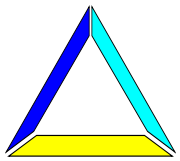
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Market structure, minimum capital requirements and the stability of the banking sector in Ukraine

Executive summary

Ukraine's banking sector consists of around 160 commercial banks, most of them being rather small. According to a widespread view, this market structure is not a healthy one, as it implies high risks for the stability of the banking sector. Supporters of this view favor a consolidation in the banking sector by means of raising minimum capital requirements. In line with this way of thinking, the National Bank of Ukraine (NBU) decided in 2001 to raise minimum capital requirements from EUR 5 m to EUR 8 m in several steps over the period 2003 to 2007. Currently, an increase up to EUR 10 m is under discussion.

In our view, this widespread view is not convincing. Raising minimum capital requirements makes banks bigger, but not necessarily safer; size is not a good indicator of solvency. Furthermore, higher minimum capital requirements increase the barriers to entry and limit competition in the banking sector. Besides, and more fundamental, it is not the job of the banking supervision to judge on the desirability of the existing market structure. The market structure has to be decided by market forces, not by regulators or politicians.

In accordance with this critique, we advice the NBU not to launch a further round of minimum capital requirements hikes up to a level of EUR 10 m. Furthermore, the NBU should consider not implementing the scheduled increases in minimum capital requirements from currently EUR 6 m to EUR 7 m in 2006 and EUR 8 m in 2007. Instead of emphasizing quantitative aspects, we recommend to focus more on qualitative aspects such as the quality of capital, ownership transparency, connected-party lending and falling capital adequacy ratios within the group of large banks.

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1. Introduction

There is a widespread view on the Ukrainian banking sector that goes as follows. The starting point is a fact concerning the existing market structure. The banking sector consists of around 160 commercial banks and most of them are small. This fact is assessed in a negative manner. The current market structure consisting of a large number of small banks is considered to be unhealthy and not compatible with a stable banking sector. This assessment is followed by the policy conclusion that the National Bank of Ukraine (NBU) in its function as the banking sector supervisor should try to correct the existing market structure and force a consolidation. The appropriate instrument for such a consolidation is believed to be raising minimum capital requirements. Following this or a similar logic, the NBU increased minimum capital requirements in 2001 and seems to be currently considering a further hike.

In this policy paper we assess the validity of this widespread view and its policy implications. We do so by looking separately at each of the four steps in the argument presented above. Thus, we deal in Part 2 with the market structure of the banking sector in Ukraine. In Part 3 we wonder whether the current market structure should be considered as unhealthy. Part 4 asks if the NBU should try to improve the existing market structure. In Part 5 we discuss the use of minimum capital requirements as an instrument for consolidation and Part 6 concludes.

2 Trends and structure of the Ukrainian banking market

Ukraine's banking sector has expanded rapidly over the recent years, in nominal terms as well as in relation to the size of the economy. The total assets have grown from UAH 40 bn to more than UAH 190 bn over the period from 2001 to the third quarter of 2005 (or from 23% to 49% of GDP). In particular, loan portfolio has grown from UAH 24 bn to UAH 140 bn (or from 14% to 36% of GDP) over the same period.[1] This expansion was mostly due to recovering trust of population in financial institutions.

In comparison to former CIS countries, the size of the banking sector relative to GDP looks pretty good in Ukraine. However, a comparison with more developed countries reveals vast potential for further deepening of the market for banking services in Ukraine (see Table 1).

[1] Source: National Bank of Ukraine, www.bank.gov.ua.

Table 1
Domestic credit provided by the banking sector (% of GDP)

Country	2000	2001	2002	2003
Armenia	11.5	9.1	7.2	5.5
Azerbaijan	9.6	5.3	8.5	9.4
Belarus	19.2	16.8	17.1	21.2
Bosnia and Herzegovina	45.5	29.8	35.8	41.6
Bulgaria	17.8	20.2	23.7	29.8
Croatia	47.2	52.9	62.7	65.5
Czech Republic	50.3	46.4	43.1	49.5
Estonia	36.4	40.2	45.8	54.8
Georgia	21.6	20.0	19.6	19.5
Hungary	55.0	50.4	54.3	58.3
Kazakhstan	12.3	11.6	13.0	13.7
Kyrgyz Republic	12.0	9.7	11.4	11.4
Latvia	23.6	28.8	36.1	45.5
Lithuania	15.2	15.7	18.0	23.7
Macedonia, FYR	14.4	19.5	15.9	17.9
Moldova	25.2	27.5	29.1	29.8
Poland	33.6	35.8	35.8	37.0
Romania	14.0	12.2	13.2	15.9
Russian Federation	24.7	25.6	26.7	27.6
Slovak Republic	56.8	60.3	51.7	44.7
Tajikistan	17.7	24.7	21.2	14.0
Turkey	50.9	71.3	59.1	53.9
Ukraine	**23.8**	**23.5**	**27.5**	**32.7**
Japan	317.2	317.2	314.2	157.3
United Kingdom	133.7	139.8	145.3	150.4
United States	257.6	250.7	238.9	261.8
Region				
Eurozone	122.9	123.6	122.7	125.1
World	182.1	179.4	175.2	162.1

Note: Domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit money banks, as well as other banking institutions where data are available (including institutions that do not accept transferable deposits but do incur such liabilities as time and savings deposits). Examples of other banking institutions are savings and mortgage loan institutions and building and loan associations.

Source: World Development Indicators 2005, World Bank.

There are around 160 operating banks in Ukraine. Most of the banks are rather small. The average balance sheet capital is UAH 135 m (EUR 22 m), and the average assets of a bank are UAH 1.1 bn (EUR 188 m).[2] A few large commercial banks dominate the market for banking services. In particular, the largest 10 banks posses about 53% of all assets of the banking sector in Ukraine. The other three groups of banks have their respective shares of about 18% (next 14 banks), 16% (next 31 bank) and 13% (the smallest 105 banks) of total assets (see Table 2).

Table 2
Market shares of the 4 groups of banks in Ukraine

	Share in total assets (as of end of Sep 05)
Group 1: the largest 10 banks	53.8%
Group 2: next 14 banks	17.7%
Group 3: next 31 banks	15.8%
Group 4: the smallest 105 banks	12.7%

Source: National Bank of Ukraine, own calculations.

It is widely believed that so-called "pocket banks" exist within the group of smaller banks. Pocket banks typically have highly non-transparent ownership structure, which allows them to maintain strong ties to specific enterprises or financial-industrial groups.

3 Is the current market structure unhealthy?

As stated above, most of the 160 banks in Ukraine are small, with the 105 smallest banks holding own funds of around EUR 8.8 m on average. Whether this is a problem for the stability in the banking sector will be discussed below.

It is definitely fundamental to ensure a "certain size" of banks through minimum capital requirements, and make sure that they have sufficient own funds, providing a cushion against unexpected losses, and promoting public confidence in the banking system. But once appropriate minimum capital levels are defined and accomplished, the bank size on its own is not the crucial factor for the stability of the banking sector. In fact what matters is whether the banks are well managed and sufficiently capitalized as reflected in the capital adequacy ratio.

From our point of view, the current minimum capital requirements in Ukraine of EUR 6 m for commercial banks operating across the country, EUR 4 m for regional commercial banks and EUR 1.3 m for local cooperative banks, as shown in Table 3 are high enough to ensure that all banks have an appropriate size.[3] We support the fact that different minimum capital requirements are defined depending on the type of bank, as commercial banks for example act typically in a more risky setting than cooperative banks. Interestingly, in the case of Ukraine bigger banks feature a lower capitalization than smaller banks. While the 10 largest banks of the country exhibit a balance-sheet-capital to asset ratio of around 9%, the 105 smallest banks meet a ratio of around 24%.[4]

Thus, the fact that most banks in Ukraine are small does not seem to be a problem per se. However, the small banks to a large part function as "pocket" banks (IMF 2005, page 70), thus acting as treasuries for financial industrial groups and large corporations.[5] Instead of providing financial intermediation services to the general public, this type of banks is used to redistribute capital within the industrial conglomerate.

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2 Source: National Bank of Ukraine.

3 We even think that the minimum capital requirements that applied until 2003, of EUR 5 m, EUR 3 m and EUR 1 m were high enough. The minimum capital requirement for commercial banks in EU countries is also EUR 5 m.

4 This is the status quo as of October 2005.

5 IMF 2005 Ukraine –Selected Issues (Country Report No. 05/416).

Involving large exposures to a single borrower or a group of borrowers, pocket banks lead to undue credit risk concentration. Furthermore, these banks facilitate connected-party abuse, i.e. connected-party lending on conditions and in volumes that are more favorable than would be economically justified. Both, the excessive portfolio concentration and the lack of objectivity in credit assessment can lead to large losses and are frequently a factor in bank failures. In addition, connected-party abuse in Ukraine is further aggravated by the lacking ownership transparency of banks, as this makes it much more feasible. Insolvency of single banks might destabilize the whole banking system. As pocket banks entail high risks, they should be a matter of concern to the Ukrainian regulators and there number should be reduced.

While it is essential to reduce the number and the role of pocket banks in Ukraine, it has to be pointed out that this does not mean that the number of small banks has to be reduced. As argued above, small banks are not dangerous per se. The German banking sector for example is characterized by a multiplicity of small banks, and nevertheless is considered to be very stable.

In fact, we believe that a healthy market structure consists of big, medium and small banks, as this allows for a competitive structure and niches activities. Particularly in a country such as Ukraine, where capital markets are still underdeveloped and banks are a relatively important source of funding for firms, small banks play an important role. Moreover, small banks can be especially important in lending to small firms in rural areas.

4 Should the NBU try to change the market structure?

As argued in the above section, the current market structure of the Ukrainian banking sector, in particular the fact that most of the banks are small, should not be seen as a problem. It does not necessarily represent a risk for the banking sector, and thus should not be a matter of concern for the regulation. In fact, the Ukrainian banking regulation should focus on limiting the role of pocket banks, improving ownership transparency and controlling connected-party abuse. Technically this should not be a problem. An appropriate draft law has been prepared by the NBU and presented to the Parliament.[6] However, it is clear that political will is necessary to implement this law.

By discussing the role of the Ukrainian regulation, it is very important to highlight that its job is to make sure that all existing banks are safe and that only serious banks enter the market. As long as these conditions are fulfilled and the banking sector stability is warranted, it is not its business to interfere in the market structure. The banking regulation should not determine whether the consolidation process in the Ukrainian banking sector has been too slow, and whether banks should merge or not. This decision has to be made by the market.

Furthermore, it is essential to keep in mind that changing the market structure through increasing capital requirements would presumably result in less and bigger banks, but certainly not in a higher capital to GDP ratio. The capital of the Ukrainian banking sector as a whole cannot be increased by simply lifting up minimum capital requirements.

To sum up again, the NBU's objective should be to ensure the Ukrainian banking sector stability, through smoothing out the factors putting the stability in danger. Since pocket banks, lacking ownership transparency and connected-party abuse form the main risks, the regulation should focus on these aspects. Not only are small banks not more dangerous per se, but they also serve a purpose. Therefore, the NBU should not try to change the market structure by changing capital requirements.

[6] According to this draft, all commercial banks would be forced to report on the ultimate owners of the legal entities, which own the banks' essential shares, as well as connected parties (family) of the people owning essential shares. The information should be enough to identify the exact people and their financial standing.

5 Should minimum capital requirements be increased?

The NBU requires existing commercial banks to maintain a minimum level of regulatory capital (i.e. own funds) in nominal terms. The current requirement for minimum regulatory capital for banks operating across the country is EUR 6 m.[7] The minimum regulatory requirement will be increased to EUR 7 m in 2006 and to EUR 8 m in 2007 (see Table 3).[8]

Table 3
Minimum regulatory capital for existing banks

Date	Local cooperative banks	Regional commercial banks	Commercial banks, operating across the country
On Jan 17, 2003	EUR 1 m	EUR 3 m	EUR 5 m
On Jan 1, 2004	EUR 1.15 m	EUR 3.5 m	EUR 5.5 m
On Jan 1, 2005	EUR 1.3 m	EUR 4 m	EUR 6 m
On Jan 1, 2006	EUR 1.4 m	EUR 4.5 m	EUR 7 m
On Jan 1, 2007	EUR 1.5 m	EUR 5 m	EUR 8 m

Source: NBU Resolution #368, Aug 28, 2001.

Besides, addressing the negative effect of the planned increase in the minimum regulatory capital for the potential entry of new firms into the banking sector, the NBU set lower minimum regulatory capital requirements for newly created banks (see Table 4).

Table 4
Minimum regulatory capital requirement for new banks

Years of operation	Local cooperative banks	Regional commercial banks	Commercial banks, operating across the country
Until one year	EUR 1 m	EUR 3 m	EUR 5 m
Up to two years	EUR 1.1 m	EUR 3.5 m	EUR 5.5 m
Up to three years	EUR 1.2 m	EUR 4 m	EUR 6 m
Up to four years	EUR 1.35 m	EUR 4.5 m	EUR 7 m
Starting from fifth year	EUR 1.5 m	EUR 5 m	EUR 8 m

Source: NBU Resolution #368, Aug 28, 2001.

This complementary measure was meant to keep barriers to entry low, thus allowing for a high level of competition. However, as the minimum regulatory capital requirement grows rather sharply with the time of operation, barriers to entry will in fact be significantly increased and competition will be curtailed.

Consequently, minimum capital requirements should not be further moved up, as they do not contribute to more stability in the banking sector, but raise barriers to entry and restrain competition.

6. Conclusions

The instrument of minimum capital requirements has been strongly used by the NBU in recent years. As of today (2005), existing banks are required to keep a minimum EUR 6

[7] To obtain permits for additional operations (e.g. opening accounts in foreign exchange, trading in securities, underwriting, making investment into other companies, etc) banks should have higher minimum regulatory capital. See NBU Resolution #275, July 17, 2001.

[8] Source: NBU Resolution #368, Aug 28, 2001. Additionally, the minimum regulatory capital requirement is calculated in hryvnia according to the NBU Resolution #112, March 17, 2004.

m in regulatory capital. In 2006, the requirement will be increased to EUR 7 m and in 2007 to EUR 8 m. Currently, a future increase to EUR 10 m is being considered. In the much wealthier European Union, only EUR 5 m are required and there are no plans to increase this norm.

The main argument for this policy has been the need for consolidation in the Ukrainian banking sector. But it is highly questionable whether the NBU should intervene and try to change the market structure by forcing a consolidation, in the hope of attaining a more stable banking sector. Large size is not a good indicator for safety and proper management, as shown by international experience. Besides, the most pressing current problems in Ukraine are not of quantitative, but of qualitative nature, such as the lack in quality of capital, the lack of ownership transparency, connected-party lending and falling capital adequacy ratios within the group of large banks. These qualitative problems will not be solved using quantitative instruments such as minimum capital requirements.

To sum up, higher minimum capital requirements will not contribute to a more stable banking sector. Instead, it increases barriers to entry, lower competition and makes lending more expensive. Consequently, we recommend restricting the use of this instrument. Firstly, minimum capital requirements should not be raised to EUR 10 m in the future. Secondly, the NBU should consider the possibility of not implementing the scheduled increase in requirements to EUR 7 m in 2006 and EUR 8 m in 2007. Thirdly, should any regulatory impediments stand on the way of bank fusions and consolidation, they should be removed. Market forces will then decide whether a consolidation is in the economic interest of the country or not.

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