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Higher Demand — Higher Price

The rapid growth of the Ukrainian banking system has had a positive impact on the reliability ratings of the country's financial institutions, especially state-owned. Foreign-owned banks continue to top the list of the most reliable banks in Ukraine

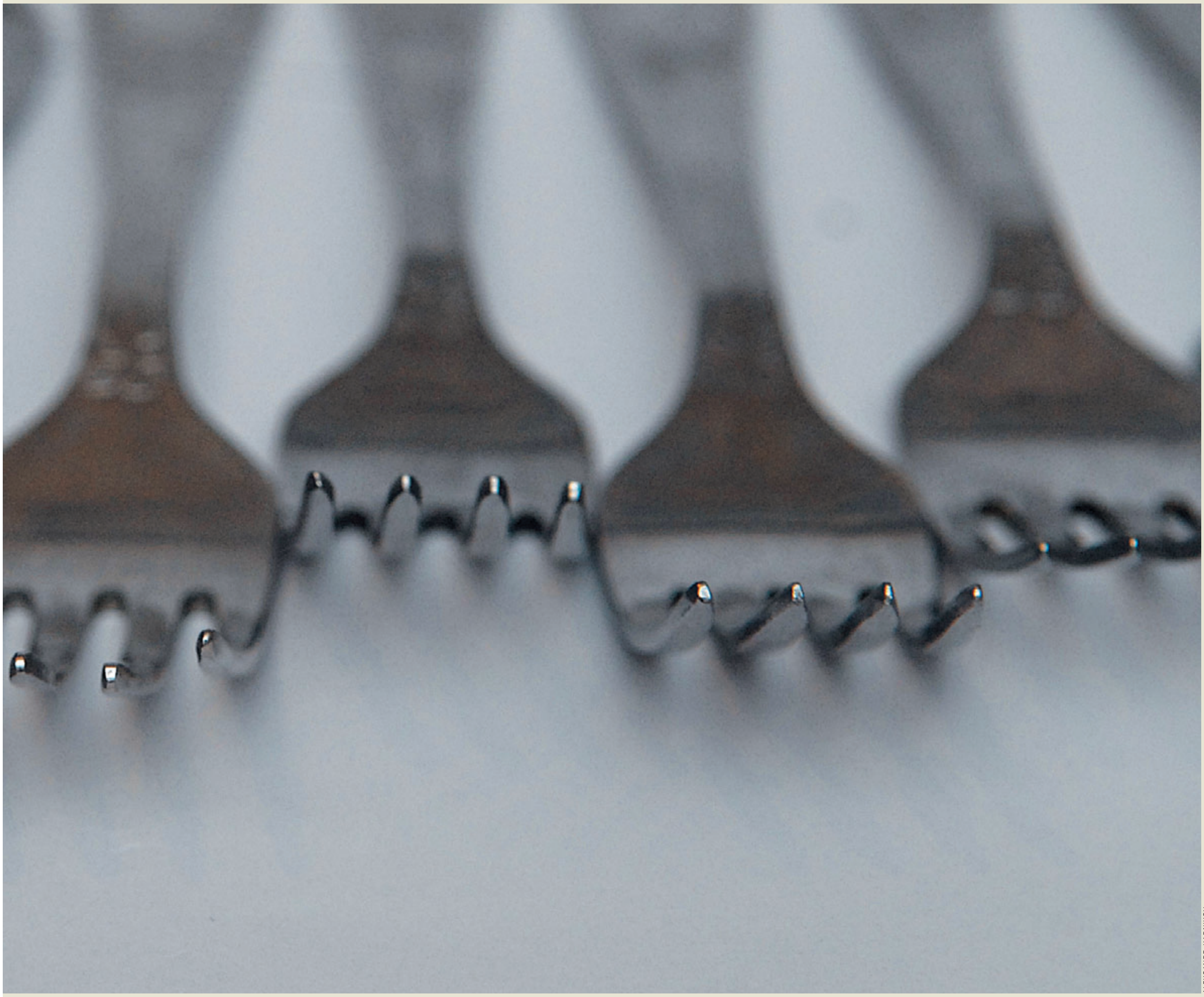
According to the (pi)-rating of *Expert-Rating*, the rating agency, set up on the basis of *Expert Ukraine Ltd*, and the Ukrainian Society of Financial Analysts (USFA), a non-governmental, non-profit professional organization of Ukrainian financial experts, ING Bank Ukraine, OTP Bank and the state-owned UkrEximBank topped the list of the most reliable Ukrainian banks in 2006. Out of 102 banks included in the (pi)-rating, 27 were evaluated as part of Group A, the group with the highest possible level of reliability. Six banks, which had previously been ranked as Group B institutions, along with two banks that were not rated last year, were added to Group A this year (see *Expert Ukraine* №1(1), May 2006).

The untouchables

Group A is predominantly made-up of partly foreign-owned banks. These banks were able to thrive due to the stable exchange rate of the hryvnia, the expanding retail market and the growing interest of domestic companies in the Euroloans market. Similar to last year's findings, the Ukrainian subsidiaries of ING, OTP, RZB, Citibank, Calyon, HVB, and VTB remained in the group of banks with the highest level of reliability.

ING Bank Ukraine assumed the top spot in the group. The bank had increased the level of its capital adequacy from 8.52% to 14.37% and the ratio of interest income and expenditures from 239% to 288%. In addition, its assets increased by 34%, while its loans to corporate sector grew by 49%. In 2006, ING Bank Ukraine continued to expand its presence in Euroloans market, even aspiring to become a “window into Europe” for both Ukrainian financial enterprises and non-financials. Additionally, ING acted as a custodian bank when the Ukrainian companies issued four depositary receipts. However, the ING Group's strategy in Ukraine is not entirely clear. While BNP Paribas, Calyon, and UniCredit are present in the domestic retail banking market, the ING Group, having secured a stable business foundation in Ukraine, continues to ignore the retail sector. If the 40% to 50% annual growth rate of Ukrainian retail banking is accompanied by the entry of new foreign banks, then — in two or three years — ING Bank's “window into Europe” strategy will cease to be profitable, and its market share will shrink considerably. We have therefore given this bank an A+ (neutral forecast) rating.

Having changed its owner in 2006, Raiffeisenbank Ukraine, now known as OTP Bank, has substantially improved its performance over the past year. Notably, its return on equity rose from 13.38% to 33.73%. OTP was ranked by the National Bank of Ukraine (NBU) as the eighth-biggest bank by asset size. The Hungarian owners of OTP were able to gain operational control of the bank only in the second half of 2006, as a result of which,



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by year-end, the bank had a relatively low capital adequacy level, 8.81%. In February 2007, OTP announced that this problem had been resolved with a 25% increase in the company's share capital.

Raiffeisen Bank Aval, another bank in the top five most reliable financial institutions, showed an almost tenfold surge of its return on equity, which jumped from 1.1% to 10.52%. Together with an improved capital adequacy ratio, this constitutes a major achievement for Aval, a bank that was hiding its profits in the last years. The improvement of the bank's performance is largely attributed to its increased lending: in 2006, while Aval remained equally active in retail and corporate banking, its assets grew by 44%, and its credit portfolio expanded by 71%.

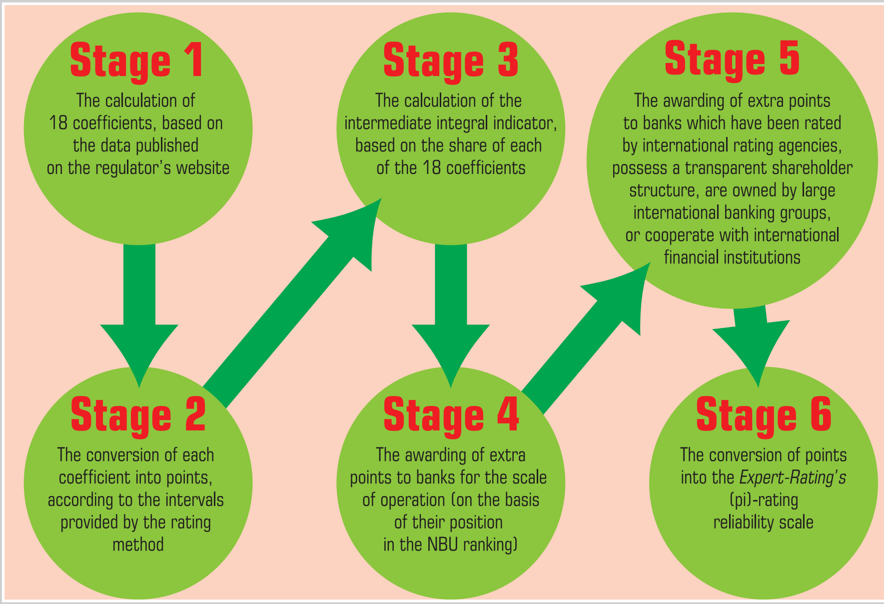
The results of last year's rating have barely revealed anything new about the leader of the 2005 ranking, Citibank Ukraine. Similar to ING, the American bank's subsidiary in Ukraine continues to ignore retail banking.

Losses are not always a bad thing

Six Ukrainian banks ended 2006 with losses. Four of these banks are associated with international banking groups. UniCredit Bank failed to improve on its satisfactory reliability level rating of 2006. The company reported a after-taxes-loss of UAH 22m ($4.4m) at the end of 2006, and is evidently still at a formative stage of its development. At the start of 2007, the volume of UniCredit Group's deposits comprised €495bn. With such a parent company behind it, UniCredit Bank cannot be considered unreliable. Yet, the development of the banking business in Ukraine in the past few years has provided evidence that, over time, unprofitable banks end up as temporary members of the Household Deposit Guarantee Fund of Ukraine. Despite this, following the completion of the branch network development and the business reconstruction, *Expert Ukraine* is positive about the future outlook of UniCredit Bank and HVB. UniCredit Group's continued financial investment into its Ukrainian subsidiaries supports this hypothesis, and emphasizes the Italians' commitment to Ukraine. The volume of the group's subsidiaries is comparable with that of BNP Paribas or Calyon. In order to swiftly end the loss-making period and branch network construction, UniCredit Group would benefit from acquiring a Ukrainian financial company that already possesses a developed branch network.

Index Bank, which was purchased by Crédit Agricole in the fall of 2006, is suffering a similar loss-making fate. Not unlike UniCredit Bank, Index Bank ended 2006 with losses of almost UAH 54m ($10.7m). As a result of this, Calyon Bank Ukraine and Index Bank, both French-owned, finished with drastically different ratings. Calyon Bank received an A++ rating, while Index Bank received C++. Index Bank maintains an already developed branch network, while Calyon Bank has become known as a gambler in the corporate credit sector. Perhaps, the French

A recurring calculation



The methodology for deciphering the reliability ratings of banks, developed by *Expert-Rating* and the Bank Analysis Commission of the Ukrainian Society of Financial Analysts in 2006, remained intact for this year's rating, with few small adjustments (see Expert Ukraine №1(1), May 2006). Banks with net assets (assets minus risk provision for assets) below UAH 300m ($59.4m) were excluded from the rating. Last year, the threshold was UAH 200m ($39.6m). As a result, the rating comprises 102 banks, for which 18 coefficients were calculated. The calculations, similar to last year's, consisted of six stages.

Stage 5 is the most information-intensive. The *Expert-Rating* analysts collected data on more than 100 banks: analysed their shareholder structure and availability of ratings by international agencies, traced whether they have links to international financial institutions, or owned by international banking groups. Twenty points were added to the intermediate integral indicator if the bank: (a) maintained a transparent shareholder structure, (b) was part of one or more international banking group or cooperated with international financial institutions, (c) was rated by one of the U.S. major agencies. If the bank incurred losses, it lost 20 points. In the final stage of the rating, the bank was assigned a place on one of the three reliability levels of the rating scale (see Table 1) on the basis of its accumulated points.

The banks were allocated positions within Groups A, B and C, based on the value of their integral indicators. Following its placement in a group, the bank automatically received a rating accompanied by the "+" sign. Thereafter, one of the rating analysts made a forecast regarding the bank's potential development, based on the latest trends in its development. If the bank received a positive forecast, it was assigned a second "+" sign. If the forecast was negative, the "+" sign was removed. In our opinion, the banks with B++ rating have a good chance of entering Group A in the short run, while banks ranked as C++ have a potential to move to Group B.

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might decide to merge the two banks under one brand, albeit such a decision would lead to further expenses.

The International Mortgage Bank (IMB), which ended 2006 with the loss of UAH 9.26m ($1.8m) is yet another foreign-owned, loss-making bank in Ukraine. In January 2007, however, IMB's share capital increased by UAH 75m ($14.9m). At the moment, all of the bank's shares are owned by the Cypriot IMB Group, previously known as Western NIS Enterprise Limited Cyprus. On 26 December 2006, IMB Group registered its sponsored Reg. S depositary receipts, possibly in anticipation of a listing of its shares on one of the European exchanges. Despite the fact that IMB Group is far off the financial heights of Crédit Agricole and UniCredit Group, it is nevertheless continuously financed by international financial organizations. The International Finance Corporation (IFC), the private sector arm of the World Bank Group, maintains its guardianship over IMB. In March 2007, IFC granted IMB a credit facility worth $7m.

The loss-making operations of UniCredit Bank, Index Bank, and IMB highlight the willingness of foreigners to conduct unprofitable businesses in Ukraine, indirectly investing in the development of the domestic banking sector. It is, however, important to keep in mind the fate of Société Générale Ukraine and Credit Suisse First Boston Ukraine, the continued losses of which resulted in their eventual exit from Ukraine, albeit without any consequences for the creditors. As we assessed these loss-making institutions as reliable, we decided to include them into this rating but not in Group A.

The first wave

UkrSibBank, Prestige Bank (recently purchased by Erste Bank Group), Alfa-Bank, and TAS-Kommerzbank, all partly foreign-owned banks, were included in the top-reliability group. In 2006, UkrSibBank increased its assets by 2.1 times, while simultaneously enlarging its retail banking portfolio by 3.1 times. The growth of its assets propelled UkrSibBank from fifth to third place in the NBU ranking. In order to sustain robust growth, this Kharkiv bank increased its share capital from UAH 0.75bn ($0.15bn) to UAH 1.75bn ($0.35bn) in 2006. Additionally, the bank was able to attract a Euroloan of $500m in December 2006. By 2010, the bank aims to gain control of 18% of the consumer finance market. As it stands now, UkrSibBank has a market share of 10–11%.

Prestige Bank, which acquired its banking license only in February 2006, rated 50th in the NBU ranking. Despite its low ranking and its incomplete branch network, the bank managed to finish the year without any losses. The 31.4% ratio of shareholders' equity to assets indicates an excessive financing from Erste Bank. In 2006, Austrian Erste Bank's assets grew by 19%, or a total of €182m. The bank finished the year with a net profit of nearly €1bn, a result which revealed Erste Bank's large resource potential compared with RZB Group or OTP. How long Prestige Bank can remain in Group A depends on whether Aval's former management team will implement resource potential of its parent company.

The Ukrainian subsidiary of Alfa-Bank of Russia improved its rating in 2006. In one year, the financial institution increased its share capital by 2.8 times, while concurrently building up the loan-to-asset ratio to 77%. The ratio of the bank's interest revenue to loans value was one of the lowest in the group, indicating the competitiveness of the bank's corporate loan programmes. In December 2006, Alfa-Bank issued $160m worth of Eurobonds.

TAS-Kommerzbank was placed at the bottom of Group A. In February 2007, Swedbank, a Swedish financial holding, purchased this bank for $753m.

State reliability

Although the method of rating calculation lends additional weight to Ukraine-based banks with international links, it is only one of the nineteen quantitative and five qualitative indicators. Therefore, the high reliability group includes fully Ukrainian-owned banks.

The two state-owned Ukrainian banks considerably consolidated their standing in

2006. UkrEximBank's return on equity grew from 17% to 20%, while its debt-to-asset ratio increased from 71% to 75%. In the last year, the bank received eight international loans, and increased its assets from UAH 10.4bn ($2.1bn) to UAH 18.1bn ($3.6bn). These developments improved the bank's NBU ranking, taking it from sixth to fourth place. An annual asset growth of almost 80% is the dream of any bank from the top ten.

OshchadBank's progress is impressive: the bank managed to move from Group B to Group A. As a result of the growth of shareholders' equity, the bank nearly doubled the level of its capital adequacy — from 8.6% to 16.13%. Additionally, the bank had also increased its debt-to-asset ratio from 21% to 38%. The revival of OshchadBank has been achieved through compulsory transfer of power utility bills servicing to this bank. The bank's management team, headed by **Oleksandr Morozov**, cut down on bad domestic government bonds. In the last year, its securities portfolio, refinanced by the NBU, decreased from UAH 3.8bn ($0.75bn) to UAH 1.8bn ($0.36bn). The government decided to use OshchadBank's financial resources to finance power utility sector, instead of using them to cover losses at the Ministry of Finance. Besides, in January 2007, OshchadBank attracted a subordinated loan from ABN Amro, worth $100m. Securing a subordinated loan should have a positive impact on the company's financial indicators inasmuch as subordinated debt is included in the bank's share capital. It has become apparent that the bank is building up its credit history in order to — following UkrEximBank's example — expand its foreign loan portfolio under reasonable rates. Morozov's team has not yet resolved many of OshchadBank's problems, albeit it has developed a correct development strategy. The policy of a new team headed by the former chairman of Aktiv-Bank, **Anatoliy Guley**, is yet to be determined. All these factors, together with an ongoing political crisis in Ukraine, propelled us to assign the bank with a negative (pi)-rating.

In safe hands

Similar to last year's findings, banks controlled by the wealthy individuals and by the financial industrial groups were placed in the highest reliability group. Nadra Bank, having increased adequacy of its shareholders' capital from 9.7% to 13.34%, and its profitability from 4.8% to 14.1%, moved up into Group A. The bank also ranked well in terms of its disclosure policy. Nadra Bank is one of the few institutions that fulfilled the NBU requirements by revealing the identity of its shareholders on its website. Now, everyone in Ukraine knows that 33.7% of the bank's shares belong to Sergey Lagur, a member of the bank's supervisory board, while 31.4% are owned by **Igor Gilenko**, the bank's President and Chairman of the Board, and a further 18.2% by **Vadim Pyatov**, another member of supervisory board. Prior to the private placement in 2006, during which East Capital Group, a Swedish investment company, purchased 6.74% of the bank's shares, Nadra registered its Reg. S depositary receipts. At first glance, it is difficult to assess whether the bank is attempting to build a solid credit history to improve its standing with Western creditors, or whether it is unable to rest until it ensures that it is the first Ukrainian bank to conduct a full-fledged IPO. In any case, the reforms, implemented by the management in the last year, have certainly had a positive impact on the bank's rating.

The sale of UkrSotsBank to Banca Intesa, an Italian bank holding, has failed. Initially, the deal was blocked by UkrSotsBank's dissatisfied minority shareholder. Subsequently, Banca Intesa failed to meet the NBU deadline. On 4 April, 2007, a statement was released informing that the bank had issued bonds, and thus indicating that the bank had remained under the control of **Viktor Pinchuk's** group. Almost a year of sustained expectations of the bank's sale helped improve its performance. As a result, its return on equity climbed from 11.5% to 14.9%. Moreover, in December 2006, UkrSotsBank issued a syndicated debt worth $250m and borrowed $400m at 8%, issuing Euronotes. Whether the bank intended it or not, it managed to establish a solid credit history. Over a year, Western analysts associated it with a large bank holding, and these perceptions were only strengthened by the findings of international rating agencies.

Dongorbank and the First Ukrainian International Bank, both controlled by **Rinat Akhmetov**, also fared well in our rating. Despite the risks involved with the unstable political situation of these companies, their financial status demonstrated continued strength.

Financial Initiative Ltd, with 99.99% of its shares owned by Investservice company, is the Group A's dark horse. The bank provides loans to UniTel and Kiev Plumbing Fixture Plant, which comprise KievMiskBud holding company. In the last year, the bank's assets grew 3.4 times. As of 2005, Bank Analysis Commission of the USFA could not rate the bank's reliability. In 2006, the bank was included in the rating, despite the fact that its disclosure policy still leaves much to be desired.

Prospective members

Forty-seven banks comprised Group B, with thirteen of them having improved their rating standing compared to the previous year. Another six companies had not been previously included in the rating at all. Aktiv-Bank, Khreshchatyk Bank, Rodovid Bank, BrokBusinessBank, and Credit-Dnipro came very close to being included in Group A. In the long run, these banks are highly likely to move into a group of banks with a higher level of reliability. Partly foreign-owned banks, particularly Kredobank, Petrokommerz Ukraine, and SEB Bank, featured in Group B. Unfortunately, the method of the (pi)-rating does not account for all the advantages acquired by these European subsidiaries through close relations with their parent companies. Nevertheless, it is abundantly clear that foreign-owned companies of Group B contain a vast potential for growth.

Twenty-eight financial institutions comprised Group C. Five of them were not ranked in the previous year because financial analysts deemed them unsuitable to be included into any of the groups. The rating of National Investments, Metallurg, and National Credit slipped last year. On the NBU asset size ranking, these institutions are usually ranked below the top fifty banks. Additionally, they have a low profitability or surplus shareholders' equity. ■

Bank reliability (pi)-rating scale — Table 1

Group	Comments on a rating category	Forecast	Meaning of forecast
A	**High level of reliability** In the short run, the probability is high that the bank will deal with unfavourable conditions on its own	A++	Positive
		A+	Neutral
		A	Negative
B	**Acceptable level of reliability** In the short run, the probability is reasonable (compared to banks of Group A) that the bank will deal with unfavourable conditions on its own	B++	Positive
		B+	Neutral
		B	Negative
C	**Satisfactory level of reliability** In the short run, the probability is satisfactory (relative to banks of Group A) that the bank will deal with unfavourable conditions on its own*	C++	Positive
		C+	Neutral
		C	Negative

*Rating C is automatically awarded to those banks that have delayed the fulfillment of their obligations to their depositors, regardless of the value of their integral indicator.