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THE AFTERMATH OF THE CRISIS

AN OVERHAUL OF UKRAINE'S BANKING SECTOR

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- In 2014-2016, Ukraine's banking sector was affected by what has proven to be the most serious crisis in the country's modern history. Over these three years, almost half of the banks, which hold 30% of the sector's assets as a whole, went bankrupt. Their total operating deficit amounted to US$ 11.8 billion (with the value of assets at the end of 2016 standing at US$ 45.7 billion) and the banks' capital in hryvnias was reduced almost by half.

- A crisis on this scale was not only the result of the economic collapse aggravated by the war with Russia (including the occupation of Crimea and the loss of control of a part of the Donbas) and the domestic political crisis (including the Revolution of Dignity), but was mainly caused by the dysfunction of the banking sector and bad practices connected with so-called oligarchic banking, which had been present in the sector for many years. In many cases the banks were not involved in typical financial operations and instead were treated by their owners as instruments to obtain funds intended for doing business in other sectors of the economy. Moreover, it turned out that some of the banks *de facto* operated in pyramid schemes.

- It can be estimated that in 2014–2016 the losses incurred by the state and banking sector clients exceeded US$ 20 billion (23% of Ukraine's GDP in 2016). These losses included clients' uninsured lost deposits, state payouts to insured deposits for insured deposits, unpaid central bank refinancing loans, the costs of refinancing, and costs of recapitalisation from central bank funds and from state budget. A portion of these funds (it is not possible to determine the exact sum) has been illegally transferred from the banking system to companies linked to the banks' owners or abroad.

- Ukraine's leadership has managed to stabilise the situation in the banking sector and halt the downward trends, in large part due to considerable support from and under major external pressure from the International Monetary Fund, the European Union and other Western states. Significant amendments were introduced to regulate the functioning of the banking sector, the sector itself was cleansed of insolvent entities, and the financial standing of banks operating on the market was strengthened and improved by way of restructuring and recapitalisation.

- Regardless of the achieved stabilisation of the situation in the banking sector, it is too early to determine whether the reforms brought success and if

the improvement is sustainable. At present, continued implementation of legal reforms is of paramount importance, including reforms to protect the rights of lenders (for example involving the improvement of loan security requirements and credit risk assessment). As far as the operation of specific banks is concerned, it is necessary for them to boost their lending activity and continue their restructuring and corporate governance reform. It is equally important to further strengthen banking supervision and to increase the efficiency of public-order institutions in preventing financial crime.

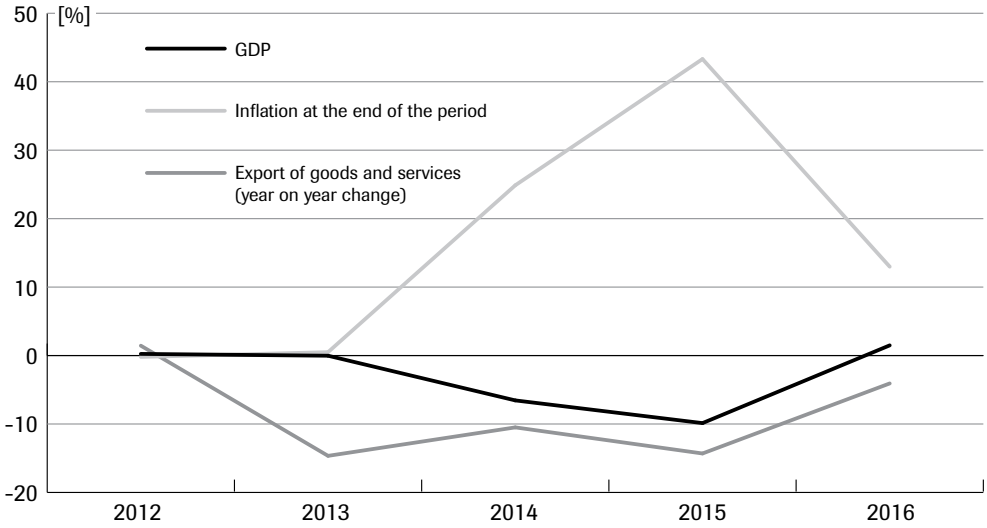
- The crisis has made it necessary for major changes to be implemented in the functioning and structure of the banking sector. Examples of these include: the consolidation of the hitherto relatively fragmented sector (at present almost 90% of assets belong to the 20 largest banks); large state-owned and foreign banks achieving a dominant market position; and a major reduction in the market share of banks with private Ukrainian capital which previously had a fairly strong position.

- The changes in the banking sector have major consequences not only for the functioning of the Ukrainian economy, but also for Ukraine's political system. Prior to the crisis, the banks had been an important instrument the oligarchs used to generate rent (not always in a legal and transparent manner) and to build political influence. Recent changes in how the sector functions have limited the opportunities to apply illegal practices in the form which has been used to date. As a result of the changes in the banks' ownership structure it is no longer widely possible to use these banks as instruments for exerting political pressure. However, it should be noted that positive trends have not yet been solidified and, given the fact that the supervision bodies and the legal system are weak and that there is omnipresent corruption, a number of irregularities do persist in the functioning of the banking sector.

I. 'BANKOPAD', OR THE COLLAPSE OF THE BANKS

The deep economic crisis which came hard on the heels of the dramatic events surrounding the Revolution of Dignity and Russia's aggression in early 2014 has resulted in a serious slump in the Ukrainian economy and a significant deterioration of macroeconomic indicators. It involved, for example, a rapid decline of GDP (-6.6% in 2014 and -9.9% in 2015), a major rise in the rate of inflation (reaching 43% at the end of 2015), an almost 70% devaluation of the hryvnia, and a drop of around 15% in foreign trade turnover and investment in 2014-2015.

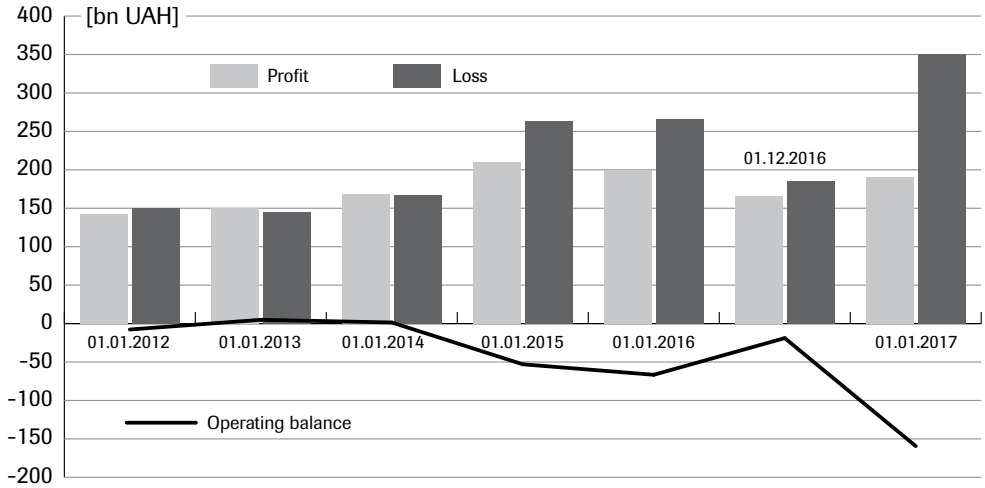
Chart 1. Ukraine's economy during the crisis, the change in GDP, inflation and the value of export of goods and services, in %



Source: International Monetary Fund

The economic crisis was one of the factors that caused the collapse in the banking sector. Most importantly, there has been a considerable deterioration of the banks' profitability and capital flight. In 2014 and 2015, Ukrainian banks recorded an operating deficit of US$ 3.3 billion (3.6% of GDP) and US$ 2.7 billion (3.1% of GDP) respectively. In 2016, the situation began to gradually stabilise and on 1 December the deficit stood at US$ 0.7 billion. However, due to the state taking over Ukraine's largest bank, PrivatBank, in December 2016 and to the need to recapitalise it, the banking sector's operating deficit increased to US$ 5.8 billion (or 6.7% of GDP) at the end of 2016. As a consequence, over these three years the accumulated deficit amounted to US$ 11.8 billion.

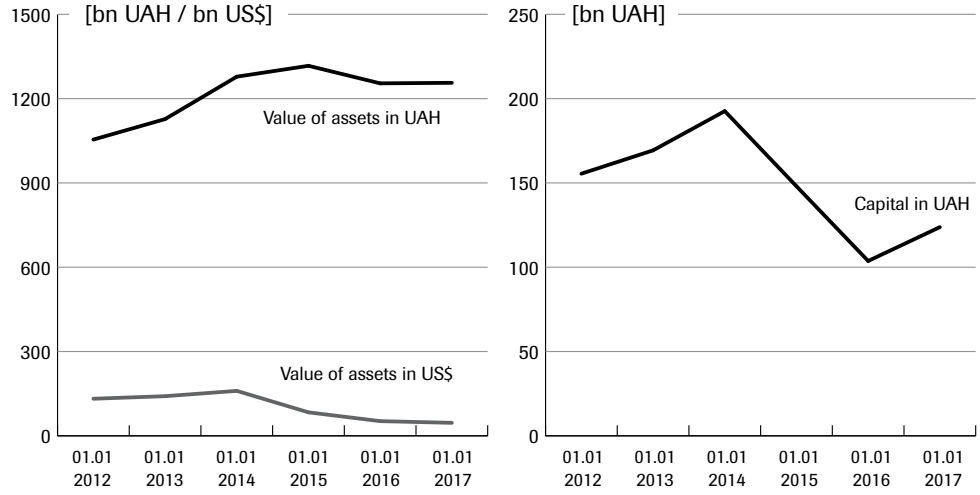
Chart 2. The banking sector's operating indicators, in billion hryvnias



Source: National Bank of Ukraine

Although the value of the banks' assets expressed in Ukraine's national currency remained practically unchanged and amounted to 125-130 billion hryvnias, due to the hryvnia's devaluation, the value of these assets calculated in US dollars fell sharply from US$ 159 billion on 1 January 2014 to US$ 46 billion on 1 January 2017. In addition, there has been a significant outflow of banking capital – from 192.6 billion hryvnias (US$ 24.1 billion) on 1 January 2014 to 103.7 billion hryvnias (US$ 4.3 billion) on 1 January 2016 and 123.8 billion hryvnias (US$ 4.5 billion) on 1 January 2017. This posed a significant threat to the banks' financial liquidity, especially in 2014 and 2015. However, in 2016 the banks gradually began to improve their liquidity due to recapitalisation and restructuring.

Chart 3. The banks' assets and the value of their capital

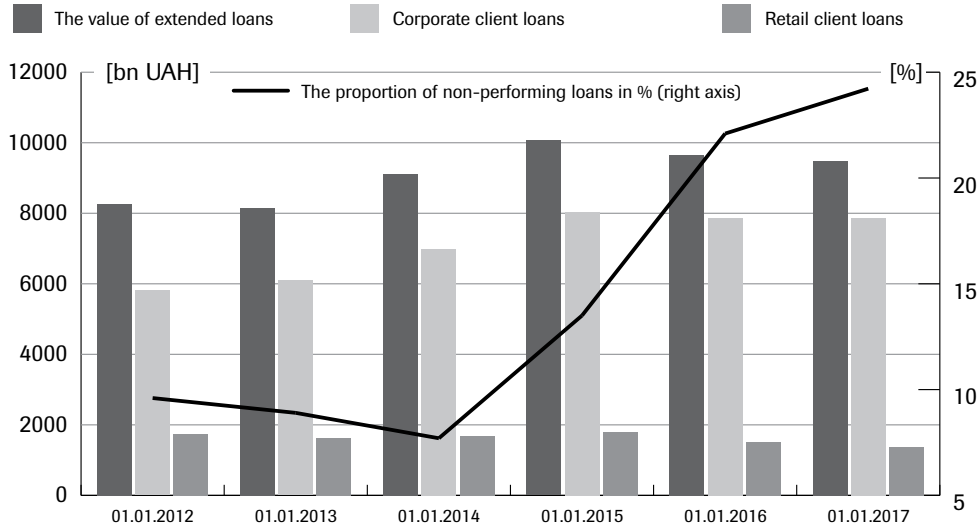


Source: Author's own calculations based on data compiled by the National Bank of Ukraine

A rapid increase in the value of the so-called 'non-performing loans' (NPL) was a major problem. According to the National Bank of Ukraine (NBU), their share in the total value of extended loans increased from 7.7% on 1 January 2014 to 30.5% on 1 January 2017. However, in connection with the state taking over PrivatBank and reassessing its loan portfolio, the NBU estimates that the share of non-performing loans may rise to 46% in 2017. According to the IMF, which uses a broader definition of NPL, an increase in the share of these loans was recorded, from 26.1% in March 2014 to 48.2% in June 2016. The capital flight and the deterioration of financial liquidity contributed to a drop in the value of extended loans which, in turn, had serious consequences for the economy and limited the opportunities for local companies to do business. Aside from the domestic situation caused by the economic crisis, the problems faced by local companies and the siphoning off of funds on a large scale, the factors that caused a major increase in the share of non-performing loans also included the Russian occupation of Crimea and the war in the Donbas, since in territories which Kyiv had lost control of borrowers simply ceased to pay off their loans to the banks. At the end of March 2014, the value of loans extended by Ukrainian banks in Crimea and in the Donbas stood at 95 billion hryvnias (around US$ 6 billion according to the exchange rate applicable at that time), of which 36 billion hryvnias (US$ 1.5 billion according to the exchange rate applicable at that time) were loans taken out by households. The share of the eastern regions in the loan portfolio of individual banks was between 25% and 33%, whereas Crimea's share was around 3%. Over 70% of loans taken out in these regions are not being serviced. According to estimates by the Ministry of Finance, losses incurred by the banks

in connection with unpaid loans in regions outside Kyiv's control amount to around 60 billion hryvnias (approximately US$ 2 billion according to the May 2017 exchange rate)[1].

Chart 4. The value of extended loans in billion hryvnias and the proportion of unpaid loans in %



Source: National Bank of Ukraine

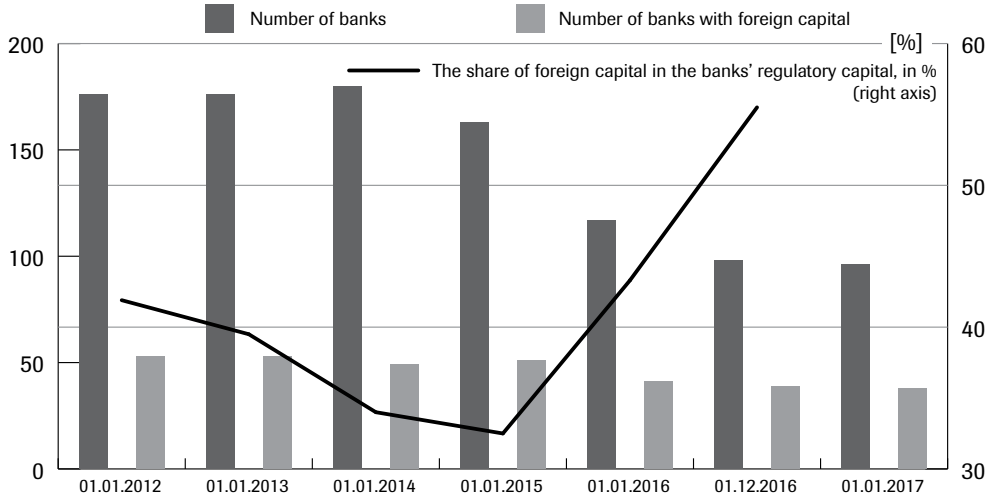
The decline of the situation in the banking sector resulted in several banks becoming insolvent. These were banks that were unable to meet the requirements introduced by the National Bank of Ukraine regarding financial liquidity, the quality of capital and the assets. The number of banks operating on the market fell from 180 in January 2014, to 93 in January 2017. The value of assets of the insolvent banks accounted for around 30% of the total value of assets in the banking sector as a whole. The insolvent banks were almost exclusively privately-owned banks with Ukrainian capital (or *de facto* Ukrainian banks registered in Cyprus or other tax havens) and the reasons behind them becoming insolvent generally included the lack of ability or will on the part of their owners to recapitalise them.

The banks that managed to sustain their market position are either state-owned banks which received recapitalisation from the central bank, or foreign banks which could count on support from their investors and which had been

[1] П. Харламов, Неподъемное бремя: как банки добиваются погашения по кредитам в Крыму и зоне АТО, *RBK-Ukraina*, 26 August 2016; https://daily.rbc.ua/rus/show/nepodemnoe-bremya-banki-dobivayutsya-pogasheniya-1472202911.html

following a very cautious lending policy. As a consequence, the status of banks with foreign capital increased considerably in the banking sector. Their share in the regulatory capital of the sector as a whole increased from 34% in January 2014, to 55.5% in December 2016.

Chart 5. 'Bankopad' – the drop in the number of banks operating in Ukraine



Source: National Bank of Ukraine

According to estimates, in 2014-2016 the total losses incurred by the state and the clients of the Ukrainian banking sector amounted to around US$ 14.5 billion, plus the costs connected with state assistance and nationalising Ukraine's largest bank, PrivatBank, which may be a further US$ 6 billion. A major portion of these losses (it is difficult to determine precisely how large) may be funds illegally transferred from the banking sector. US$ 3 billion are refinancing loans unpaid to the central bank by the insolvent banks, US$ 8.5 billion are non-insured clients' deposits which had been lost, and another US$ 3 billion are payments made by the state as insurance for deposits which clients had made in banks that became insolvent. So far, only a minor portion of the lost funds has been recovered – around US$ 150 million[2]. According to official information, as at the beginning of 2017, the Deposit Guarantee Fund opened 3,835 criminal cases with a total value of 295.5 billion hryvnias (US$ 10.8 billion), of which 262 cases with a value of 62.56 billion hryvnias (US$ 2.3 billion) involve theft and siphoning off funds from the banks.

[2] I. Koshiw, Y. Romanyshyn, Ukraine in danger of never recovering stolen billions, *Kyiv Post*, 23 December 2016.

II. OLIGARCHIC BANKING

The large scale of the crisis in Ukraine's banking sector was not only caused by the poor economic situation, but mainly by structural irregularities and pathologies in the banking system and in how the banks function which had been present for many years. This situation results from the fact that an oligarchic system exists in Ukraine. This is characterised by the massive and non-transparent influence on state institutions which informal politico-business groups have and by a high level of corruption. The dysfunction of the banking sector has also been caused by the inefficiency of the state institutions and the lack of proper supervision of this sector mainly on the part of the market regulator and financial supervision bodies and also by the state services combating financial crime. This was combined with insufficient legal regulations (for example the insufficient protection of lenders' rights, faulty regulations regarding loan security evaluation) and the large-scale corruption and weakness of prosecution bodies and the judiciary.

The most frequent pathologies in the banking system can be illustrated by three main categories of banks that have become insolvent. The first category includes the so-called 'oligarchic banks' involved in obtaining funds for companies owned by local business moguls. The second category are the so-called 'zombie banks' that only had liabilities and no capital, and were used to siphon off funds to offshore locations. The third category includes banks involved in money laundering which had neither assets nor liabilities and were used to hide and/or transfer illegal funds to offshore accounts. In addition, the practice of siphoning off funds from state-owned banks should be mentioned, for example using political connections to obtain attractive loans which then were not paid off. The banks were also used in other types of illegal practices, for example in 'corporate raiding' i.e. illegal company takeovers.

In the oligarchic system the banks were an important tool to manage financial flows, obtain funds and to finance business activity. Practically every major oligarch owned a bank (or even several banks) or indirectly controlled a bank via a network of his associates. The activity of a bank of this kind focused mainly on providing services to companies owned by this oligarch. Only later could this bank offer its services to other clients.

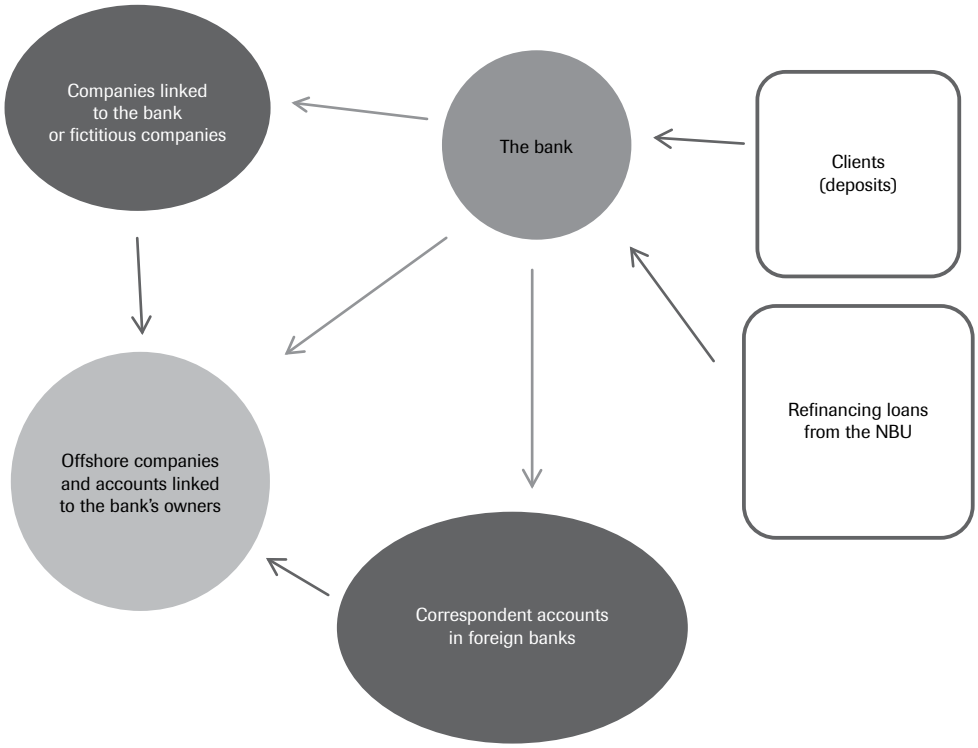
The fact that the owners treated these banks exclusively as tools to finance their private businesses, and not as companies providing finance and banking services available to everyone, was one of the most frequent irregularities in the

Ukrainian banking sector[3]. In practice, this type of activity (so-called 'captive banking') boiled down to obtaining capital – often from the market by offering an excessively high interest rate on deposits or in the form of refinancing obtained from the central bank – and then transferring the funds to companies linked to the bank's owner as loans frequently extended on very favourable conditions and with insufficient collateral. In many cases, these loans were offered to companies linked to the bank's owners or shareholders on an enormous scale. Former central bank governor Valeriya Hontaryeva estimates that a staggering 97-100% of the corporate loan portfolio of PrivatBank (Ukraine's largest bank which until the end of December 2016 had belonged to two oligarchs, Ihor Kolomoyskyi and Henadiy Boholyubov) was extended to companies linked to the owners[4]. The most important problem was that these loans were not properly secured, which *de facto* facilitated the transfer of major funds from the market. The losses incurred in this way either turned out to be irreversible or had to be compensated for from state funds (for example, in the case of deposits, the compensation was paid out from the Deposit Guarantee Fund). For example, after the state took over PrivatBank it turned out that the bank's capital shortfall amounted to around US$ 5.7 billion (at the beginning of 2017 the government adopted a plan to recapitalise the bank with approximately US$ 4.3 billion and an additional US$1.5 billion in June 2017).

[3] This approach is well illustrated by the words: "You're not a bank, you're a cash desk. You should remember it!". These words were allegedly said in October 2013 by Oleksandr Dynnyk, the then deputy head of the VETEK company owned by Serhiy Kurchenko, a businessman linked to Yanukovych, to Ihor Frantskevych, then president of Brokbiznesbank that also belonged to Kurchenko. Frantskevych, who was a bank-manager Kurchenko had hired to run his bank, had objected to the transfer of major funds from the bank. In December 2013, Frantskevych was replaced by Dynnyk as the bank's president. After: Ю. Сколотяный, Ограбление страны: "кейс Брокбизнесбанка" без ручки, *Zerkalo Nedeli*, 18 December 2015; http://gazeta.zn.ua/finances/ograblenie-strany-keys-brokbiznesbanka-bez-ruchki-_.html

[4] The former private owners of PrivatBank which is now state-owned deny this information.

Chart 6. Captive banking in Ukraine



Much more serious consequences involve the 'oligarchic banks' that have become insolvent. For example, the following cases of banks becoming insolvent received the most media attention:

- Nadra Bank owned by Dmytro Firtash, an oligarch active mainly in the chemical and gas sector; in 2008-2009 the bank received recapitalisation from the central bank of around US$ 1.5 billion, of which a mere US$ 13 million has been recovered;
- Finance and Credit Bank owned by Kostyantyn Zhevago, active mainly in the metallurgical and machine-building sector; the bank's clients lost US$ 380 million and the state lost US$ 60 million of recapitalisation which has not been returned;
- VAB Bank owned by Oleh Bakhmatyuk who is doing business in the agricultural and food processing sector; US$ 220 million of additional capital provided by the central bank has been lost and the bank guarantee fund had to compensate the clients for US$ 395 million of lost deposits; so far, the investigators have determined that the total value of loans the bank had extended to companies linked to Bakhmatyuk was US$ 125 million;

- banks controlled by individuals associated with former president Yanukovych, for example Brokbiznesbank owned by Serhiy Kurchenko and several smaller banks: for example the WBR bank owned by Yanukovych's son Oleksandr, Expobank controlled by Serhiy Arbuzov, Profinbank controlled by Yuriy Ivanyushchenko and Kyivska Rus controlled by Yuriy Boyko and Yevhen Bakulin;
- 25% of its assets belonging to the city of Kyiv; the central bank estimates that 75% of its loan portfolio was actually extended to companies linked to the bank's private stakeholders, mainly the oligarch Vasyl Khmelnytsky;
- Forum Bank which belonged to Vadym Novinsky, a businessman of Russian origin active in the metallurgical, machine- and ship-building sector, and agriculture.

Irregularities were also recorded in the activity of the so-called 'zombie banks'. These banks had no assets and their operation exclusively involved transferring funds to offshore locations, mainly to accounts in tax havens. One of the operating schemes (the so-called 'Alpine banks' scheme) involved transferring funds via foreign financial institutions—for example: Meinl Bank and Winter Bank (registered in Austria), East-West United Bank (registered in Luxembourg), Bank Frick (registered in Liechtenstein), and Julius Baer (registered in Switzerland). Simply put, the scheme involved the Ukrainian bank opening correspondent accounts in foreign banks. Next, the bank's Ukrainian shareholders took out a loan from the foreign bank using the funds transferred to correspondent accounts as collateral. A portion of this loan was intended as recapitalisation for the Ukrainian bank and another portion was transferred to offshore locations. When the loan was not paid off, the funds accumulated on correspondent accounts were seized by foreign lenders. According to Ukrainian central bank governor Valeriya Hontaryeva, in 2014 alone a staggering US$ 2 billion could have been siphoned off in this manner. Similar schemes for transferring money to offshore locations were used by both 'zombie banks' and 'oligarchic banks'.

Finally, some of the banks operated in a *de facto* pyramid scheme. One example involves the Mykhailivskiy Bank which offered high interest on deposits. The obtained funds were subsequently forwarded to a foundation linked to the bank's owners, making them exempt from banking supervision and from insurance offered by the bank guarantee fund. The funds were then transferred to other locations by the individuals who actually controlled the bank. As a consequence, the clients lost their deposits totalling over US$ 38 million.

When the political and economic crisis in Ukraine worsened at the beginning of 2014, numerous bank owners or the individuals who actually controlled specific banks, as well as other individuals involved in business activity, began to transfer funds from Ukraine to offshore locations via Ukrainian banks. This continued on a large scale until around 2016. The reason behind this strategy was the omnipresent chaos (surrounding the political changes, the war with Russia, the economic crisis), corruption, weakness of state institutions, and mistakes made by financial supervision bodies and security institutions. Detailed information is scarce as to the exact amount of funds that could have been transferred in this manner. However, it can be stated that the scale of this activity must have been enormous considering that the losses incurred by the state in connection with this practice exceeded US$ 20 billion.

III. STABILISATION – REAL OR FEIGNED?

The crisis in the banking sector has become one of the most serious challenges the Ukrainian leadership faced after 2014. An improvement of the situation in the banking sector was considered one of the priorities of the US$ 17.5 billion support programme implemented by the IMF[5]. The key role in implementing the reform programme was played by the NBU (which is the central bank and market regulator) in collaboration of the government and the Ministry of Finance and with support from the president, as well as significant substantive and financial assistance from the IMF without which no improvement would have been possible.

The counter-crisis actions carried out in 2014-2016 mainly involved:

- performing a thorough assessment of the situation in the sector and of the banks' financial standing,
- cleansing the banking system of insolvent banks and/or those that operated illegally or which were *de facto* operating in pyramid scheme,
- improving the financial situation of the other banks operating on the market,
- increasing transparency in how the banking sector functions,
- improving corporate governance and the functioning of state-owned banks.

In 2015-2016, the central bank performed a diagnostic of the situation of the largest banks. This involved assessing their financial liquidity, loan portfolios, investor relations (including loans extended to individuals linked to the owners). The analysis comprised two elements: an assessment of the quality of assets and the performance of stress tests alongside an analysis of the banks' resilience to macroeconomic shocks. It covered the 60 largest banks which hold 97% of the sector's assets. The stress tests revealed that the quality of the loan portfolio was much worse than the banks had declared. At the same time, the tests formed the basis for a programme to be devised involving the central banks recapitalising the banks. Moreover, in the initial stage of the crisis, regulations were implemented to limit the transfer of funds to offshore locations. At present, these regulations are being cancelled due to an improvement of the economic situation.

[5] International Monetary Fund, Second review under the extended fund facility and requests for waivers of non-observance of performance criteria, rephasing of access and financing assurances review, IMF Country Report No. 16/319, September 2016.

The present situation indicates that the authorities have managed to stabilise the situation in the banking sector and halt the downward trends. This is confirmed by specific indicators that show a slow increase in the banks' assets, capital and revenues, as well as an increase in the value of loans offered to clients. It is rather unlikely that other major banks will become insolvent as almost all insolvent and non-transparent banks have been removed from the market. When the state took over Ukraine's largest bank, PrivatBank, at the end of December 2016 and launched its reorganisation programme, it became possible to remove the final potential major threat to the stability of the banking system posed by PrivatBank's potential collapse. The NBU is hoping that in 2017 the banks will manage to achieve a positive balance.

Despite positive trends in the banking sector and a slow improvement of the macroeconomic situation, it is too early to conclude that the upward trends are sustainable. Using vivid language one can say that the fire was put out and now it is necessary to rebuild what has been destroyed. In 2017, the most important goals of the reform programme supervised by the NBU involve resuming and increasing the banks' lending activity, introducing legal regulations to protect the rights of lenders, including new rules for loan risk assessment and loan security, as well as implementing new banking supervision rules and banks' liquidity standards. The unstable domestic political situation, caused by strong internal conflict, continues to be a major problem that translates into the poor quality and inefficiency of parliamentary work. For example, in 2016 the Ukrainian parliament did not manage to adopt any significant legal acts of major significance to the banking sector which contributed to an improvement in how it functions. In addition, attention should be paid to the extremely low level of efficiency of state institutions in recovering funds siphoned off from the banking sector. At the same time, due to the weakness of the applicable law and of the judiciary, the NBU's decisions, including those pertaining to the closing of banks, are being repealed in the courts. Even the activity of the National Bank of Ukraine has come under scrutiny by investigative bodies. In February 2017, the National Anti-Corruption Bureau of Ukraine (NABU) launched an investigation into the legitimacy of NBU spending funds to refinance banks in 2015-2016. So far, no charges have been formulated.

IV. "PRIVATBANK IS THE GUARANTOR OF THE CONSTITUTION"[6]

The very strong position of one market participant, PrivatBank, was and continues to be a unique feature of Ukraine's banking system. Until December 2016, it had belonged to two oligarchs: Ihor Kolomoyskyi and Henadiy Boholyubov (who owned 49.98% and 41.57% of the shares respectively). On 21 December 2016, 100% of the bank's shares was taken over by the state represented by the Ministry of Finance for the symbolic price of 1 hryvnia.

PrivatBank, one of Ukraine's oldest banks, built its strong position after the 2008-2009 financial crisis. Since then, it continued to increase its assets at a much faster pace than other banks did. Between Q1 2007 and Q1 2016, the value of assets of all Ukrainian banks rose by 400%, whereas for PrivatBank this figure was 752%. Between the beginning of 2010 until the autumn of 2016, the bank's market share rose from 16% to 36% in the retail clients segment and from 11% to 25% in the corporate clients segment. When it was taken over by the state, the bank provided services to 20.5 million retail clients (more than half of Ukraine's adult population), 500,000 one-person businesses (70% of the total) and 600,000 larger companies (56% of the total)[7]. The bank owed its impressive reach to the development of the network of offices and ATMs across the country, as well as to its credit card services, in particular its high quality innovative IT services (including the Privat24 system developed exclusively for this bank). Due to its size, the bank was considered as 'a system bank', i.e. one of the banks of key significance for Ukraine's banking system (in 2016, aside from PrivatBank, two state-owned banks Oschadbank and Ukreximbank were also on this list), which is defined as an institution which would pose a threat to the stability of Ukraine's banking system were it to become insolvent or operate in an improper manner. This meant that the state offered special treatment to this bank, including special supervision, and was obliged to support it.

[6] This is a quotation from a skit by Ukrainian comedy group Kvartal 95. In the skit, Ihor Kolomoyskyi talks to President Poroshenko: "Poroshenko: What kind of joke is that? PrivatBank is the guarantor of the constitution?; Kolomoyskyi: Isn't it the case?" after: https://youtu.be/Et-mM92HPxQ?t=434 (from 7:14 till 7:30 min.)

[7] Data after: Елена Шкарпова, Хорошийбанк, плохойакционер, злойрегулятор, voxukraine.org for *Ukrayinska Pravda*, 20 January 2017;www.pravda.com.ua/rus/articles/2017/01/20/7132961 Юлия Самаева, "Приват" — государство: заходдомата, *Zerkalo Nedeli*, 9 December 2016; http://gazeta.zn.ua/macrolevel/privat-gosudarstvo-za-hod-do-mata-_.html

However, under previous shareholders PrivatBank's activity sparked controversy mainly due to non-transparent financial operations. Banks owned by PrivatBank in Latvia and Cyprus incurred fines from local supervision bodies for money laundering (in 2015 the Cypriot regulator imposed a €1.5 million penalty on a subsidiary of PrivatBank). The bank was also involved in siphoning off funds in the so-called Alpine banks scheme; according to estimates in 2014-2016 more than €1.16 billion may have been siphoned off in this way. Over the last three years, other methods for siphoning off funds included the so-called 'back-to-back loans'[8], according to estimates the amount siphoned off this way could be at least €700 million. Serious doubts have also emerged regarding the loans of around €2 billion extended in 2014-2016 which have *de facto* been injected into companies linked to Ihor Kolomoyskyi. The practice boiled down to extending loans to various fictitious companies with minimum capital (worth around €36) registered in Kharkiv and Dnipropetrovsk[9] and mainly involved in the retail sale of fuels (companies controlled by Kolomoyskyi included Ukrnafta, the main player on Ukraine's oil market), from where the money was transferred to offshore locations[10]. The capital that has been siphoned off from the banks included both funds obtained on the market (for example deposits, loans) and refinancing loans from the state. Considering the scale and the nature of the bank's activity, it is possible to conclude that when the economic crisis broke out in Ukraine, the bank's owners decided to take advantage of it to siphon off as many funds as possible to save their own revenues. In doing so, they exploited the fact that due to the bank's significance for the economy as a whole the government was forced to offer assistance to it regardless of its deteriorating financial standing (the assistance offered by the government included refinancing loans, and the postponement of the implementation of certain administrative orders by the bank). As a consequence, according to official information in December 2016, the bank's funding shortfall amounted to around 148 billion hryvnias (around US$ 5.7 billion). At the same time, due to its size the bank was being used by its previous owners as a tool to put pressure on the government and to force it to take political decisions that would be favourable for this group.

8 'Back-to-back loan' is a loan two companies from different countries mutually grant each other. It is expressed in the currency of the lending company's country (for example Ukrainian companies extend a loan expressed in hryvnias to a company registered in the EU and a European company offers a Ukrainian company a loan expressed in euros). The purpose of this transaction is to secure oneself against exchange rate fluctuation.

9 The city is now called Dnipro.

10 Graham Stack, How PrivatBank billions vanished through Alpine 'transit banks', bneIntelliNews, 20 December 2016; http://www.intellinews.com/how-privatbank-billions-vanished-through-alpine-transit-banks-112551/?source=ukraine

However, as the shortfall in the bank's finances grew, the two sides found themselves in a difficult situation. Kolomoyskyi and Boholyubov were not able, or rather were not willing, to recapitalise the bank. Were the bank to become insolvent, though, they would suffer major financial losses (for example, they would be responsible for the lost deposits and for acting to the detriment of the company, which would expose them to criminal liability). The state authorities (i.e. the president, the government, the central bank), for their part, would not let PrivatBank become insolvent (or perhaps did not want to) due to the social cost potentially associated with this failure (more than 20 million clients) and the threat of the collapse of the financial system as a whole. In this situation, and also under pressure from the international community (including the IMF), a decision was made that the state would purchase 100% of the bank's shares for the symbolic price of 1 hryvnia. In addition to this, the bank's capitalisation was increased (by the central bank via refinancing loans and the issue of internal bonds) by 116.8 billion hryvnias (US$ 4.3 billion), of which 107 billion hryvnias was provided immediately after the state took over the bank back in December 2016. Another tranche of state financial support worth US$1.5 billion to the bank was transferred in June 2017. It should be noted that the bank had already received refinancing loans totalling US$ 1.2 billion.

It was against this backdrop that another conflict emerged over how the state took over the bank. The bank's previous private owners filed a lawsuit with a court in London against the present owner, i.e. the state, concerning the purchase of the bonds previously issued by the bank worth US$ 600 million. The state, for its part, explained that the bank's nationalisation had been carried out in line with the 'bail-in' rescue procedure which forces the lenders of the rescued bank to bear some of the costs and that the bonds were seized to cover these costs. At the same time, court trials are underway in which the NBU's decisions to recognise some of the borrowers as persons linked to the bank and, as such, forced to bear the costs of rescuing the bank under the bail-in procedure, have been appealed against (this concerns for example the companies owned by or linked to brothers Hryhoriy and Ihor Surkis, business partners of the bank's previous owners[11]).

Summing up, as a whole the transaction involving the state taking over the bank was favourable for Kolomoyskyi and Boholyubov, who have cast off their

[11] For more on this see: Ю. Самаева, НБУ vs "Динамо". Кто забьет в наши ворота?, *Zerkalo Nedeli*, 19 May 2017; https://gazeta.zn.ua/macrolevel/nbu-vs-dinamo-kto-zabet-v-nashi-vorota-248847_.html

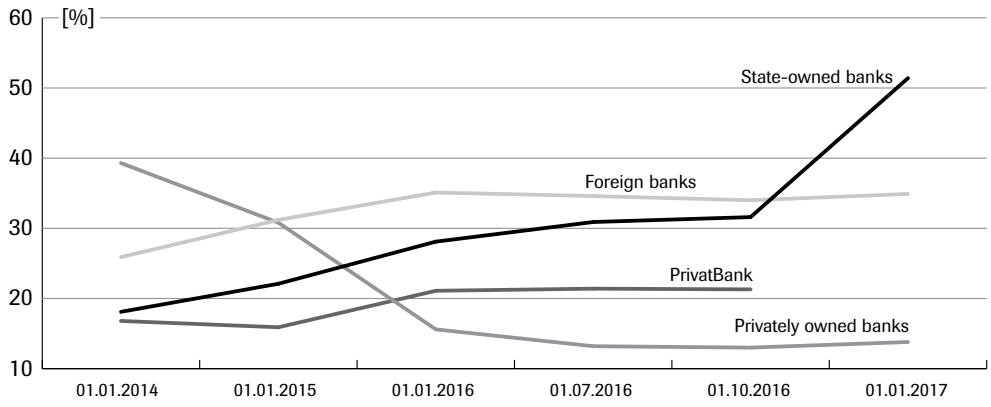
problems associated with a bank that needed enormous recapitalisation, having siphoned off major funds from it. The state, for its part, was placed in a dead end, as on the one hand it assumed liability for considerable costs of the bank's restructuring and on the other, managed to avoid the insolvency of a bank of strategic importance, thus maintaining the country's financial stability and avoiding major social costs.

V. THE SITUATION AFTER THE CRISIS

The 2014-2016 crisis has resulted in very serious changes in how Ukraine's banking sector is structured and functions. The sector's structure became more concentrated; at the beginning of 2017, the 20 largest banks held 89.4% of the assets present in the system as a whole, whereas in December 2013 the proportion had been 73%. The banks that have become insolvent almost exclusively belonged to Ukrainian private capital (except two small state-owned banks – Rodovid and Bank Kyiv). As a consequence, the role and the share of state-owned banks and banks with foreign capital have increased significantly. The Ukrainian state owns seven banks (including Ukraine's largest bank, PrivatBank) which in total hold 51.3% of the system's assets, whereas in December 2013 the proportion had been 18.1%. The share of assets controlled by banks with foreign capital increased from 25.9% in December 2013 to 34.9% in December 2016. Over the same period, the share of assets held by private banks fell from 56.1% to 13.8%.

The period between December 2013 and December 2016 also saw a major change in the distribution of deposits made by retail clients. The share of state-owned banks rose from 13.3% to 59.6%, the share of foreign banks increased from 22.2% to 26.4%, and the share of Ukrainian private banks fell from 64.6% to 14%. At present, only two out of Ukraine's 20 largest banks are privately-owned (PUMB, owned by Rinat Akhmetov, and Pivdennyi, owned by a group of businessmen from Odessa), and the state owns Ukraine's four largest banks (PrivatBank, Oschadbank, Ukreximbank, Ukrgasbank). The remainder are controlled by foreign investors.

Chart 7. The structure of the banking sector, the share of net assets in %



Source: National Bank of Ukraine
** In December 2016, PrivatBank was taken over by the state*

VI. THE STATE-OWNED BANKS – THE CONTEST FOR CONTROL OF FINANCIAL FLOWS

Until the Revolution of Dignity and the economic crisis, the main problem of the state-owned banks had involved individuals holding power or their aides using these banks as tools to obtain low-cost funding or to siphon off funds belonging to the state. In doing so, these individuals used the fact that these banks were state-owned banks of strategic significance for the system as a whole, which was why the state would not allow them to become insolvent and was forced to continuously provide them with support. It is difficult to assess how much money has been siphoned off from state-owned banks as no precise estimates are available. The scale of recapitalisation of state-owned banks may indirectly be indicative of the costs borne by the state treasury. Between 2008 and 2016, the state's spending on this purpose amounted to US$ 8.7 billion. This does not mean that the entire sum has been siphoned off, it only suggests that the scale of this practice may have been enormous.

The state-owned banks' 'politically-motivated' lending to companies controlled by politicians and individuals linked to them had been a common practice throughout the period of Ukraine's independence, but it evidently gained momentum during Viktor Yanukovych's presidency in 2010-2013. A whole range of methods was being used to this end. One such method involved extending huge loans without properly securing them (or securing them with fictitious assets). In 2011, the company SCM owned by Rinat Akhmetov, using the mediation of an associated company ESU linked to it, took out two loans from Ukreximbank and Oschadbank worth US$ 2 billion each for the purchase of a stake in the company Ukrtelecom (which at that time was being privatised). The loans are not being paid off and ESU has already restructured its related debt twice[12]. Another example of banks offering funding to businesses run by politicians involves Oschadbank extending a loan worth US$ 600 million to the Active Solar capital group linked to Andriy Klyuyev, an influential politician in the Yanukovych era, who informally controlled this bank. It should be noted that a loan of this size violated the standards regarding debt concentration to one creditor. Oschadbank only recently managed to obtain court decisions enabling it to collect the debt in its full amount. According to media reports, around a third

[12] What makes this case even more striking is that Akhmetov not only bought the shares in the state-owned company at an attractive price (US$ 10 billion)—he also using money from loans taken out from from state-owned banks (US$ 4 billion) which so far have not been paid off (*de facto* this means that instead US$ 10 billion he paid US$ 6 billion from his own funds).

of Ukreximbank's corporate loan portfolio was extended to companies linked to Viktor Polishchuk, a businessman who used to be particularly active in the Yanukovych era. Other illegal practices included overestimating the value of collateral when taking out a loan, understating the cost of loans and extending loans against the bank's lending strategy[13].

Other major problems the state-owned banks face include mismanagement and widespread corruption. Between the beginning of 2016 and February 2017, the courts issued 332 verdicts in criminal cases involving Oschadbank and 114 involving Ukreximbank. In most cases these banks were the aggrieved party.

Control of the state-owned banks also has major political significance. The composition of the management and supervisory boards is the result of political arrangements made within the ruling coalition. The present governing bodies of the largest state-owned banks are linked either to People's Front and its leader, former prime minister Arseniy Yatsenyuk (for example Oschadbank and Ukrgasbank) or President Poroshenko (for example Ukreximbank, but also the NBU). As for PrivatBank, Oleksandr Shlapak has been appointed its president. His candidacy has been agreed by way of compromise between President Poroshenko and Prime Minister Groysman but he also has good relations with other politicians (including Yatsenyuk).

The programme for reforming how state-owned banks are managed (which is also an element of the IMF assistance programme) announced by the government assumes an improvement of the banks' financial standing and corporate governance, followed by the privatisation of a portion of their shares. The government is planning to sell a portion (i.e. 20%) of its stake in state-owned banks. Due to the fact that no other investors are interested in entering the Ukrainian market, the government is primarily hoping that international financial institutions such as the European Bank for Reconstruction and Development will be the new shareholders. The government has recently announced that over the next five years it intends to reduce the share of state-owned banks in Ukraine's banking sector from the present level of more than 50% down to 30%. According to the strategy for reforming state-owned banks which the government adopted in 2015, the privatisation of Oschadbank and Ukreximbank is to be launched in mid-2018, and the privatisation of Ukrgasbank by the end of 2017. Taking

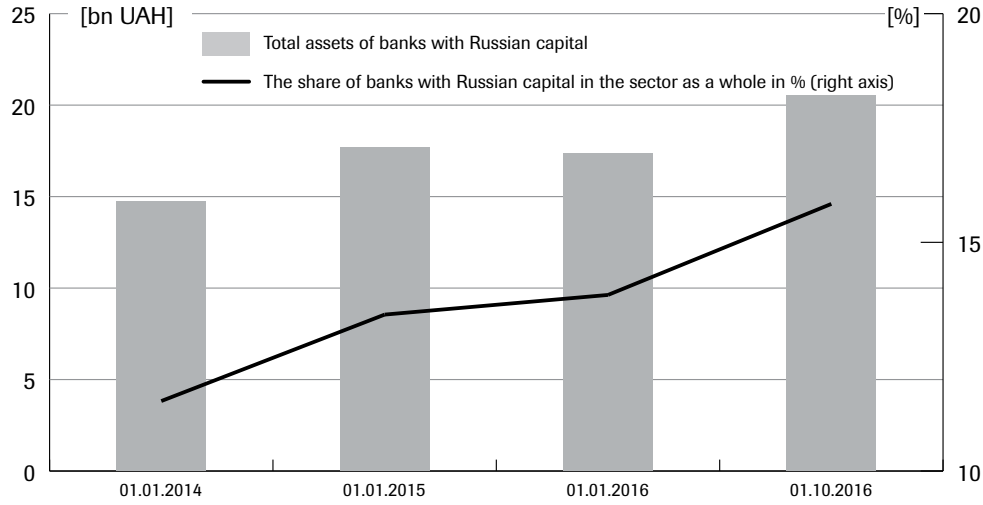
[13] Д. Марчак, Что не так с госбанками в Украине и как это исправить, *Ekonomichna Pravda*, 1 September 2016; http://www.epravda.com.ua/cdn/cd1/2016/08/chto-ne-tak-s-gos-bankami/index.html

account of the situation in the banking sector, the lack of interest on the part of foreign investors and the fiasco of the privatisation programme which has already been carried out in other sectors of the economy, it is rather unlikely that these deadlines will be kept.

VII. THE RUSSIAN BANKS ARE CHANGING THEIR SPOTS

The financial crisis and – most importantly – the war with Russia have significantly impacted the position of banks with Russian capital in Ukraine's banking sector. The change is mainly evident in how they function, not in their share in the sector as a whose, as this has *de facto* even increased. Until Russia's aggression, Russian banks or banks owned by Russian citizens but registered in other countries had occupied a major place on the Ukrainian market and their market share was 11%, or 11.53% including banks with Russian minority capital[14]. Over two years, this proportion continued to rise and on 1 October 2016 it stood at 15.64% for banks with a controlling stake and 15.84% for all banks with Russian capital (including banks owned by Russians but registered in other countries).

Chart 8. The share of banks with Russian capital in Ukraine's banking sector in billion hryvnias*



Source: Author's own calculations based on data compiled by the National Bank of Ukraine
***** *The share of all banks with Russian capital has been taken into account, including those with a minority stake, and banks owned by Russian citizens but registered in other countries.*

The main reason behind the increased significance of Russian banks has been the collapse of a number of Ukrainian private banks and the capital flight from the Ukrainian market. In addition to this, during the crisis Russian banks

[14] This figure also includes Alfa Bank which belongs to ABH Holdings, a company registered in Luxembourg, whose main shareholders are Russians holding Israeli and Russian citizenship, Mikhail Fridman and German Khan, Russian citizens Aleksey Kuzmichev and Pyotr Aven, and the Italian bank UniCredit SpA.

received considerable recapitalisation from their shareholders, which also enabled them to strengthen their market position (the recapitalisation was not provided in the form of payments of funds but mainly by converting interbank loans and subordinated loans from parent companies into regulatory capital). The total value of recapitalisation provided to Russian banks stood at US$ 2 billion in 2015 and at more than US$ 1.4 billion in 2016 (this accounted for a major portion of foreign direct investment in Ukraine and made Russia Ukraine's biggest foreign investor).

Russia's aggression against Ukraine has placed Russian banks in a very difficult situation. This was mainly caused by the fact that they were perceived by the clients as institutions stemming from the aggressor country and as such had a very negative image. In January and later in March and April 2017 picket lines were organised in front of these banks' headquarters and their offices were blocked in several cities in Ukraine (including Kyiv and Kharkiv). This perception has caused numerous clients to withdraw from these banks' services. Between January 2014 and April 2016, the value of deposits made by retail clients in Russian banks fell from 9.3% to 5.8% of the total value of retail client deposits in the banking system; for corporate clients the proportion fell from 8.3% to 3.3% of the total value of deposits[15]. Frequent cases of loans not being honoured had equally painful consequences and significantly worsened the Russian banks' loan portfolio. At the end of 2015, unpaid loans accounted for 67% of the loan portfolio of Sberbank, 85% of Prominvestbank's and a staggering 95% of VTB's. In addition, the Russian banks have lost access to refinancing from the NBU and could only count on support from their shareholders. As a consequence, the Russian banks' indicators have significantly deteriorated. For example, on 1 October 2016 their asset profitability was the sector's lowest and stood at -32.3% for VTB Bank, -19.35% for BM Bank, -14.10% for Prominvestbank, with the average ratio for Ukraine's banking sector as a whole being -5.46%. This has led to a situation in which Russian banks began for all intents and purposes to vegetate while trying to survive hard times. A portion of them are making attempts to withdraw from the Ukrainian market and sell their shares. Representatives of Prominvestbank and Vnesheconombank and other banks have announced their intention to sell their shares in banks in Ukraine. However, a buyer is yet to be found. In May 2017, two potential buyers announced their intention to buy shares in Prominvestbank: Ukrainian oligarch Oleksandr Yaroslavsky (owner of the DCH group) and a consortium created by Pavel Fuks

[15] Data for banks whose investors are registered in Russia.

(a Russian investor in the property development sector) and Maksym Mykytas (a Ukrainian MP). Potential investors are scared off by Ukraine's persistently difficult economic situation and the poor financial standing of Russian banks, which require major funds for investment. Russian shareholders, on their part, are not willing to excessively invest in their Ukrainian companies due to the risk of losing major outlays (they will recapitalise their banks so that these can survive on the market, but will avoid development-oriented investment). Besides this, it is unfavourable for them to sell their assets at an excessively low price and to withdraw from the market with major losses.

Alfa Bank has adopted a unique manner of operating on the Ukrainian market. It positions itself as a European bank and the NBU does not consider it to be a Russian bank. It has even managed to develop its business – in October 2016 it took over 100% of shares in Ukrsotsbank (Ukraine's sixth largest bank) owned by the Italian bank UniCredit[16]. In March 2017, 100% of shares in Sberbank-Ukraina (the seventh largest bank) was sold to a consortium led by Said Gutseriyev, son of the Russian oligarch Mikhail Gutseriyev. The consortium included an undisclosed company registered in Belarus and controlled by Gutseriyev and the Latvian bank Norvik Banka (owned by Grigoriy Guselnikov who holds dual Russian and British citizenship). This transaction also illustrates a certain manner of operation applied by Russian investors which involves transferring ownership of banks to companies registered in EU countries instead of Russian companies giving up control of these banks. This is intended to help them build up a positive image for these banks as European banks. It is also meant to enable the banks to escape potential restrictions and sanctions that the Ukrainian government may impose on Russian companies. For example, in March 2017 Kyiv banned the transfer to Russia of funds from Russian banks operating in Ukraine in reaction to Russia recognising documents issued by the Donetsk and Luhansk separatist republics.

[16] The transaction involved an asset swap. The owner of Alfa Bank, ABH Holdings, took over 100% of shares in Ukrsotsbank in exchange for transferring 9.9% of its shares to UniCredit.

VIII. THE POLITICAL CONSEQUENCES OF THE CHANGES IN THE BANKING SECTOR

The changes in the banking sector have important consequences for the political system in Ukraine. This is particularly evident in two areas: 1) the position of oligarchic groups in the system (the oligarchic banking discussed above formed an important tool for them to generate profit and build influence); 2) the potential attempts by oligarchs to influence politicians holding power by using the instrument of control of the banking system.

The collapse of banks with private Ukrainian capital, that belonged to major and minor oligarchs, has limited the array of tools these oligarchs can use to build their business position in specific sectors of the economy and the opportunities to apply certain fund transferring schemes. This has weakened the oligarchs' influence on the banking sector and, more generally, on the economy as a whole. For example, at present it is more difficult for them to obtain funds from the market and to take out loans using oligarchic banking schemes (or so-called 'captive banking'). The remaining banks operating on the market that are foreign-owned and profit-oriented apply a very cautious lending strategy and require loans to be properly secured, which makes siphoning off funds via these banks increasingly difficult. Due to stepped-up control on the part of the regulator, increased transparency of operations and ownership structure connections, as well as legal changes introduced by the government in collaboration with and under strong pressure from Western partners (the IMF, the EU, the USA), the functioning of the former oligarchic banking model with all its pathologies will no longer be possible. Rinat Akhmetov's PUMB is the only major bank owned by an oligarch that has survived. It has done so because it adjusted its corporate governance and operating model to market standards. The legal changes and the increased supervision of financial flows in the context of money laundering will be of particular importance, especially for combating corruption, even if it is likely to take several years to implement them in full.

These changes may result in limiting specific oligarchs' capability to influence the political system via the banking sector in its current form. Theoretically, the weakening of the formerly very strong status of oligarchs in the banking sector may enable the government to strengthen the state's position towards the oligarchs. One example may be the nationalisation of PrivatBank that used to belong to the highly influential Ihor Kolomoyskyi (and his business partner Henadiy Boholyubov). Kolomoyskyi took advantage of his control of Ukraine's largest bank – a bank of significance for the country's banking system as a whole

– to put pressure on the government and to obtain political decisions he found favourable. The functioning of a bank of this size has a significant impact not only on the banking system but also on the country's economy as a whole, and the government was forced to take this into account. When other banks became insolvent, the influence other oligarchs had on the banking sector weakened. This concerns mainly oligarchs linked to former president Yanukovych (including Oleksandr Yanukovych, Kurchenko, Ivanyushchenko, Arbuzov), but also Dmytro Firtash, Vadym Novinsky, Vasyl Khmelnytsky, Oleh Bakhmatyuk, Kostyantyn Zhevago, Viktor Pinchuk and others.

This does not mean that the oligarchs are losing their instruments to exert influence on the political system. However, it does mean that the former schemes for influencing the political system via the banking sector are likely to change. The oligarchs' influence persists both in the banking system and in the political system as a whole. However, the changes that happened in the banking sector and the implemented reforms inspire a change in the form and the manner of building tools to exert political influence and the use of banks and the banking sector to pursue this practice.

RAFAŁ SADOWSKI

Work on this paper was completed in May 2017

APPENDIX

Ukraine's 20 largest banks as on 1 January 2017

No.	Name	Owners, proportion of shares, in %
1	PrivatBank	the state, represented by the Ministry of Finance of Ukraine 100%
2	Oschadbank	the state, represented by the Council of Ministers 100%
3	Ukreximbank	the state, represented by the Council of Ministers 100%
4	Ukrgasbank	the state, represented by the Ministry of Finance of Ukraine 100%
5	Raiffeisen Aval	Raiffeisen Bank International AG 68% (Austria); European Bank for Reconstruction and Development 30%
6	Ukrsotsbank	ABH Holdings 99%
7	Sberbank	100% of shares belonged to Sberbank of Russia; in March 2017 they were sold to a consortium belonging to Norvik Banka (Latvia) and an undisclosed company registered in Belarus
8	UkrSibbank	BNP Paribas S.A. 59% (France); Société Fédérale de Participation et d'lnvestissement 10% (Belgium); European Bank for Reconstruction and Development 40%
9	PUMB	Rinat Akhmetov 99%
10	Alfa Bank	ABH Holdings 100%
11	Prominvestbank	Vnesheconombank (VEB) 99% (Russia)
12	Crédit Agricole	Crédit Agricole S.A. 99.9% (France)
13	OTP Bank	OTP Bank 100% (Hungary)
14	VTB Bank	VTB Bank 99.99% (Russia)
15	Pivdennyi Bank	a group of businessmen from Odessa: Yuri Rodin 18%; Mark Bekker 19%; Alla Vanetsyants 11% and others.
16	Citibank	Citigroup Inc 100% (United States)
17	ING Bank Ukraina	ING Group N.V. 100% (Netherlands)
18	ProCredit Bank	ProCredit Holding AG&Co. KGaA (Germany, Belgium, Netherlands, USA) 72%; KfW Group (Germany) 27.8%
19	Kredobank	PKO BP 99.5% (Poland)
20	Megabank	European Bank for Reconstruction and Development 15%; KfW (Germany) 15%; the government of Germany (15%); International Finance Corporation (USA, World Bank) 6%, Viktor Subbotin (a businessman from Kharkiv) 5%