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## **THE IMPACT OF FINANCIAL CRISIS ON THE BANKING SECTOR OF UKRAINE**

### **Summary:**

*Especially relevant today is the impact of the crisis on peculiarities of the banking sector of Ukraine. The main problems domestic banking sector is the high dependence on foreign capital, a large amount of bad loans and risks banking portfolios. Significantly affect the banking sector of Ukraine shadow economy. Significantly increased the number of insolvent banks. Increased risks for banks with low levels of problem loans, but aggressive lending strategy. One of possibility a qualitative change in the situation is the introduction of modern banking relationships. Required gradual transformation of traditional banking institutions in creative banks.*

### **Keywords:**

*Bank, banking sector, National Bank, financial risks, creative banks, banking risk management, Ukrainian banking system, problem loans, traditional banks.*

## **Introduction**

The rapid development of the banking sector requires more attention towards the activities of financial and credit institutions. That is why the risk management becomes especially relevant for the management of any bank because except being a means of loss prevention it also helps to make extra profits. Due to the constantly increasing influence of risks on financial activities the problem of banking risk management becomes especially relevant. Banking risks management refers to different ways of forecasting probable risks in banking activities and to the measures aimed at reducing the following risks.

## **Results of the research**

Issues of formation and development of the banking sector have always interested foreign and domestic researchers (this can be explained by the fact that the banking sector has a considerable influence on the overall socio-economic processes within the country).

In 2011, report "Eastern European banking: Moving toward a New Paradigm" published by McKinsey & Company identified the Ukrainian banking sector as the weakest in the region. McKinsey & Company outlined such problems of the domestic banking sector as high dependence on foreign capital, a large amount of non-performing loans (35%) and the risks of bank portfolios. It should be noted that apart from the problems outlined by McKinsey & Company, the Ukrainian banking sector, in our opinion, has the following functional features that hamper its further development: fragmented processes which are beyond the control of the national regulator, low capitalization, a high level of economic and geographical concentration, a high level of risks and a significant influence of the shadow economy.

The following are the internal causes of functional failure of the Ukrainian banking system:

1. Banks with Ukrainian capital – governmental intervention in lending policies of public banks with the aim of solving current financial problems and the problem of state monopolies which leads to poor quality of loan portfolios in these banks; the uncertainty of the state policy of overcoming the economic crisis and, consequently, the uncertainty of the role public banks play in economic processes.
2. Banks with Western capital – a discrepancy between their current presence in Ukraine and their strategic objectives; the technological inability to provide loans; problems of receiving funds from parent banks.
3. Banks with Russian capital – the specific strategic objectives of their presence in Ukraine are contrary to the interests of the Ukrainian economy; the pressure of Russian policy on the loan policy of Russian banks in Ukraine; the subordination of banking business to political goals: political risks. Because of the low level of capitalization the build-up of capital and assets for Ukrainian banks is an objective necessity.

The minimum amount of regulatory capital of the bank (N1) which received a banking license till 11 July 2014 shall be equal to 120 million UAH till 10 July 2017; 150 million UAH - from 11 July 2017; 200 million UAH - from 11 July 2018; 250 million UAH - from 11 July 2019; 300 million UAH - from 11 July 2020; 350 million UAH - from 11 July 2021; 400 million UAH - from 11 July 2022; 450 million UAH - from 11 July 2023; 500 million UAH - from 11 July 2024.

A high level of economic and geographical concentration. As of 1 January 2015 sixteen largest Ukrainian banks (banks of the first group) owned 72, 99% of the total assets of the whole banking sector (961 093 million UAH), and the fourth group which includes 90 banks owns only 5, 08 % of banking sector assets.

As far as the regional concentration is concerned, the analysis of the bank network demonstrates that most banks are located in a few major cities. In the city of Kiev and Kiev Region 71% of the total number of banking institutions were located. Dnipropetrovsk, Donetsk and Odessa Regions account for almost

16% of the total number of banks. This concentration can be explained by the fact that these regions are the most developed industrial regions of Ukraine with a high investment rating.

This situation requires further analysis of issues regarding the formation of regional and municipal banks with the aim of providing the individuals and legal entities with certain banking services that are tailored to the specific economic development of the region or city. In 2014 the loan borrowers faced major difficulties in servicing their loans which significantly increased the riskiness of the banking business. According to the National Bank of Ukraine, the share of negatively classified debts in the total volume of loan indebtedness of the banks within a year increased from 12, 9 to 19, 0%. In particular, the number of overdue loans increased by 92, 5%.

In our opinion, the basic ways of reducing the level of risks in the Ukrainian banking system in mid-term are the following:

- the diversification of bank assets and the introduction of new deposit programmes;
- the reduction of operating expenses and increase of income due to bank charges;
- the increase of capitalization level of the banking sector by attracting additional equity capital, the improvement of calculation methods of amounts and standards of the regulatory capital and risk standards;
- the improvement of procedures of bank resolution, reorganization and liquidation;
- the development of the structure of the banking sector towards the optimal combination of large banks with the extensive network of branches and regional or municipal banks;
- creation of conditions for attracting investment in the domestic banking system in amounts that will not create significant financial risks.

In Q3, most banks introduced no changes to the loan application approval standards. Specifically, 99% of banks reported the unchanged standards for mortgages and 71% of banks for consumer loans. However, 21% of banks noted minor softening of consumer lending standards. Over the next quarter, both consumer and mortgage lending standards are projected to soften. Lowering the lending standards can be primarily attributed to the reduced cost of resources and eased balance sheet restrictions. Cautious expectations concerning macroeconomic indicators and collateral risk were the major drags on lending. For the first time in the last two years, the approval rate for consumer loan applications increased; 30% of respondents recorded growth compared to 9% in the last quarter, while 7% (versus 31%, respectively) recorded its decrease. According to the majority of banks, the households demand changed neither for mortgages (89% of responses) nor for consumer loans (69%). However, 23% of banks noted a slight increase in demand for consumer loans. The respondents expect the trends to continue in the next quarter, with demand for consumer loans increasing (39% of responses) and demand for mortgages remaining flat (92%).

The main drivers pushing the demand for consumer loans upward were the expenses on durable goods and improved consumer confidence. The banks see the interest rates (38% of responses) as the key factor that restrained mortgage lending.

Informal (shadow) economy. It is common knowledge that the shadow economy is a set of uncontrolled and unregulated illegal economic relations between the subjects of economic activity. It is focused on such strategic directions of economic activity as industrial, commercial and financial sectors of economy. Alongside with legitimate economic institutions shadow economic institutions appear that duplicate the functions of the official economy.

According to different calculation methods proposed by the Ministry of Economic Development, in the first quarter of 2012 the size of the informal (shadow) economy in Ukraine amounted to 31-44% of GDP. Such size of shadow economy in Ukraine is becoming a threat to the national security. If the size of shadow economy exceeds 30% and the number of people engaged in it exceeds 40%, it will pose a threat to the controllability of the economy. It is widely known that one of the elements of fighting money laundering (transforming the proceeds of crime into ostensibly legitimate money) is a compulsory identification of bank clients.

According to the Law of Ukraine "On Banks and Banking", banks are not allowed to open and keep anonymous (numbered) accounts. In addition, banks are not allowed to enter into correspondent relations with banks or any other non-resident financial institutions that have no permanent registration and do not operate at the place of their registration, and/or are not subject to relevant supervision in their countries, as well as with banks and any other non-resident financial institutions that enter into such correspondent relations. Besides, in order to reduce the risk of money laundering in the banking sector the following measures are to be taken: State Committee for Financial Monitoring should timely provide domestic banking institutions with information on new types of fraud (securities fraud, fictitious bankruptcy and illegal withdrawal of money from bank accounts); a unified analytical system should be created to monitor illicit financial transactions and enlarge the list of transactions subject to monitoring (for example, operations with precious metals or real estate); criminal responsibility for fraud and economic crimes in banking sector should become more severe. Therefore, the conducted analysis of the Ukrainian banking sector demonstrates that poorly controlled fragmented processes, a low level of capitalization, a significant economic and geographical concentration, a high level of risks together with a big threat posed by the shadow economy hamper the development of Ukrainian banking sector. A proper way of changing this situation is to enhance modern banking with such elements of alternative banking as a gradual (evolutionary) transformation of traditional banks into "creative" banks. So, in order to ensure the effective functioning in the conditions of the "creative economy", banks should be involved in a continuous process of conversion (transformation) by diversifying their strategies and business directions.

In addition, the risk management system of a "creative" bank is a response to threats of the external environment which ensures further development of such bank by changing its internal organizational capabilities and creating new strategies.

It should be noted that Islamic banks are currently using some tools of "creative" banks. Islamic banks pay exceptional attention to the essence and potential of projects in which they are investing money, while traditional banks often assess projects only by the factor of loan collateral. Given the fact that speculative activities are prohibited by Sharia Law, Islamic banks are more interested in funding the real sector (thus, by doing so they effectively stimulate the economy). In fact, Islamic banks were hardly affected by the financial banking crisis. So, the conducted analysis of the Ukrainian banking sector demonstrated the following key problems: the availability of fragmented processes, a high level of risks, a significant economic and geographical concentration, a significant impact of the informal (shadow) economy and a low level of capitalization. One way of solving the aforementioned problems (primarily, regarding the improvement of risk management system) is the gradual transformation of traditional banks into creative banks.