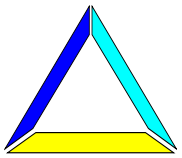
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Credit unions in Ukraine: The immediate priority should be stability, not growth

Executive summary

The credit union sector is expanding rapidly in Ukraine. From June 2005 to June 2006, outstanding loans more than doubled. Measured by capital, credit unions represent nowadays 3.3% of the consolidated banking and credit union system. But the credit union sector remains beset with deep and serious structural problems. In particular, the solvency of several credit unions seems to be rather fragile, which in turn makes their deposits unsafe. Besides, credit unions provide mainly short-term consumer loans for purchasing long-lived goods in cities. Thus, they do not contribute much to the development of small business and of rural areas, as is the case in most countries. Consequently, the recent growth is not necessarily a good thing. In fact, it might have increased the size of existing structural problems.

The regulator DFP and the government have put forward a set of proposals for reforming the sector, which pursue two goals: stability and growth. Since these are partly competing goals, we argue on the necessity to set a clear hierarchy between goals. Furthermore, we recommend treating stability with absolute priority. Consequently, a sequencing of goals and measures should be introduced into the plan. As long as the stability goal has not been achieved, no attempts should be launched for promoting growth. Thus, the “stability goal” should come first and only afterwards should a “growth goal” be pursued. In accordance with this view, we support all measures planned by the government and the DFP, which will increase stability. But the measures aimed at promoting growth should be implemented at a later stage.

Furthermore, we propose the establishment of an institution with the double functions of sector-internal supervision and running of a deposit insurance fund. The combination of these two functions will set the right incentives for a tough self-regulation and thus introduce a key principle of cooperative banking to Ukraine’s credit union sector.

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1 Introduction

Opinions on the role that credit unions[1] and cooperative banking should play in Ukraine's financial system differ vastly among policy makers and analysts. In many cases, positions are based more on ideologies than on serious analysis. On the one side, we have a group of strong believers in the principles of cooperative banking and its potential for Ukraine. Their argument goes as follows: Certain groups of the population, mainly SME and rural population, have still no adequate access to banking services in Ukraine. Credit unions and cooperative banking contributed in solving such problems in Western countries in the past; but also in some modern transition economies credit unions play a major role in improving access to banking services. Thus, there is no reason why credit unions should not play a major role in Ukraine's financial system. Consequently, credit unions must be pushed forward by politics and the supervision. The faster credit unions grow in Ukraine, the better.

On the other side, we have a group of radical opponents of credit unions. They agree on the existence of a lack of access to banking services by certain groups of business and the population. But they claim credit unions would not help, in part because of the poor image of cooperatives in Ukraine due to negative experiences during Soviet times. Besides and more importantly, they emphasize the existence of more advance, modern instruments to improve access to banking services, mainly micro-lending. In short, they consider cooperative banking as an institution of the past, not the future. Consequently, policy makers in Ukraine should not spend their valuable time dealing with credit unions and their regulation.

While we agree with some of the statements of both positions, we reject their corresponding policy recommendations. Ukraine does already have a sizeable and fast growing credit union sector, which is beset with serious problems, including the safety of deposits from private households. Thus, policy makers and the financial supervision should deal seriously with this sector, whether they like it or not. But it is also very doubtful whether the best way to deal with the sector is by pushing it forward and by promoting its growth. Also stability issues have to be taken into account. Consequently, the issue of sequencing of goals and measures has to be dealt with.

In Part 2 we describe the current situation and identify the main structural problems facing the credit union sector. In Part 3 we discuss the issue of sequencing of reform measures. In Part 4 we review and assess current government plans for reform and in Part 5 we provide our policy recommendations for reform.

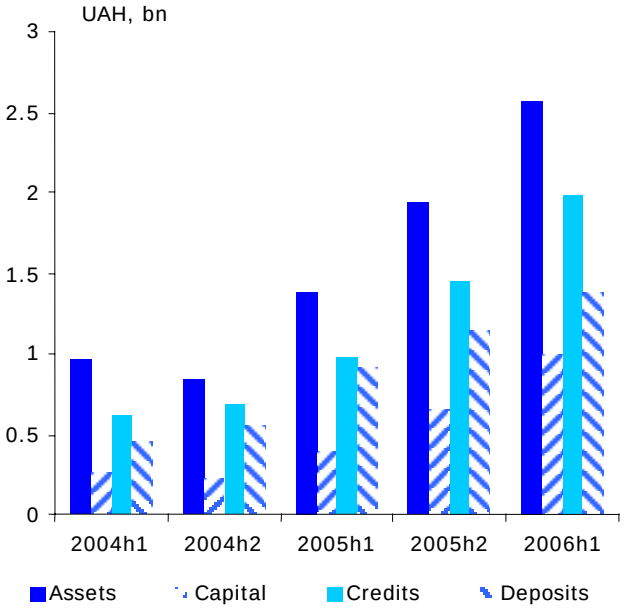
2 The current situation

2.1 Aggregate view

Ukraine's credit union (CU) sector is relatively small, but it is growing fast. The combined assets of the existing 747 institutions amounted to UAH 2.6 bn in June 2006, which is 85% higher than 12 months earlier. As seen in the chart below, further indicators such as capital, credit and deposits also increased sharply in recent times. As of June 2006, the CU had UAH 2.0 bn of credits outstanding granted to 563,900 borrowers and attracted UAH 1.1 bn in deposits from 90,600 depositors. The ratio of capital to assets improved from 29% to 39% over the 12 months ending in June 2006.

[1] The World Council of Credit Unions (WOCCU) defines credit unions as follows: "A credit union is a cooperative financial organization owned and operated by and for its members, according to democratic principles, for the purpose of encouraging savings, using pooled funds to make loans to members and providing financial services to enable members to improve their economic and social condition".

Picture 1
Credit union indicators



Source: DFP

Despite the recent fast growth of the banking sector in Ukraine, CUs were able to increase their share in the consolidated commercial banking and credit union sector. From June 2005 to June 2006, their share in capital increased from 1.9% to 3.3%. During the same period, the share in credits grew from 0.9% to 1.1%, while the share in deposits remained unchanged at 0.9%.

CUs focus their business on private households, to which they provide around 80% of their loans. In this market segment, CUs have achieved some quantitative importance. As of June 2006, 3.2% of the outstanding loans to households of the consolidated commercial banking and credit union sector were issued by CUs. The respective share for consumer credits was 2.9% and for mortgage lending 1.3%. The corresponding share in private deposits was close to 1.5%.

Thus, at the aggregate level the picture looks pretty good. Furthermore, the increasing quantitative importance of the CU sector implies that this sector has to be taken into account in any comprehensive analysis of Ukraine's financial sector.

2.2 Structural problems

Though the aggregate view looks rosy, there are significant problems that totals don't show. CUs face severe structural problems. Below, we will focus on three main topics: solvency problems, absence of deposit insurance or guarantee scheme, and sharp dissonance between purported goals of the credit co-operation system and the current activities of CUs.

(i) Solvency problems

The solvency problems are quite acute for the CUs in Ukraine. CUs breaches in state regulation are quite common. As of 1.07.2006, 14% of CUs were in breach of short-term liquidity requirements, and 23% were loss-making, thus breaching profitability requirements. Also the requirement to accumulate 15% of assets in reserve capital was not fulfilled by 84% of CUs; but this requirement is in our view too strict.

Developed credit co-operation systems, especially those in Western Europe, rely on an effective multi-level system of supervision and control to ensure solvency. As a

consequence, bankruptcies of credit unions or of cooperative banks are quite rare events in Western Europe.

In Ukraine we see a different picture as weak state and self-regulatory supervision, and ineffective internal controls inhibit fully-fledged action on solvency problems. The state supervision has quite severe resource constraints and therefore mainly focuses on off-site supervision and ratio analysis. The total budget allocation for the State Commission for the Regulation of Financial Services (hereafter: DFP), which supervises most of the non-banking financial sector including credit unions, pension funds, insurance and other financial companies, amounted to only UAH 15.6 m in 2006. Thus, the regulator has quite a wide authority, but limited possibilities to implement them.

There are several instruments more or less successfully used by the DFP for regulating CUs. One of the most actively used is the suspension or revoking of the license of CUs to borrow outside funds or to receive deposits from CU members, thus limiting the additional funding of CUs to own capital or to fresh capital injections. This measure allows the DFP to limit the activity of insolvent or fragile CUs, but the effective restructuring or liquidation efforts are impeded by legislative hurdles and resource limitation. For instance, one of the most effective regulatory measures, namely the removal of officials and the introduction of temporary administration, was used only once, due to the lack of practical expertise. As for now, only three people are licensed as temporary administrators.

The supervision of CUs on state level is typically complemented by a self-regulation conducted by associations of CUs. Such associations can collect and process data, disseminate information and elaborate recommendations; in some cases they can even take limited corrective action. In Ukraine the options for self-regulation are still under exploration, as a pilot study of self-supervision was conducted and technical guidelines for granting self-regulatory authority[2] were developed. But these initiatives face significant delays, which can partly be explained by the existence of two competing associations of CUs.

Last, the internal control does not work properly. The internal revision conducted by the supervisory board is not effective. Furthermore, the typical control of CU management by their members hardly takes place in Ukraine. Many “members” do apparently not even know that they are members; the distinction between capital contributions and deposits is blurred for most members. Besides, to become a member, individuals need to contribute an insignificant amount of for example 1 UAH. So, no strong commitment is attached by members while entering a CU. Finally, members can withdraw their contributions (capital) at any time without pre-notice (“on sight”). As a consequence, capital has partly a short-term nature similar to that of current accounts.

(ii) Lack of safety for depositors

Today a considerable number of CUs can be regarded as problematical, putting member’s share capital and deposits at risk. Despite this, no countrywide deposit guarantee scheme and no stabilization facility exist. Some CUs insure their deposits individually. And UNASCU, a CUs association accounting for roughly 1/3 of CUs in Ukraine, has a stabilization facility. But the funds in the facility are rather low and there are not proper guidelines for the investment of these funds. There are also indications that specialized private insurance company for deposit insurance might be established with the backing from the DFP. But still, the question of deposit guarantees remains open and so far deposits of members remain exposed to high risk.

(iii) Poor targeting

It is customary for credit unions in most countries to serve members that have restricted access to conventional credit and to have large portion of their credits issued to rural

[2] See the Guidelines on granting self-regulatory authority to the association of credit unions (approved by the DFP resolution 6280 on 03.10.2006).

population and small businesses. Therefore CUs are useful as an instrument for achieving important economic and social goals, such as:

- Regional development
- SME development
- Poverty reduction
- Rural development

Credit unions usually enjoy partial exemption from rigorous regulatory requirements and extensive supervision procedures applied to traditional credit institutions. This preferential treatment can be attributed to their role in achieving aforementioned goals. However, in Ukraine CUs are mainly oriented on satisfying consumer needs of regular urban inhabitant. As of 1.07.2006 the share of rural loans in average CU loan portfolio was only 3%, the share of commercial loans (that is loans to private enterprises owned by members) 14% and the share of consumer loans was 49%. Moreover, CU membership is limited to private households and CUs are legislatively allowed to lend directly to their members or to their private enterprises and farms of their members and prohibited from providing loans to other forms of small business. Furthermore, we should take into account that recent growth of CUs was largely fueled by a couple of dozens CUs either affiliated with banks or oriented on consumer credits. Still without convincing reasons to justify a special regulatory regime for CUs, this regime turns out to be just unfair competition between commercial banks and CUs. Several CUs affiliated with banks work as credit and/or deposit brokers that funnel funds to and from the banks. Such "affiliated" CUs[3] at best work as middlemen and at worst help banks avoid adequate supervision.

3 The sequencing of measures: Stability vs. growth

Given the serious structural problems described above, it is questionable whether the recent growth of the CU sector should be considered as a positive development. First, recent growth might have contributed to put more depositors and/or members at risk. Second, it did not significantly contribute to increase loans for SME and rural business. Third, it did not contribute much to mobilize funds from rural communities. Forth, the recent growth can be partly explained by the exploitation of regulatory loopholes and by an unfair competition between CUs and commercial banks. Consequently, the further short-term growth of the sector should not be considered as an immediate goal of policy makers and regulators.

Instead, the focus of policy makers and regulators should be to restore stability in the sector. By stability, we mean in particular higher levels of solvency, including the liquidation of insolvent CUs (market consolidation) and a better protection of depositors of CUs. Once stability has been restored, then the focus of policy could be complemented by a growth goal. But it does not make any sense to try to push growth in a fragile sector. This would only magnify the size of problems and risks.

4 Government plans for structural reform: Description and assessment

The long-term government plans on credit unions reform are to a large extent based on a document called "Concept for the development of credit co-operation system in Ukraine" (hereafter: Concept), which has been approved by the Cabinet of Ministers.[4] However, to become effective, most of these measures have to be adopted by Parliament. The state regulator backs the Concept and is pushing towards its adoption. Besides the Concept, several other proposals for reform have been publicly discussed in recent times and might eventually be considered for approval in Parliament. Broadly speaking, one can divide the proposals for reform into two packages: the stability and the growth measures.

[3] The regulator has identified 12 such "affiliated" CUs, with a market share of 15% (Source: "Business" newspaper 14.08.2006).
[4] Resolution of the Cabinet of Ministers 321-p dated 7.07.2006.

4.1 Stability measures

Most measures in the Concept aim towards gaining stability in the sector. Among the measures we can name:

(i) Using self-regulatory mechanisms in supervision;

(ii) Differentiation of supervision and regulatory requirements depending on the of level of risk;

(iii) Effective use of temporary administration to restructure fragile credit unions;

(iv) Allowing small business and farms to become members

(i) The regulator DFP approved guidelines that spell out requirements and the application process for the establishment of a self-regulatory organization by Ukrainian associations of CUs. Such an organization may be able to work out rules of conduct for CUs, certify professional qualifications of CU officers and employees, conduct preliminary analysis and issue preliminary recommendations on financial reports of CUs. According to the guidelines, none of the existing associations qualifies as a self-regulatory organization and they will need to extend their membership base to be eligible for this right. However, we can still expect the successful creation of self-regulatory organizations in the near future as associations might try to lure more new members actively with the prospect of self-regulation in sight.

(ii) As there are more than 700 CUs and their sizes differed by thousands times in terms of assets and members, one-size-fits-all supervision seems unsustainable. For now there is a draft-stage regulation that divides CUs in three groups: high-risk, medium-risk and low-risk CUs depending on asset size, branching, and financial services offered and risk concentration. High-risk CUs are defined as having assets size of more than UAH 10 m or out-of-region branches or concentrated risks, and low-risk CUs as those with assets less than UAH 0.5 m and using only share capital to issue credits[5]. Among other planned changes[6] in this direction is the development of the differentiated regulatory requirements and early warning system to identify impending changes in the high-risk group of CUs.

(iii) The possibility of the real use of temporary administration was shown during the first and for now the only example of temporary administration in CU.[7] Though there were indications[8] of more CU administrations coming, none were introduced. The further use of temporary administrations even on single cases will be of great importance as it can pave the way to customary usage of this regulatory instrument.

(iv) The Concept also foresees legislative changes that include allowing CUs to provide financial services to a wider customer base that will include small business and farms[9]. This measure might contribute to some growth, but more importantly it will contribute to a better member structure and a more appropriate targeting of members, in accordance with the economic and social goals pursued by traditional CUs. As a consequence, this measure might promote the cooperative "culture" and thus increase stability.

Beyond the Concept, there are several further proposals and plans, which would improve the stability of the sector.

(v) One important proposal is to increase the minimum contribution to become a CU member. As stated above, currently the fee necessary to become a member in a CU is insignificant. This situation inhibits the development of a true cooperate spirit. Without

[5] See DFP draft resolution "On classification of CUs to different regulatory regimes" from 23.10.2006.
[6] See DFP resolution 6044 "On action plan to implement differentiation of regulatory requirements to CUs" from 27.07.2006
[7] See DFP resolution 6243 "On introduction of temporary administration in Nadiya CU" from 19.09.2006.
[8] Interview of Olenchyk to Kommersant-Ukrayina from 27.07.2006
[9] As we mentioned earlier, CUs can already issue credits to farms and private enterprises owned by members.

doubt, the proposed increase will contribute to a better member structure and to more stability in the sector.

(vi) A further proposal concerns the withdrawal of contributions (capital) by members. In order to provide the CU's capital a more long-term character, a pre-notice requirement of e.g. one year for the withdrawal of capital should be introduced. This requirement would also contribute to a clearer distinction between capital and deposits for the often poor-informed members.

(vii) Among other plans there is the creation[10] of joint Ukrainian-Polish deposit insurance company that will insure CU deposits, liquidity and solvency risks of CUs. The Polish founder is an insurance company founded by credit unions to provide them with deposit and other insurance. The plan also provides for gradual transfer of control over the newly founded company to Ukrainian CUs. The insurance company was expected to start operations by the end of 2006, but it is unclear whether the plan will go ahead.

As we can see, the DFP and the government have already envisaged appropriate measures for improving the solvency of CUs and the safety of deposits. Thus, the regulator and the government identified the stability of the sector as a main priority for reform.

4.2 Growth measures

The Concept also foresees three measures to promote growth in the sector.

(i) CUs might be allowed to provide a wider range of financial services including payments for goods and services and factoring. This measure will improve the competitive position of CUs against commercial banks and thus most certainly promote their growth.

(ii) Also the restrictions on investment by CUs are foreseen to be eased to allow CUs to invest in all types of mortgage and government securities. Again, measures like this will enable CUs to work more as banks and gain in competitive advantage.

(iii) The Concept also envisages allowing CUs to accept deposits and issue credits in foreign currency. This measure would make CUs more attractive for potential clients wishing to save or borrow in foreign currency or could work as a motor for further and rapid growth.

Besides these measures in the Concept, further proposals have been discussed regarding the range of services, which a CU is allowed to offer. Services such as bank transfers, the running of wage and pensions accounts, and the provision of credit cards can be named as the most important services in discussion.

Thus, the regulator DFP and the government are not just pursuing a stability goal, as shown in 4.1, but also a growth goal. In short, the authorities are trying to pursue two goals at the same time: stability and growth.

5 Conclusions and policy recommendations

The share of the CU sector in Ukraine is not very big, but it is big enough to create trouble in the financial sector. One should not forget that CUs have attracted deposits from around 90,000 individuals. Thus, anyone interested in the stability of Ukraine's financial sector should also deal with the CU sector. Both followers and opponents of cooperative banking and credit unions in Ukraine should take this sector seriously and try to contribute to reform it.

In general, we support the DFP and government plans (the "Concept") for reforming the credit unions sector. But in our view, it is crucial to set clear priorities regarding the identified goals of stability and growth. Such a decision is necessary, because some measures for promoting growth are detrimental for stability and vice versa (competing goals). In our view, the goal of stability should be treated with absolute priority.

[10] This intention has been stated jointly by Olenchyk and Buczynsky, the President of the mutual insurance society of Polish SKOKs.

Consequently, we advise the government and the DFP to introduce a sequencing element into the plan. The first step should be to adopt all those measures, which will contribute to more stability in the sector (stability measures). Once these measures have shown a positive effect and the stability of the sector is not in danger any longer, then a second step should follow, in which measures are introduced for the promotion of growth in the sector (growth measures).

To strengthen the stability component of the reform, we also recommend the creation of an institution at the sector level with a double function. The institution should conduct the sector-internal supervision of single credit unions. This would improve the solvency of the sector and implement an important element of true cooperative banking, namely self-regulation. The same institution should also run an insurance fund for the deposits in credit unions. If well drafted, such a fund could improve the protection of depositors. On top, the responsibility for running the fund creates strong incentives for the institution to check and supervise the credit unions very carefully. Lax supervision would mean higher claims on the insurance fund, which would weaken the institution. Thus, the combination of these two functions provides the right incentives and creates a solid system of self-regulation.

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