GML International Limited
Kyiv Representative Office
Prov. Muzeyny 4
Kyiv 01001, UKRAINE
Tel: +380 (44) 490 5570
Fax: +380 (44) 490 5569
email: office@gml.kiev.ua

Contact: Mr. Mykola Pasko

Research Note – July 2004

Overview of the Ukraine Banking Industry

Summary:

- At the beginning of January 2004, there were 179 registered banks in Ukraine, of which 158 had licenses to conduct banking operations. 132 banks were incorporated as joint-stock companies, 94 as open joint-stock companies and 38 as closed joint-stock companies. 22 banks were limited liability companies, 19 banks were partially foreign-owned (seven have 100% foreign capital) and two were state owned banks. The National Bank of Ukraine (the "NBU") reports that 7 new banks were registered in 2003.

- The NBU had required banks to maintain a capital adequacy ratio of 8% of risk-weighted assets, computed on the basis of Ukrainian accounting rules. From April 2004 the NBU increased the ratio to 10%. New banks are required to maintain a capital adequacy ratio of 15% of risk-weighted assets during the first year of activity, and a ratio of 12% during the second year.

- Banking sector profits grew 41.5% y/y in 2003 to UAH 968 mn (USD 182 mn). Total assets of the sector reached UAH 105.6 bn (USD 19.8 bn), up 55.8% y/y. The growth of the banking sector in Ukraine can be seen in the context of data for the first 11 months of calendar 2003, which indicate that 80% of all credits were provided to the private sector, with only 3.5% of loans being non-performing. Parallel growth in liabilities was supported by increased retail and wholesale deposits as a result of resumed confidence in the sector. Total liabilities of the sector reached UAH 87.3 bn (USD 16.4 bn) at the end of 2003.

Summary (continued):

- Credit ratings assigned to obligations of Ukrainian banks are as follows:

Bank name	Rating agency	Current rating	Type of rating	Date assigned or last changed
FUIB*	Fitch IBCA	B-	long-term	19.01.2004
Industrialbank	Fitch IBCA	CCC	long-term	03.02.2003
Nadra Bank	Moody's	B2	long-term	14.12.2003
Pravex Bank	Moody's	B2	long-term	26.11.2003
PrivatBank	Standard & Poors Fitch IBCA	B- B-	long-term long-term	28.10.2003 10.07.2003
Ukreximbank	Moody's Fitch IBCA	B2 B+	long-term long-term	01.06.2004 25.05.2004
Ukrsibbank	Moody's Fitch IBCA	B2 B-	long-term long-term	11.02.2004 03.03.2004
Ukrsotsbank	Moody's	B2	long-term	14.12.2003
VaBank	Moody's	B2	long-term	15.12.2003

* First Ukrainian International Bank

- In late 2003, PrivatBank placed USD 100 mn of 3-year loan participation notes at a yield of 10.875%. In April 2004, Ukrsibbank successfully completed a USD 100 mn 3 year issue at a yield of 10.5%. Ukrsotsbank, Ukrsibbank, Aval, Ukreximbank and FUIB have all raised syndicated loans in the last 12 months. Other Eurobond and loan facilities are being considered by the leading institutions.

Introduction

Ukraine's banking sector is one of the most modern and dynamic sectors in the Ukrainian economy. The sector survived years of hyperinflation, a decade of economic decline and a difficult macroeconomic environment without major systemic failures. It weathered the Russian financial crisis of 1998 reasonably well, and in the last four years has developed considerably.

In 1991, Ukraine as an independent state embarked on the course of market reform. At the time Ukraine achieved independence the country had no real banking system, as under the centrally planned Soviet economy, the banking system was run from Moscow. Gosbank, the state bank of the Former Soviet Union, performed most of the functions in the banking system and a small group of state-owned specialised banks formed a second tier. Banks in the Former Soviet Union made no credit decisions or project assessments, but instead mainly performed settlement, accounting and verification functions. President Gorbachev's attempts to transform the Soviet economy led to recognition of private ownership rights and to the creation of private and co-operative enterprises. In 1990, the first Ukrainian commercial banks began emerging in the form of co-operative or joint stock companies, many set up by state-owned companies on a sectoral basis.

The break-up of the Soviet Union and abolition of the rouble zone led the Ukrainian authorities to the development of an independent financial system comprising formerly state-owned banks as well as newly established commercial banks. In June 1991, the NBU was established to perform the functions of a Central Bank for the country.

Until 1995, the banking sector in Ukraine lacked the essential infrastructure to support a modern banking system. This period was characterised by hyperinflation, dollarisation, widespread use of barter for settlement of financial transactions, negative real interest rates, excessive central bank lending, and very low currency reserves. As a result of the assistance of the international financial institutions in 1994, the NBU established a monetary stabilisation programme to curb inflation, tighten monetary policy and to stabilise the exchange rate of the Ukrainian currency, the Hryvna (the "UAH").

Establishment of a national payment system based on advanced computer technology in 1994 gave a strong impulse to the development of the banking system and improved the mechanism for interstate settlements within the Commonwealth of Independent States (the "CIS"). By the late 1990s, the number of banks in Ukraine had grown to more than two hundred. Since then the NBU has reorganised it's banking supervision and set up a system for monitoring major economic indicators and established prudent reporting requirements for commercial banks. During the last six years, more than thirty banks unable to comply with the stricter regulations of the NBU have ceased to exist as a result of liquidation, reorganisation and mergers. A new highly professional group of banks established over recent years have proved resilient to the country's economic difficulties, and low levels of non-performing loans have proved to be a major advantage for these banks.

As a result of the Russian financial crisis of 1998 and the Ukrainian government's de facto default on Treasury Bills in 1999 and restructuring of Ukraine's Eurobond and other external debt commencing in 1999, Ukrainian banks became isolated from their foreign correspondents, and confidence in Ukrainian banks declined. However, the Ukrainian financial sector showed strong resilience to this external shock, with not a single bank failure in Ukraine as a direct result of the Russian crisis.

The legal framework has been improved with the Law on Banks and Banking Activity approved in 2001, and the Law on Household Deposit Guarantee Fund enacted in September 2001. The amount insured per depositor is still very low, but it has more than tripled since inception and reached UAH 2,000 (around USD 375) in October 2003.

The National Bank of Ukraine

According to the Law of Ukraine on the NBU, adopted in May 1999, the NBU is the central bank of Ukraine. Its overall responsibilities include pursuit of Ukrainian Government policy, supervision of and maintenance of the value of the national currency (including determining currency in circulation), targeting exchange rates against foreign currencies, and supervision and coordination of the functioning of the banking system in general.

The Constitution of Ukraine, adopted in 1996, stipulates that the main function of the NBU is to ensure stability of the UAH. To carry out its main function, the NBU fosters the stability of the banking system and, within its competence, price stability.

Since December 2002, Mr. Serhiy Tihipko has been the Governor of the NBU. He previously served as Chairman of PrivatBank, the largest private commercial bank headquartered in Dnepropetrovsk, and later as Vice Prime Minister of Economy in 1997-2000 and was a member of the Ukrainian Parliament from 2000-2002.

The NBU also accumulates and manages the country's gold and currency reserves. During the last three years, due to growth and reforms in the Ukrainian economy, the resumption of IMF lending and a consistent foreign trade surplus, the country's currency reserves have tripled. In 1999, the NBU introduced a floating exchange rate regime for the UAH. Since then the exchange rate against the USD has been stable, deviating in a narrow range of UAH 5.3 - 5.4 per USD. The NBU has managed to achieve a stable exchange rate through intervention in the open market to prevent UAH volatility.

The NBU establishes the discount rate and other interest rates in the Ukrainian economy. During 2003, the NBU reduced the discount rate on four occasions, from 12.5% to 7% and on three occasions it changed the reserve requirements for commercial banks. The discount rate is presently 7.5%.

The NBU gives permission for the registration of commercial banks and licenses banking business. It also determines the level of emergency funds available to commercial banks.

Structure of the Ukrainian Banking System

Ukraine has a two-tier banking system, which consists of the NBU, and commercial banks of different types of ownership. As stated above, as of 1 January 2004, 179 banks were registered at the State Register of banks, of which 158 banks held NBU licenses to perform banking transactions. 132 banks were incorporated as joint-stock companies (94 as open joint-stock companies and 38 as closed joint-stock companies). 22 banks were limited liability companies, 19 banks were partially foreign-owned (seven have 100% foreign capital) and two were state owned banks. There are 20 banks under liquidation, including 12 banks under liquidation in accordance with decisions of the NBU and 8 banks in accordance with decisions of the Ukrainian courts.

In 2004, we expect the process of consolidation of the banking sector to continue. In future we expect the number of commercial banks in Ukraine to decline to less than one hundred.

Commercial banks are formed as joint-stock companies or partnerships by private individuals and/or legal entities. The present range of commercial banking activity includes receiving deposits of enterprises, institutions and individuals; providing credit to economic entities and individuals; investing in securities, maintaining cash balances, reserves and other assets; providing settlement services in the economy; performing foreign exchange settlements and other services for individuals and legal entities. Recently, services such as mortgage banking and securities underwriting have started to develop.

Based on size, capital and importance to the banking system we can identify the following segments of Ukraine's banking sector:

Systemic Banks

Six banks, whose joint capital exceeds UAH 3 billion (approximately USD 500 million), control much of the capital and political power in Ukraine: Prominvestbank, Aval, PrivatBank, Ukreximbank, Oshchadbank (Savings Bank), and Ukrsotsbank. Each of these banks in this segment has national importance and countrywide branch networks.

Prominvestbank and Ukrsotsbank were privatised in 1991-1993 and now only a nominal share in these banks belongs to State-owned enterprises. Two banks, Ukreximbank and Oshchadbank, remain under full State ownership and are involved in financing State programmes. The activities and strategies of these banks are still under strong governmental influence.

Largest Commercial Banks

Currently this group consists of some 10-15 Ukrainian commercial banks which are smaller than the six "systemic banks" referred to above. Within this group, four commercial banks are unquestionable leaders: Ukrsibbank, Nadra Bank, First Ukrainian International Bank (FUIB), and Brokbusinessbank. For more information on the top 12 banks in Ukraine, we provide their website addresses below (although not all have English versions).

Aval Bank	-	www.aval.ua
Brokbusiness	-	www.bankbb.com
FUIB	-	www.fuib.com
Nadra Bank	-	www.nadra.com.ua
Oshchadbank	-	www.oshadnybank.com
Pravex Bank	-	www.pravex.com
PrivatBank	-	www.privatbank.ua
Prominvest	-	www.pib.com.ua
Ukreximbank	-	www.eximb.com
Ukrsibbank	-	www.ukrsibbank.com.ua
Ukrsotsbank	-	www.ukrsotsbank.com
VaBank	-	www.vabank.com.ua

Other Commercial Banks

In addition to the above two groups, over 130 other banks have been registered since 1992. For various reasons these banks remain quite limited in resources and market share. Generally speaking, as is very common in all countries which emerged after the collapse of the Former Soviet Union, one may surmise that many such banks were established primarily to serve specific financial needs of the owners.

Foreign-Owned Banks

There are 19 banks which have a foreign shareholding in their authorised capital. Six banks are 100% foreign-owned: Raiffeisen Bank ("RZB"), ING, Citibank, Calyon Bank Ukraine (formerly Credit Lyonnais), HVB and Pedkao. The total share of authorised foreign capital in the Ukrainian banking sector was around 12.4% as of September 1, 2003. Large Russian banks such as Alfa Bank, National Reserve Bank and Petrocommerzbank have established subsidiaries in Ukraine since 2000.

The Ukrainian government generally opposes the establishment of branches of foreign banks in Ukraine. Therefore, only subsidiaries with the status of a separate legal entity and own capital are allowed to operate in Ukraine. This is due to the argument of the Ukrainian authorities that they do not have the necessary tools to audit and control the activity of foreign bank branches in Ukraine. Most foreign banks set up their subsidiaries in Ukraine to serve international clients rather than to build a local clientele. Only RZB Ukraine is among the top ten banks in Ukraine in terms of local lending activity.

Commercial Bank Regulations

To be eligible to apply for a banking license, banks must demonstrate that they meet all the requirements to have in place appropriate banking equipment, software, means of communications, premises and qualified personnel.

There are no administrative restrictions or limits on foreign capital in either individual banks or in the banking system as a whole. The same rules apply to all market participants and Ukraine considers itself to have one of the most liberal sets of regulations for foreign bank participation in the CIS.

As stated above, the NBU had required banks to maintain a capital adequacy ratio of 8% of risk-weighted assets, computed on the basis of Ukrainian accounting rules. Commencing April 2004, the NBU increased the ratio to 10%. New banks are required to maintain a capital adequacy ratio of 15% of risk-weighted assets during the first year of activity, and a ratio of 12% during the second year. All Ukrainian banks converted to International Accounting Standards on January 1, 1998.

Currency controls in Ukraine are strict and complex and are governed by the laws and regulations of the NBU. Current legislation stipulates that the UAH is the only legal tender in Ukraine, which may be accepted without limitation for the settlement of debts and obligations. Currency decrees stipulate that individual licenses have to be obtained from the NBU to carry out certain operations involving foreign exchange. Regulations are frequently changing.

Ukrainian legislation and regulations regarding taxation and other operational matters continue to evolve, as is typical of an economy at Ukraine's stage of transition. Legislation and regulations are not always clearly written and their interpretation is subject to the opinions of local regional and national authorities, and other governmental bodies. Instances of inconsistent opinions and enforcement are not unusual in Ukraine.

Banking Products in Ukraine

Major commercial banks in Ukraine offer all of the usual banking products and services. Some offer internet banking, consulting services, insurance, and execution of transactions in investments and securities. Other relatively recent product developments are local currency corporate bonds with maturities of up to 18 months, consumer and automobile loans, and mortgage lending. The range, automation and quality of services have improved significantly during the last 3 years.

Banks in Ukraine have focused on retail business in order to attract the cheaper and relatively more stable source of funding which deposits represent. Interest rates paid by Ukrainian banks on USD and EUR time deposits are up to 3 times higher than rates offered by European and American banks.

To increase the trust of the Ukrainian population in commercial banks, the Ukrainian government created the Household Deposit Guarantee Fund in September 1998. The Fund insures deposits of citizens placed in participating banks in national and foreign currency (including interest) up to a limit of UAH 2,000 per deposit per bank in the event of bankruptcy of the bank.

As of 1 April 2003, there were 78 banks (about 50% of the total number of banks) which were members of domestic and international payment systems. The Ukrainian clearing system is generally regarded as being one of the best in Europe, and most settlements are executed with value on the same day as the instructions are given. Settlement by cheque does not exist in Ukraine (in common with many other countries in the region), and therefore wire transfers are regarded as the normal means of payment settlement.

There is currently no market in Ukraine for derivative financial instruments to manage liquidity or risk. The NBU is working on the development of a set of rules designed to regulate this segment of the financial markets. It is expected that forward and futures trading rules applicable to both UAH and foreign currencies will be enacted before the end of 2005. In the Ukrainian banking market, many short-term loans are granted with clear the expectation of both borrower and lender of rolling over the loan at maturity.

The securities markets in Ukraine are characterised primarily by speculative and arbitrage operations. The largest activities in the share markets in Ukraine are focused on consolidating large and controlling blocks of shares issued by privatised enterprises. The scale of corporate bond trading in Ukraine significantly exceeds the trading of shares.

Restrictions on Trade Finance

Selective and attractive investment opportunities in Ukraine are available in the area of trade finance, however great prudence is required in the selection of opportunities, and local presence and expertise is essential to be able to perform appropriate due diligence. Present Ukrainian legislation is somewhat contradictory in terms of restrictions on the use of bills of exchange and promissory notes in trade-related transactions, but it is expected that new legislation will in future be enacted to bring rules in line with ICC/UCP and Geneva Convention practices.

It is still, however, possible to structure and conclude complex international cross-border trade financings via documentary credits and other instruments in Ukraine, with the involvement of the leading Ukrainian banks. Many of the largest banks in Ukraine have interbank credit lines and letter of credit confirmation/discounting lines from foreign banks, and are members of the SWIFT system (and/or have tested telex arrangements in place with foreign banks). Accordingly, leading Ukrainian banks are able to issue (in many cases confirmed) import letters of credit, act as advising bank for incoming export letters of credit, and issue guarantees and counter-guarantees (in many cases, confirmed).

Industry Analysis

During the last several years, Ukraine's banking industry has benefited from significant achievements such as the introduction of International Accounting Standards, new bank regulations based on compliance with core banking principles, information exchange and greater transparency. The importance of the banking system in the economy is steadily growing and the banking sector has reached a relatively mature phase, which is characterised by strong competition. However, as stated above, the number of banks is considered to be excessive given existing market volumes of business.

There are several internal factors that characterise bank activity in recent years: the need to increase capital, pressure to reduce operating costs, competition for blue chip customers and competition in the introduction of new products.

As in previous years, in 2003 Ukraine's commercial banks continued to increase capital, assets, credit portfolios, liabilities and other indicators.

<u>Highlights – Aggregate Figures for the Ukraine Banking Sector for 2003</u>

Statutory Capital			Up 35.3% to UAH 8,115.6 million	
Balance Sheet Capital			Up 30.7% to UAH 13,051.4 million	
Structure of Balance Sheet Capital				
	Statutory Capital		62.2%	
	Retained Profits		8.2%	
	Revaluation of Fixed Assets & Non-material Assets		9.8%	
	Current Year Result		7.4%	
	Reserve Fund		6.0%	
	Other Funds		6.4%	
Liabilities			Up 61.9% to UAH 87,305.2 million	
of which:	Non-Residents		UAH 10,302.0 million	
	of which:	Deposits	Individuals	36.8%
			Legal entities	35.9%

Highlights – Aggregate Figures for the Ukraine Banking Sector for 2003 (continued)

Assets			Up 55.8% to UAH 105,559.3 million
of which:	Net Assets (Total Assets – Reserves)		Up 57.1% to UAH 100,356.6 million
	of which:	Non-Performing Assets	Down from 3.7% to 3.3% of Assets
		Share of Bad Loans	Down from 4.5% to 3.4% of Assets

Total Assets – Composition (%)

Liquid Assets	15.2%
Loan Portfolios	69.6%
Investments in Securities	6.2%
Notes Payable	1.1%
Fixed and Intangible Assets	6.2%
Accrued Revenues	1.2%
Other Assets	0.5%

Loan Portfolios – Composition

Loans to Legal Entities	78.9%
International Loans	8.9%
Loans to Individuals	12.1%
Loans to Governmental bodies	0.1%

Revenues		Up 32% to UAH 23,445.1 million	
of which:	Interest	UAH 9,468 million	(68%)
	Commissions	UAH 3,462.3 million	(24.9%)
	Trading	UAH 739.5 million	(5.3%)
	Other	UAH 244.8 million	(1.8%)

Industry Weaknesses

It is important to note that Ukrainian banks are still relatively inexperienced in performing banking functions in a market economy, rather than simply allocating funds as directed by the government, which was their primary function under Soviet-era central planning.

Risks faced by all commercial banks in Ukraine include uncertain macroeconomic conditions, changing legal requirements, uncertain access to credit resources, the threat of inflation, and the absence of interest rate, exchange rate, and credit hedging instruments. Ukrainian banks compete fiercely for long-term, relatively inexpensive deposits, because a large portion of the economy is still cash-based. Ukrainians are estimated to hold as much as USD 12 billion in "mattress money" cash savings at home. Non-banking financial institutions in Ukraine are underdeveloped and do not provide any significant liquidity to the Ukrainian financial system.

Ukraine's banking industry is characterised by a low level of financial intermediation and a high net interest rate spread. Weaknesses in the judicial and law enforcement system continue to constrain the development of financial intermediation. The quality of the banking industry's total loan portfolio has tended to improve every year, mainly due to the closure of weak banks.

With the goal of increasing the efficiency of banks, and strengthening confidence in the banking system and to decrease risks from servicing particular clients, the NBU has established, together with the commercial banks, the Common Information System for registering Delinquent Borrowers, who have failed to repay credits granted by banks (the "CIS List"). The NBU regulates the functioning of the CIS List, and assures its accuracy and reliability. As of the date hereof, 122 banks have concluded agreements with the NBU to participate in this CIS List. Total assets of the banks participating in the CIS List amount to more than 80% of the assets of the Ukrainian banking system.

Banking Sector Prospects and Conclusions

By international standards, the Ukrainian banking sector is still in the early stages of development. Its future growth, sophistication and competitiveness is subject to the country's overall economic growth, the development of the stock market and non-bank financial institutions. Ukraine's pension reform, which started in early 2004, and the development of the mortgage market can create new opportunities for the banks.

Given the current high growth rate and other developments within the economy and the buoyant situation in the banking sector, a systemic crisis in the banking industry seems unlikely in the short term, taking into account the strong administrative and supervisory control exercised by the NBU. Government currency reserves are presently at record levels, inflation is falling broadly in line with expected targets, and the UAH exchange rate against the USD has been stable for the last three years. In general, the banking sector is very much healthier than it was even prior to Russia's financial crisis in 1998.

If Ukraine's expected GDP growth is maintained at the current pace of 4-5% per annum and the shadow economy sector diminishes (which can be expected to result from lower corporate tax rates), increasing demand for banking services will continue to fuel the growth of the banking sector.

The Presidential election in October 2004 is highly unlikely to precipitate an economic or financial crisis. Ukraine's banking system and the economy as a whole performed well in 2002-2003, the years of the most active political opposition in the modern history of Ukraine. In our view, only Government difficulties in the servicing of internal government debt could be expected to lead to liquidity problems for the major banks. Government support for the banks in general is not expected to be significant even during difficult economic periods, and increases in bank capital are expected to be achieved only through private investment and retained earnings.

As stated above, Ukraine is clearly over-banked, and consolidation of capital is inevitable. New and innovative banking products and improvements in quality of services are the factors driving competition, and cross-selling and e-banking will continue to gain popularity and acceptance. The long-term investment portfolios of the banking system are set to grow. When the NBU liberalises currency markets and permits forward and futures trading, the risk of losses for some banks may increase in the near terms, due to the low levels of expertise in dealing with these instruments.

Banks will benefit from corporate tax rate cuts as more money enters the banking system, but they will face higher costs due to the introduction of employee benefits, pension agreements, and likely higher required spending on IT automation. High demand for medium-term consumer lending, in particular for housing and car loans, will be difficult to meet due to the predominance of short-term deposits in the banking system. The larger banks will continue to access the Eurobond and international syndicated loan markets as both their own individual ratings, and Ukraine's sovereign ratings improve.

Ukraine's banking industry is presently reaping the benefits of reforms in many areas of the national economy. Strong growth and sectoral developments present great opportunities in investment and trade. Prudence, excellent relationships with banks, and local presence and expertise is however absolutely essential in order to take advantage of these newly emerging investment opportunities.

GML International Limited has maintained a Representative Office in Kyiv since 1993, making this the longest-established of GML's five overseas offices. Having built strong relationships over more than a decade with relevant state and professional bodies that manage the process of privatisation and foreign investment, GML is extremely well positioned to assist clients in identifying suitable investment opportunities. GML focuses on value-added transactions that offer superior returns while controlling risk, sourced primarily through our operations in the trade finance and à forfait markets, but also available to us on the basis of our excellent access to public and private institutions and information sources in Ukraine.