprises in the securities portfolios of the joint investment institutions limits these institutions' possibilities to influence the economic and financial activity of enterprises. It also makes it very difficult to obtain investment income from the securities of which investment portfolios are formed. Given a certain level of constant expenditures, such a situation has caused the joint investment institutions to sustain losses and to reduce their activities. Many are effectively in liquidation.
38. A third point is that in spite of certain efforts made by the Securities and Stock Market State Commission (SSMSC) and the State Property Fund of Ukraine (SPFU), supervision of investment funds and mutual funds of investment companies remained insufficient and not systemic in recent years. As a result, at present, dozens of funds are under criminal investigation, and it is unlikely that such funds will ever be able to make settlements with owners of their investment certificates.
39. In summary, most of the operating investment funds and mutual funds of companies have fully exhausted their function as "certificate privatization" vehicles and have no real prospects for further development.
40. It is noted that in 1999-2000, 79 investment funds ended their declared term of activities (33 – in 1999, and 46 – in 2000), as did 56 mutual funds of investment companies (11 – in 1999, and 45 – in 2000). This, in turn, results in investment funds and mutual funds of investment companies having to make settlements with their participants by redemption of investment certificates. Under present-day conditions this is very difficult. Due to the low liquidity of the securities market, the overwhelming majority of funds and companies are not in a position to redeem their certificates. In view of this, the Presidential Decree of August 8, 1999 allowed investment funds and mutual funds of investment companies to redeem certificates not only through cash payment, but also by swapping them for enterprise shares that are fund assets. This is not a particularly desirable outcome although it makes the best of a bad situation. It certainly differs from the high hopes held for these investment vehicles in the early days of the mass privatization process in 1994-95.
41. The adoption by the Verkhovna Rada of the law On Joint Investment Institutes (Unit and Corporate Investment Funds) of March 15, 2001, became an important event in ensuring the further development of joint investment institutions in Ukraine. In general, the law creates the foundations for creating fully-fledged joint investment institutions; for properly organizing their work; as well as for developing the infrastructure necessary for their activity: in the first instance, assets management companies. Closed-end investment funds and closed-end mutual funds of investment companies that were created in accordance with the procedure established before this new law became effective, will continue to operate pursuant to the Regulations on Investment Funds and Investment Companies, approved by the Presidential Decree of February 19, 1994. But this will

apply only for the period for which they were created. After the expiration of the term of activity of such investment funds and mutual funds of investment companies, they should be liquidated or take a decision on their reorganization into a share (unit) or corporate investment fund. This will entail bringing their statutory documents and activities into line with the requirements of the new law. In their turn, open-end investment funds and open-end mutual funds of investment companies that were created in accordance with the procedure established by the legislation before this law became effective, are obliged to be liquidated or bring their activity in line with the requirements of this law during two years from the date upon which this law took effect.

42. The key factor in ensuring the successful transformation of old, and creating new, joint investment institutions will be the quality of SSMSC regulation and supervision of these institutions activities and the parallel activities of assets management companies and custodians. A top priority in this process is ensuring a reliable protection of investors' rights and, in the first instance, the rights of individuals. According to expert assessments, the most likely number of new joint investment institutions will be 30 to 40 powerful share (unit) and corporate funds that will be able to meet the needs of both large portfolio investors and ordinary individual investors. Of special note is such type of joint investment institution as venture funds, which can potentially become an important source of innovation capital for the future.