

Foreign affiliates are more reliable

Out of the 22 banks having the highest pi-ratings of liability by results of 2007 performance only 12 either partly or completely belong to foreigners. Last year, banks with broad access to long term and inexpensive financing raised money at the expense of the margin between the cost of credits in Ukrainian and foreign markets.

In 2007 assets of Ukrainian banking industry soared by 76% that is half as large again in 2006. The financing from abroad of the banks which are either under the non-residents control or are being prepared for selling is the key source of such growth. Scenarios of foreign expansion are not unlike. After completion of the sale the foreign owners change the Board, increase a certain period after the statutory fund thus increasing the spread for future debt financing.

In spite of similarity of growth scenarios the forms of the growth of banking industry during 2006–2007 were different. The credit portfolio in 2007 was growing in proportion to assets growth while in 2006 the credit portfolio had been growing more rapidly in comparison with assets growth rate.

However a number of banks to have been assigned an A grade rating of liability declined from 27 in 2006 to 22 in 2007. The significant growth of competition in banking industry has lead to decrease of ROE of many financial establishments first of all those not yet bought out by foreigners and have no access to cheap loans.

Risks of system

The study of consolidated data of Ukrainian banking system shows that there is no special reason to be anxious about its liability. The basic indicators of their activity are sound. The share of high liquid assets, for example, has decreased by 0.15 percentage points only. Ratio of equity capital and assets has decreased just by 0.9% and the level of equity adequacy is still far from the critical 8% benchmark. However an alarm tendency is peeping out from behind such a glowing statistics.

First, the NBU official statistics denotes the growth of credit portfolios quality. This fact is being confirmed by ratio of credit operations provision and total volume of crediting portfolio evolution. In 2007, this indicator has fallen down by 0.66 percentage point. The tendency is obviously contrary to the facts, especially against the growth of share of population lending in total volume of banks loans. The current system of reserves accrual on credit operations in Ukrainian banks has a number of flaws. Particularly, banks when lending individuals have an opportunity to conceal the problem credit by overcrediting the client. Though overcrediting in several banks branches amounts already 20–25% out of their portfolio the banks persistently continue to report to NBU the 5–7% level of portfolio quality.

Second, the growth of volumes of individuals lending helps the banks to conceal the true quality of their credit portfolio. New credits 'dilute' the old portfolios with problem loans. The medium term of revelation of problem liabilities on majority types of consumer credits exceeds 12 month that is why the quality of banks credit portfolios will noticeably worsen only by the time the growth rate lowered.

The third factor is the constantly growing impact of foreign banks on domestic banking. If at the beginning of 2007 the banks under non residents had had one third of the banking industry assets, then in the early 2008 this indicator exceeded 40%. Whereas the acquisition of Ukrainian banks is going on it is possible to forecast the further growth of foreign impact. Such impact leads to imbalance of rates on money-market and intensifies the speculative capital flow into the country. In the medium-term perspective this tendency will be in the double nature, that is, against the situation on the world market the substantial share of foreigners can become either strengthening factor for national economics development or the cause of abrupt and painful outflow of capital.

Foreign leaders

General tendency is that banks with foreign investors step-by-step supplant from A group financial institutes owned by Ukrainian residents. The first top five banks to take the maximal summarized integral index in our rating include only banks owned by non residents. Calion Bank Ukraine is at the top of A group. We, at Expert Rating, think that acquisition of Index Bank by Credit Agricole Group (includes Calion Bank) in 2006, had had a positive impact on bank's position on national market of financial services. The first top three banks (Calion Bank, Citybank Ukraine and ING Bank Ukraine) ignored the retail sector.

ING Bank Ukraine has officially announced the start of its retail banking in Ukraine. At last, after the 10 years of its performance in Ukraine, the ING Group management consented the independent development of retail business. No one financial international group before has managed to start a big retail bank from scratch, therefore it is naturally to expect in 2008 the acquisition of Ukrainian banks by ING Group. Otherwise it will cost ING Bank the networking and will inevitably abuse the indicators of its current performance.

Raiffeisen Bank Avval became the constant tenant in Group A. In spite of its belonging to the banks specialized on retail banking it has managed to keep its return on equity (ROE) on 10% plus level as well as to maintain the acceptable level of both liquidity and solvency.

Reliable residents

The three years running there is a good many banks in Group A including PrivatBank, UkrEximBank, DongorBank, the First Ukrainian International Bank (PUMB) not to belong to international financial-banking groups. Each of these banks endeavors to conduct an independent financial policy.

PrivatBank In environment of severe competition with foreigners manages to remain the best bank on asset volume. UkrEximBank and OshchadBank by the end of 2007 showed a good enough ROE and assets quality. Judging the state-owned banks' key indicators in 2007 one can ask the question: whether it is so necessary to go them private if efficiency of their activity is not worse than that of Raiffeizen Bank Avval. Nadra Bank the second year in succession to enter the Group A is in the run-up to the IPO and is aspiring to show the market good statistics.

The appearance in Group A of such banks as Financial initiative, Brokbusinessbank, Kliringoviy Dom and Kredit-Dnipro can be considered to be surprise. The Kyiv based Financial initiative bank had already entered Group A in 2006 but only in 2007 bank began to display activity in the market specifically having had time to announce the intention to open 150 branches all over the country and to issue Eurobonds. Kliringoviy Dom and Kredit-Dnipro banks being not great on National Bank classification set for Group A due to good financial indicators (liquidity, ROE, assets quality and capital adequacy). In 2007 Kredit-Dnipro bank made a syndicated loan to the sum of US\$14m.

Thus, 22 banks out of 107 to comprise the Rating had got the highest level of reliability (A grade), the liability level of 59 banks was found acceptable (B grade) and 26 were C rated (satisfactory level). The level of the system protectability during the year had grown at the expense of both consolidation of large international banking holdings in the national market and arrangement of unprecedented external supporting to certain Ukrainian banks.

The changes in Rating Groups consisting are not serious. Majority of competitors secured the same positions as of the previous year. This situation is fully natural for there were no any substantial changes in the NBU ranking either. We, in Expert-Rating, are sure that in 2008 the buyup of Ukrainian banks by foreigners will expanse thus increasing the dependence of both national money-market and banking system as a whole on process of globalization in the world financial market. The top on asset size 10 large system banks as well as middle and small banks acquired by large banking holdings will comprise the group of the most reliable banks. Expert-Rating Agency estimates the potential of bankruptcy in 2008 as 3 banks from Group B and 6 banks from Group C. Chain of bankruptcies is possible under the unfavourable state of monetary market, for example if NBU begins the dramatic restriction of active money volume.

The third rating of Ukrainian banks' reliability

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 #16(67), April 24, 2007*). 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:

<u>Stage 1</u>	<u>Stage 2</u>	<u>Stage 3</u>	<u>Stage 4</u>	<u>Stage 5</u>	<u>Stage 6</u>
The calculation of 18 coefficients, based on the data published on the regulator's website	The conversion of each coefficient into points, according to the intervals provided by the rating method	The calculation of the intermediate integral indicator, based on the share of each of the 18 coefficients	The awarding of extra points to banks for the scale of operation (on the basis of their position in the NBU ranking)	The awarding of extra points to banks which have been rated by international rating agencies, possess a transparent shareholder structure, are owned by large international banking groups, or have links to international financial institutions	The conversion of points into the Expert-Rating's (pi)-rating reliability scale

Banks with net assets (assets minus active transaction reserves) below UAH 500m (\$99m) were excluded from the rating. Last year, the threshold was UAH 300m. The rating 2007 permeative boundary was raised in proportion to increase of consolidated assets of banking system over the past year.

We in Expert-rating cut down the number of corrective factors from five to three. Banks disclosing the owners' structure were not encouraged for in the beginning of 2008 it did National Bank of Ukraine having published the main owners of the majority of banks which took part in our rating. It was decided too not to take into consideration when carrying the rating research the fact of interaction of banks with international finance and credit organizations (IFCO). The majority of financial institutions does not need the mediation of IFCO already and independently borrow money in the western markets. The changed number of market factors made us to bring down the pass mark by 20 units as to each group in table 3.

Table 3

Bank reliability (pi)-rating scale

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. The bank has been assigned a neutral forecast*	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.

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