

Kornieieva Yuliia Volodymyrivna

ORCID ID 0000-0002-1823-7618

Dr. Sc. (Economics), Head of the Department of Macroeconomic Regulation
and International Economic Relations, Academy of Financial Management,
Ministry of finances of Ukraine, Ukraine

STATE BANKING SECTOR REDUCING: THE CASE OF PRIVATBANK

***Abstract.** The issue is devoted to the analyses of main positions of the Strategy for State Banking Sector Reforming approved by Ukrainian government in September 2020 concerning reducing market share of the state-owned banks. The accent is made on full withdrawal of the state from the capital of state-owned PrivatBank. The article contains analyzes of the main issues related to the sale of the largest state-owned bank in Ukraine.*

***Keywords:** state-owned bank, privatization, strategic investor.*

The main material presenting. According to the Strategy for State *Banking Sector Reforming* (hereinafter referred to as the Strategy) approved in September 2020, Ukrainian government plans to reduce the share of state-owned banks to 25% by 2025. The strategy stipulates that the withdrawal of the state from the capital of state-owned banks will take place by: sale of majority stakes to foreign and local strategic investors, international financial organizations; initial public offering (IPO) [1]. In case of PrivatBank the state aims full capital withdrawal.

First of all, arises two main questions concerning time horizon for *State Banking Sector Reducing*:

- 1) *when the PrivatBank privatization procedures can be completed?* and
- 2) *when it will be actually more profitable for Ukraine to sell PrivatBank?*

First, the Strategy clearly states that preparations for the state's withdrawal from bank capital in Ukraine will begin only after the end of the crisis caused by the COVID - 19 pandemic and the achievement of a stable economic recovery. Secondly, the privatization of the large object - a lengthy process that includes such steps as the search for a strategic investor, matching the major items of investment contracts. Access to international capital markets also requires prolonged and

painstaking preparatory procedures. Thirdly, the existence of more than 100 lawsuits related to Privat - are additional risks for potential investors. It is important to understand that a large strategic investor will agree to engage in these processes only in case of a significant discount on the object for sale. And finally, the government should be aware that putting up large profitable objects during the crisis can lead to lost profits.

According to the United Nations data presented in the report “World Economic Situation and Prospects 2021”, during 2020 the world economy declined for 4.3%, which is more than two and a half times deeper than during the global financial crisis of 2008-2009. At the same time, the expected recovery in 2021 won't compensate the losses of 2020 [2]. Regarding the domestic market, it should be noted that the National Bank of Ukraine (NBU) has downgraded the forecast of Ukraine's GDP growth in 2021 from 4.2% to 3.8%, noting a GDP reduction during the first quarter of 2021 [3]. Key risks for the national economy such as strengthening of quarantine restrictions, low vaccination rates and escalation of military conflict in the east are still relevant. Also, a rapid rise in unemployment to 35.8% and a decline in industrial production by 4.5%, which has a negative impact on the banking sector, which is highly sensitive to the state of business activity was observed in Ukraine during 2020 [4].

So, answering above mentioned questions, it is important to understand that in the short run it is technically impossible and simply not profitable for Ukraine to implement privatization plan concerning PrivatBank, as the sale of assets during a crisis will always be with a discount under unfavorable market situation. Therefore, under a favorable scenario, the nearest real time for privatization of PrivatBank is the end of 2023.

Then *Why was the PrivatBank privatization case was raised by Ukrainian officials?*

According to the Memorandum of Economic and Financial Policies between Ukraine and IMF (June 2, 2020), Ukrainian government has committed the reduction of the state share in the banking sector through the entry of foreign investors into the capital of state banks, namely:

– European Bank for Reconstruction and Development (EBRD) to the capital of Oschadbank JSC;

– International Finance Corporation (IFC) of the World Bank Group - to JSB Ukgasbank [5].

An agreement between IFC and Ukgasbank has already been reached during winter 2021, according to which the International Finance Corporation provides a 5-year loan of 30 million EUR to the state-owned Ukgasbank with the possibility of converting it into a 20% share in the capital of the state financial institution. Also, the Tax Committee of the Verkhovna Rada of Ukraine recently supported the accession of Oschadbank to the Deposit Guarantee Fund, which is a prerequisite for privatization. Therefore, Oschadbank is currently actively preparing for a 100 million EUR loan agreement with the EBRD with the possibility of converting debt into shares of the bank.

Negotiations with the IMF are ongoing, and there is a high probability that the Fund will support the trend of reducing state capital in the banking sector of Ukraine, which increased sharply after the nationalization of PrivatBank in December 2016. Therefore, the statement of the NBU Chairman Kyryl Shevchenko in this case is in fact an announcement of intentions to privatize PrivatBank in the framework of further cooperation with the IMF [6].

What can hinder the implementation of the government's ambitious privatization plans?

Preliminary plans for reformatting the state banking sector in Ukraine, formalized in the official document concerning strategic principles of state banking sector reform accepted in 2018, have not been implemented in full. The government has already planned full privatization of PrivatBank by 2022 by selling it to international strategic investors or through an initial public offering [7]. However, realization of this goal was prevented by a number of factors, such as:

- the completion of the reform of corporate governance of state banking sector;
- pending lawsuits with ex-owners;
- high share of problem loans in state-owned banks;
- economic crisis caused by the COVID-19 pandemic.

Despite significant progress in some areas, such as the completion of corporate governance reform in state banking sector, significant challenges still remain actual today. Regardless active work on the reduction of non-performing loans, as of the end of 2020, the share of non-performing loans in PrivatBank's portfolio was 74% [8]. Also, the problems related to lawsuits against PrivatBank remain unresolved.

Will the government find a strategic investor for PrivatBank?

According to the data of the European Banking Federation, an average return on equity (ROE) of banks among the EU 28 was 5,4% in 2019 [9]. During the crisis of 2020, return on capital in the banking sector of Ukraine fluctuated within 20%. It is important to note that with the average level of profitability of banks at the level of 30% in 2019, the ROE of PrivatBank was 76% [10].

According to the NBU's data, 61,3% of the entire Ukrainian banking sector profit in 2020 was formed by PrivatBank. In addition, the country's most profitable bank is a systemic player:

- PrivatBank accounts for 21,2% of net assets of the banking sector of Ukraine;
- PrivatBank accumulates 33,1% of deposits of individuals;
- PrivatBank serves 56% of active payment cards (22,6 million units);
- PrivatBank has an extensive banking infrastructure, covering 57% of ATMs and 58% of POS terminals [8].

Thus, despite certain aggravating factors (high share of non-performing loans, lawsuits), PrivatBank is undoubtedly the most attractive object for investors among state-owned banks. Besides Ukrainian banking market has considerable potential for growth. Still, taking into account the high cost of the facility (at least 4 billion USD), it will be very difficult to find strategic investor among residents of Ukraine. Thus, the emphasis will be shifted towards foreign capital. As the potential of the Ukrainian stock market is limited, international platforms will be used to privatize such a large facility as PrivatBank through IPO.

The listing of state-owned banks is a worldwide practice that was actively used during the 1980s and 1990s by such countries as Poland, Portugal, Australia, Croatia, the Czech Republic, Denmark, Germany, Italy, Norway, Spain, Sweden, and so on. Through the IPO were privatized the Hungarian OTP Bank (1997), the

Latvian Unibank (1995), and the Dutch ING Bank. IPO was actively used for privatization of state-owned banks in France, where 9 banks were sold through IPOs in the late 1980s and early 1990s, such as the BNP in 1993 (now known as BNP Paribas) and the Société Générale in 1987 [11].

What are the risks of PrivatBank`s privatization by foreigners?

According to the NBU data, as for May 2021 in Ukraine operates 73 solvent banks, 33 of which have a certain share of foreign capital, and 23 banks are 100% owned by a foreign investor [10]. In 2016, there were only 17 of them, so there is a tendency to increase. Analyzing the distribution of net assets as of the end of 2020 – 30,2% of assets fall on foreign banks [8].

According to the Guidelines for calculating the level of economic security of Ukraine, adopted by government in 2013, the share of foreign capital in the authorized capital of banks should not exceed a 60% critical limit. At the same time, a 30% limit is considered to be satisfactory for providing financial security [12].

In case of PrivatBank`s privatization by foreign investors, 51,3% of the Ukrainian banking sector will be under the control of foreign capital, which poses certain threats to the country's financial security:

- increasing dependence on foreign markets;
- potential conflict of interest between a foreign investor and the needs of Ukraine;
- growing dependence of the banking system of Ukraine on foreign countries.

At the same time, the admission of foreign capital to the banking sector is a common practice among European countries. Foreign investors own 86% of the Czech banking sector, 98,9% in Slovakia, 90% in Croatia, 74% in Romania, 78% in Bulgaria and 54% in Poland [13].

So, why the most profitable bank in the country should be privatized?

The concentration of state capital in the banking system of Ukraine is quite high – 52,5% (at the end of 2020), whereby 21,2% of the net assets (387 billion USD) accounted for PrivatBank [8]. In turn, the share of state capital in the banking sector of developed market economies usually varies between 6-8%. Among the countries of Central and Eastern Europe this indicator is as follows: in the Czech

Republic – 0,9%, Hungary – 10,5%, Croatia - 6%, Slovakia – 0,6%, Bulgaria – 4,8%, Poland - 33% [13].

Despite certain risks, the entry of a strategic foreign investor into the banking sector has significant advantages, such as:

- expanding sources of capital;
- growth of foreign investment flows to the real sector of the economy;
- expected growth of credit programs for business on better terms than the market offers today;
- strengthening the competitiveness of the banking system;
- restriction of the state banking sector`s monopoly;
- strengthening the stability of the banking system, as the share of non-performing loans in the portfolios of the 5 largest foreign banks operating in Ukraine is only 12,9%. At the same time, the average level of above-mentioned indicator for state-owned banks is 43,7%;
- increasing transparency and accountability of banks;
- highest corporate governance standards implementation;
- limited opportunities to monetize the state budget deficit and, as a result, reduce inflationary pressures. As the main buyers of IGLBs that the government issues to finance the state budget deficit are state-owned banks. The share of IGLBs in PrivatBank's assets is over 40% [8].

At the same time, it is important to note that ordinary clients of bank will not experience drastic changes, as the NBU can't leave the supervision function so it will continue to control the activities of the financial institution.

Conclusions. Reduction of state capital in the banking sector of Ukraine is a strategically correct decision, which corresponds to the implementation of the concept of sustainable economic growth in the medium and long term. However, the practical implementation of tactical decisions - the privatization of PrivatBank - is clearly not on time. The sale of the most profitable bank in Ukraine, which last year generated more than 60% of the profits of the entire banking sector, during the crisis will mean a generous gift to potential investors. In addition, the negative

train of lawsuits will allow investors to get an even bigger discount. Therefore, it is advisable to wait for the recovery of the world economy and look for reliable strategic partners.

References:

1. Засади стратегічного реформування державного банківського сектору (стратегічні принципи) / Кабінет міністрів України. 9 вересня 2020. Київ, 2020. 21 с. URL: <https://mof.gov.ua/storage/files/SOB%20Strategy.pdf>
2. World Economic Situation and Prospects 2021 / United Nations, New York, 2021. 198 p. URL: <https://www.un.org/development/desa/dpad/publication/world-economic-situation-and-prospects-2021/>
3. Інфляційний звіт: квітень 2021 / НБУ, 2021. 50 с. URL: https://bank.gov.ua/admin_uploads/article/IR_2021-Q2.pdf?v=4
4. State Statistical Service of Ukraine. URL: <http://www.ukrstat.gov.ua/>
5. Ukraine: Request for Stand-by Arrangement-Press Release; Staff Report; and Statement by the Executive Director for Ukraine / IMF, 2020. URL: <https://www.imf.org/en/Publications/CR/Issues/2020/06/10/Ukraine-Request-for-Stand-by-Arrangement-Press-Release-Staff-Report-and-Statement-by-the-49501>
6. Ukraine central bank chief Shevchenko on independence, IMF cash and PrivatBank / Global Capital, 15 Apr 2021. URL: <https://www.globalcapital.com/article/b1rdx1pt404vbt/ukraine-central-bank-chief-shevchenko-on-independence-imf-cash-and-privatbank>
7. Засади стратегічного реформування державного банківського сектору (стратегічні принципи) / Кабінет міністрів України. лютий 2018. Київ, 2018. 8 с. URL: <https://www.oschadbank.ua/sites/default/files/files/documents-2019/zasady-strategi4nogo-reformuvannya.pdf>
8. Огляд банківського сектору / НБУ, лютий 2021. 12 с. URL: https://bank.gov.ua/admin_uploads/article/Banking_Sector_Review_2021-02.pdf?v=4
9. Banking sector performance / European Banking Federation. URL: <https://www.ebf.eu/facts-and-figures/banking-sector-performance/>
10. National Bank of Ukraine Data. URL: <https://bank.gov.ua/ua/statistic/supervision-statist/data-supervision#1>
11. Andrews M. State-Owned Banks, Stability, Privatization, and Growth: Practical Policy Decisions in a World Without Empirical Proof. *IMF Working Paper*. WP/05/10. 2005. URL: <https://www.imf.org/external/pubs/ft/wp/2005/wp0510.pdf>

12. Методичні рекомендації щодо розрахунку рівня економічної безпеки України / Наказ Міністерства економічного розвитку і торгівлі України, 29.10.2013. № 1277. URL: <https://zakon.rada.gov.ua/rada/show/v1277731-13#Text>
13. CEE banking sector report 2020. *Raiffeisen Research*. November 2020. URL: <https://www.raiffeisenresearch.com/servlet/NoAuthLibraryServlet?action=viewDocument&encrypt=b0bc1dfb-a056-4e1e-95ea-11c305f117e5&mime=HTML&id=replaceme@bluematrix.com>