# Banking on better times

## The rush to enter Ukraine's banking sector led to disappointment but investors may be forced to think long-term

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Once seen as an extremely attractive and promising investment for Western banking institutions, since 2008 the Ukrainian banking sector has turned into a big headache for many. When people talk about the presence of Western financial sector investors in Ukraine, a common remark is that that they are looking to sell their banks and leave the country. Such sentiments also reflect the general public's gloomy perception of the banking sector. However, ultimate conclusions do not have to be so straightforward. What is undoubtedly true is that most Western investors - if not all – now regret their decision to acquire a bank in Ukraine. First of all, this is because in most cases the acquisition was costly. After the first international acquisition of a Ukrainian bank in 2005, marking the beginning of Western investors' massive inflow, more than 20 M&A deals took place before the financial crisis escalated in 2008. The average price-to-book value multiple paid by investors soared by nearly 5 times. Then the credit crunch crisis hit the Ukrainian market abruptly, bringing a strong devaluation and asset quality deterioration, thus the value of acquired assets dropped steeply. Furthermore, investors started receiving additional bills. The National Bank of Ukraine launched a series of stress tests which required increases in equity. In 2009-2010 the paid-in equity of the banking sector had to increase by close to USD 8 billion, an almost 77% increase. This must have been an exceptionally heavy burden for investors.

### From Orange optimism to credit crunch liabilities

A number of factors first attracted Western investors to the Ukrainian banking sector. Ukraine is geographically close to the EU and has a large territory and population. In the pre-crisis period, economic indicators looked predominantly healthy. Politically, however, the country was far from stable, but nevertheless perceived as a favourable place for investment. The banking sector itself grew strongly: average annual growth in total assets equaled 62% in 2004-2008. Still, Ukraine is considered to be largely unbanked even by Eastern European standards. The financial crisis created a new reality. Considerable economic downturn caused a plunge of the country's GDP by more than 15% in 2009 after years of strong growth. High inflation, soaring unemployment, lower purchasing power coupled with great levels of uncertainty and mistrust were factors that forced those businesses who survived into a defensive position rather than allowing them to think about development. As a result, the number and volume of bad loans rose. This led to significant losses in the banking sector and shifted the focus of most banks to dealing with problem borrowers throughout 2009 and much of 2010.

### Western investors may have little choice but to stay

The major challenge for banks in Ukraine since then has been to re-focus on their future growth strategies. The level of financial transparency of businesses and private individuals has dropped, undermining the reliability of creditworthiness assessments and lending. The funding of lending is another challenge. Restrictions on foreign currency lending introduced by the National Bank of Ukraine made granting a loan in foreign currency to a typical borrower economically unjustifiable. As opposed to foreign currency, local currency offers shorter maturities and higher interest rates and thus largely cannot meet the investment needs of borrowers. As local banking regulation is not predictable it poses even further risks to foreign shareholders of Ukrainian banks. As an example, by changing the regulatory requirement for open currency position compliance - one of the anti-crisis measures - the National Bank of Ukraine forced banks and their shareholders to bear significant currency risk. Against such a background, it is natural to expect that investors have a negative attitude towards their investments in Ukraine. Most Western shareholders, at least those who are driven purely by economic interest, would admit that they would be happy to sell their shares and exit Ukraine. But such a desire is highly unlikely to be realized. There are generally no other investors who are interested in buying. While such a picture does not look comfortable, it actually adds to the stability of the banking sector as Western shareholders have no choice but to support and strengthen their banks in Ukraine, even though they are not keen to invest and might be too risk averse to lend to the economy now. This is a short-term prospective.

### Faith in Ukrainian banks returning

In mid-term, the situation may change as banks will have cleaned their books, digested losses and returned to profitability, raising their attractiveness from the investment point of view. In the meantime, depositors' trust in banks has already come back and led to an all-time record inflow of customer funds into the banking sector during 2010. Demand for loans is steadily picking up as well. Opportunities to sell acquisitions will arise and the Western investors will need to decide to either continue investing or leave.

One scenario could be that many international investors will re-establish their interest in Ukraine. Whether this will be the case will, besides factors related to their positions back home and global market development, undoubtedly also depend on whether Ukraine does its homework to secure investors' interests. Namely, Ukraine must establish a reliable and favourable investment framework that will protect the interests of banking sector investors. Ensuring the fair and efficient functioning of courts, improving banking legislation, and establishing a transparent and predictable regulatory environment are just a few critical tasks on the list. Achieving progress in this respect should be a high priority irrespective of broader foreign investment promotion because a stronger financial sector will significantly increase the safety and sustainability of the Ukrainian business environment in general.

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