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STATE REGULATION OF BAD LOANS OF UKRAINIAN BANKS IN THE MODERN CONDITIONS

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Abstract. *The article deals with the current state and causes of banking bad loans in Ukraine and in the world. The role of the state in the process of regulation of banking bad loans in Ukraine, Europe and post-Soviet countries is investigated. The author examines the Ukrainian experience of normative regulation of bad loans and the level of its harmonization with the European standards. In view of the foreign experience, recommendations to accelerate the process of reducing the level of banking bad loans under current Ukrainian realities are given.*

Keywords: *NPL, government regulation, bad debt, regulatory documents, problem assets sale, asset management company, restructuring sites.*

Аннотация. *В статье проанализировано современное состояние и причины возникновения проблемной задолженности банков в Украине и мире. Исследована роль государства в процессе регулирования банковской проблемной задолженности в Украине, Европе и стран постсоветского пространства. Автором рассмотрен украинский опыт нормативного регулирования проблемной задолженности и уровень его гармонизации с европейскими стандартами. Учитывая зарубежный опыт, даны рекомендации по ускорению процесса снижения уровня проблемной задолженности банков в современных украинских реалиях.*

Ключевые слова: *NPL, государственное регулирование, проблемная задолженность, нормативные документы, продажа проблемных активов, компании по управлению активами, площадки реструктуризации.*

Introduction. The high level of bad loans has a direct impact not only on the development of corporate lending, but also on the economy of the country. Banking bad loans increasing is a direct consequence of the global financial crisis. At the end of 2018, its volume in Central, Eastern and South-Eastern Europe reached EUR 56 billion [2]. Bad loans continue to limit profitability and capitalization of banks, that has a negative impact on credit ratings, especially for small and medium-sized banks. This problem is also characterized for Ukrainian banking sector. We're forced to state that Ukraine remains the absolute world leader in the level of bad loans of banks. Thus, the issue of optimization of state regulation and the research of effective measures to manage bad loans of banks is currently of great interest.

Literature Review and Problem Statement. The issue of banking bad loans regulation is considered by the following Ukrainian and foreign researchers: S. Allen, O. Baranovsky, T. Bolgar, P. Chub, O. Dzublyuk, A. Epifanov, E. Erhardt, J. Fell, M. Grodzik, O. Lavrushin, R. Merton, V. Mishchenko, S. Pavlyuk, E. Pozdnyakov, L. Primostka, J. Shinky, O. Vovchak, S. Yaremenko, I. Zozulya. Highly appreciating the scientific achievements of scientists in this field, it should be noted that the issue of optimization and harmonization of national state regulation of banking bad loans in accordance with world standards, is still lacking.

The purpose of the research is to analyze the current state of the bad loans level of Ukrainian banks and to provide the recommendations on optimization of state regulation for its reduction in the current realities of functioning of the Ukrainian banking sector, using the experience of European countries and the post-Soviet space.

Results of the Research. The crisis in the mortgage market, the poor quality of loan portfolios, and, at the same time, the failure of the bad loans management mechanism have led to increasing of banks' bad loans. In Ukraine, the level of bad loans began to increase rapidly from mid-2014. The reasons of that were: the economic and political crises in the country, the devaluation of the national currency, the increase in the share of insolvent debtors, and the occupation of part of the territory of Ukraine. According to the report of the National Bank of Ukraine, 17% of bad loans of the banks were related to the loss of territories, markets, or to domestic demand falling. In particular, state-owned banks have more than UAH 30 billion loans, issued in uncontrolled territory [1].

In 2017, there was a sharp nominal increase in the volume of bad loans due to the transition to international standards of non-performing loans (NPL) determination. The banks recognized the real quality of the delayed loans, which can be indicated by the increase in overdue loans, which subsequently became non-performing. In January 2019, the NPLs in the credit portfolio of Ukrainian banks amounted to 52.85%. Of these, the share of overdue loans in the portfolio of state-owned banks reached 67.92%, including Privatbank - 83.35% [1]. Thus, it can be stated that two thirds of bad loans are concentrated in portfolios of state-owned banks. Corporate loans are one of the main components of such banks' credit portfolio, accounting for up to 70%. Major debtors are large holding companies [1]. It should be mentioned, that such loans cannot be sold, because there is no effective and transparent mechanism for their realization. Obviously, the quality of loans is deteriorating, while increasing the overall NPL level.

The banking sector of other countries is also characterized by significant level of bad loans, however, it is measured on a scale other than in Ukraine (Fig. 1).

NPLs in Ukraine are several times higher than in other post-Soviet countries. According to S&P report, by the end of 2018, NPLs in Russia and Belarus reached about 15% of credit portfolio of the banking sector, and in Kazakhstan, NPLs still be extremely high, exceeding 25% of the credit portfolio [4]. Georgia's banks are showing better asset quality than banks in other countries in the region. This is due to more efficient banking supervision procedures, despite the high dollarization of the country's credit portfolio. Herewith, NPLs in Georgia is at the level of 5.8%, which is 9.1 times less than the appropriate indicator in Ukraine.

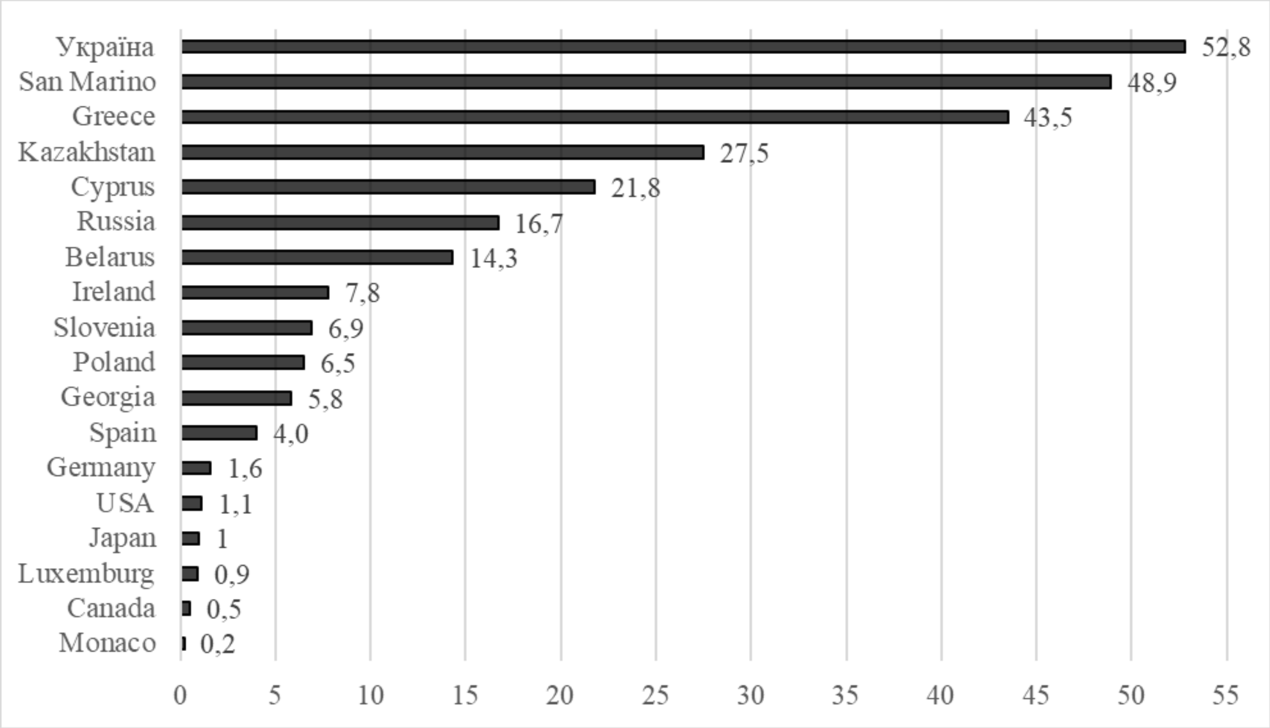

Figure 1. Non-performing loans in credit portfolios of banks of Ukraine and other countries*, %

** Ukraine, Belarus, Georgia, Kazakhstan, Russia - as of 01.01.2019; Greece, Ireland, Spain, Cyprus, Luxembourg, Germany, Slovenia, Poland - as of 01.10.2018; Canada, Monaco, San Marino, USA, Japan as of 01.01.2018.*

Source: compiled by the author on the basis of [2], [3], [4]

Average NPLs in the European Union was 3.3% in October 2018 [3]. However, while NPLs in the EU is much lower than in the post-Soviet countries, it is still high compared to other large developed countries. Thus, at the beginning of 2018, the World Bank reported NPLs close to 0% in Monaco and Canada, up to 1% in Luxembourg, the USA and Japan [2].

Therefore, Ukrainian banks are leading the world in terms of non-performing loans. The defining NPLs growth was driven by the imbalances in the banking system, accumulated over the years, primarily due to low credit standards, neglect of debt concentration limits, related party lending and high foreign currency lending.

The level of bad loans of banks can be influenced by the state, directly by the bank- creditor, as well as by various associations of credit institutions (Fig. 2). These entities can take direct or indirect (through their representatives) participation in the development of regulatory documents aimed at regulating bad loans of banks.

Traditionally, the state has played a key role in overcoming the effects of banking crises, especially in the context of regulating banking bad loans. This is due to the following measures:

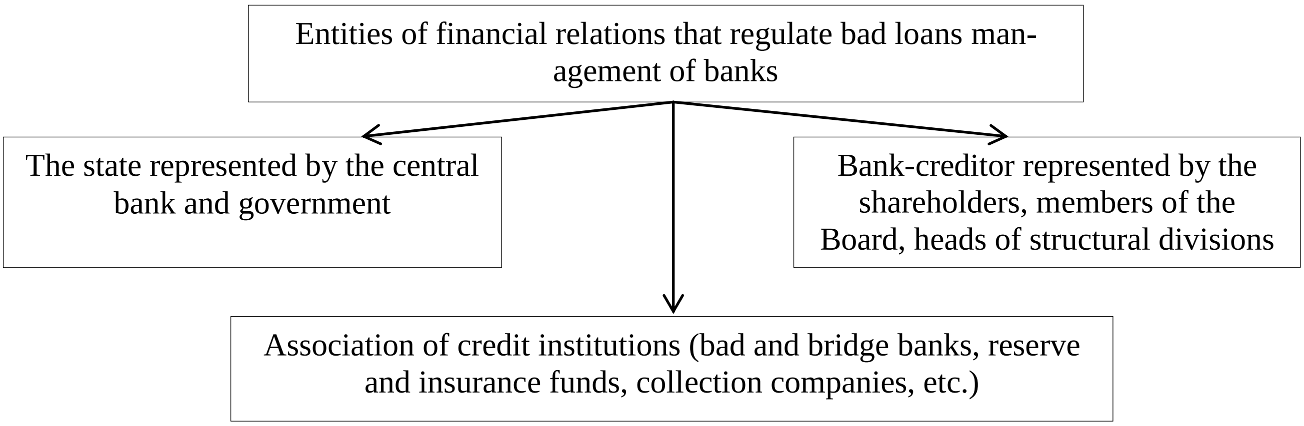

Figure 2. Entities of financial relations that regulate the level of banking bad loans
Source: generalized and supplemented by the authors on the basis of [5, c.24-26]

1. Reforms in the area of problem loans restructuring (improving restructuring and bankruptcy procedures, introducing tax incentives, promoting debt exchange instruments, optimizing credit bureaus, mediating dialogue and coordinating parties to facilitate private initiatives to create platforms for restructuring, such as private initiatives. In the world, nowadays, the common way to reduce credit risks is selling bad loans to investment funds. However, in Ukraine, such market is in stage of formation. Nowadays, the largest provider of bad loans and its collateral is the Deposit Guarantee Fund, which sells assets of insolvent banks through the ProZorro platform. In 2018, NPLs were sold for the amount of UAH 4.611 billion, herewith the five largest NPL buyers are Ukrainian companies (Integrity, JSC Glory, Geneva, LLC Market-Service, Avistar) [6]. Attraction of foreign investors is complicated by the imperfection of legislative regulation in Ukraine. Thus, selling bad credit portfolios, there are difficulties with re-issuing collateral and taxation. Sometimes, due to the lengthy loans sale process, the limitation period is missed, that eliminates the possibility of foreclosure. One of the conditions of entry to the foreign investor market is a quality assurance of the agreement, which includes legal and financial analysis of the situation, identifying risks and specific recommendations for the asset acquisition, based on local realities.

2. Direct investments by market approaches in accordance with the rules on state support and the Directive on financial rehabilitation and banks sanation [7]. One way to invest is to create or invest in corporate restructuring funds with private investors who have the authority to restructure bad loans. State asset management companies are intended for the acquisition of problem loans from banks and the "clearing" of bank balances. Positive examples of such companies are: NAMA, established in Ireland in 2010, SAREB, established in Spain in 2012, and BAMC, established in Slovenia in 2013 [3]. They have played a key role in reducing the pressure on banks' balance sheets, increasing market liquidity and enhancing pricing transparency, thereby stimulating demand for bad assets by investors and developing third-party servicing companies. As a result, over the

last 5 years NPLs in Ireland has decreased by 17.1%; in Spain – by 8.6%; in Slovenia - by 8.2% [2].

State asset management companies can be an effective NPL management tool, but it should be noted, that the effect will be temporary in the absence of other reforms. The examples of such activity can be the experience of Kazakhstan and Russia. Thus, during the last three years, the regulator in Kazakhstan has tried to carry out a system-wide analysis of asset quality with the subsequent transfer of bad assets into a specially created Bad Loan Fund [4]. However, it is clear that these actions have failed, as the NPL level still be extremely high (around 25%), despite large-scale purchases of government-owned assets. The author argues that, such situation reflects the lack of significant progress in corporate management and sufficient regulatory power to promote transparency and market discipline.

In Ukraine, there have been attempts of such institution functioning, too. It was Rodovid Bank, which has not become a bad bank in seven years and is currently being liquidated by the Deposit Guarantee Fund. In general, the idea of the bad bank in Ukraine has both supporters and critics. The main advantages and disadvantages of such institution in the Ukrainian banking market are presented in Table 1.

Table 1. Advantages and disadvantages of bad bank in Ukraine

Advantages	Disadvantages
Reducing the burden on the banking system of bad assets of banks, which will enable managers of banks to focus on solving current problems of the bank and its strategic development.	The possibility of corruption schemes associated with the use of non-market mechanisms for selecting banks to asset acquisition.
The ability to reduce credit risk and release funds to increase crediting and stabilize the situation in the real sector of the economy.	Public funds use to correct the mistakes of private equity owners and managers of banking institutions.
The possibility of the bank that is on the verge of bankruptcy to receive funds from the bad assets sale and partially offset the losses.	Imperfection of the regulatory framework, significant burden on the state budget.

Source: generalized and supplemented by the authors on the basis of [8, c. 25-27; 9, c. 140*]*

In our opinion, the effective functioning of the bad bank in Ukraine is possible, but this requires a number of legal measures.

Analyzing the European experience in debt management, we can conclude that since the beginning of the crisis, most European governments have changed their approaches to dealing with bad loans, as well as restructuring and bankruptcy procedures, debt collection rules and tax incentives. The low NPLs of European Union banks is mostly the result of the implementation of the Action Plan by European Central Bank (ECB), which has taken the following measures in recent years:

- Guidance to banks on non-performing loans was issued to implement a single supervisory mechanism, to provide banks with the optimal tools for NPLs reduction, to identify specific supervisory powers for NPLs regulation, and so on [10];

- the recommendations for improving the effectiveness of monitoring the current state of loans have been provided. For example, the introduction of an early identification mechanism for potentially bad loans and actions that will prevent them from becoming NPLs, have been given;
- new initiatives have been introduced to support demand for bad loans in the market;
- the requirements for reporting and disclosure within the context of supervision [11].

One of the ECB's initiatives is to strengthen the requirements for its own credit risk assessment models as one of the main determinants of banking capital adequacy [11]. The author argues that, the introduction of similar requirements for Ukraine is premature, as banking capital adequacy is currently governed by a regulatory approach. However, according to the activation in bad debt regulation in the Ukrainian banking sector, the practice of internal valuation models can be expected, but not in the near future.

In recent years, the NBU concentrates on the regulatory framework in accordance with the current international requirements (Fig. 3). The period of 2016-2019 can be noted as an active phase of reforming the regulatory framework for managing NPL in Ukraine.

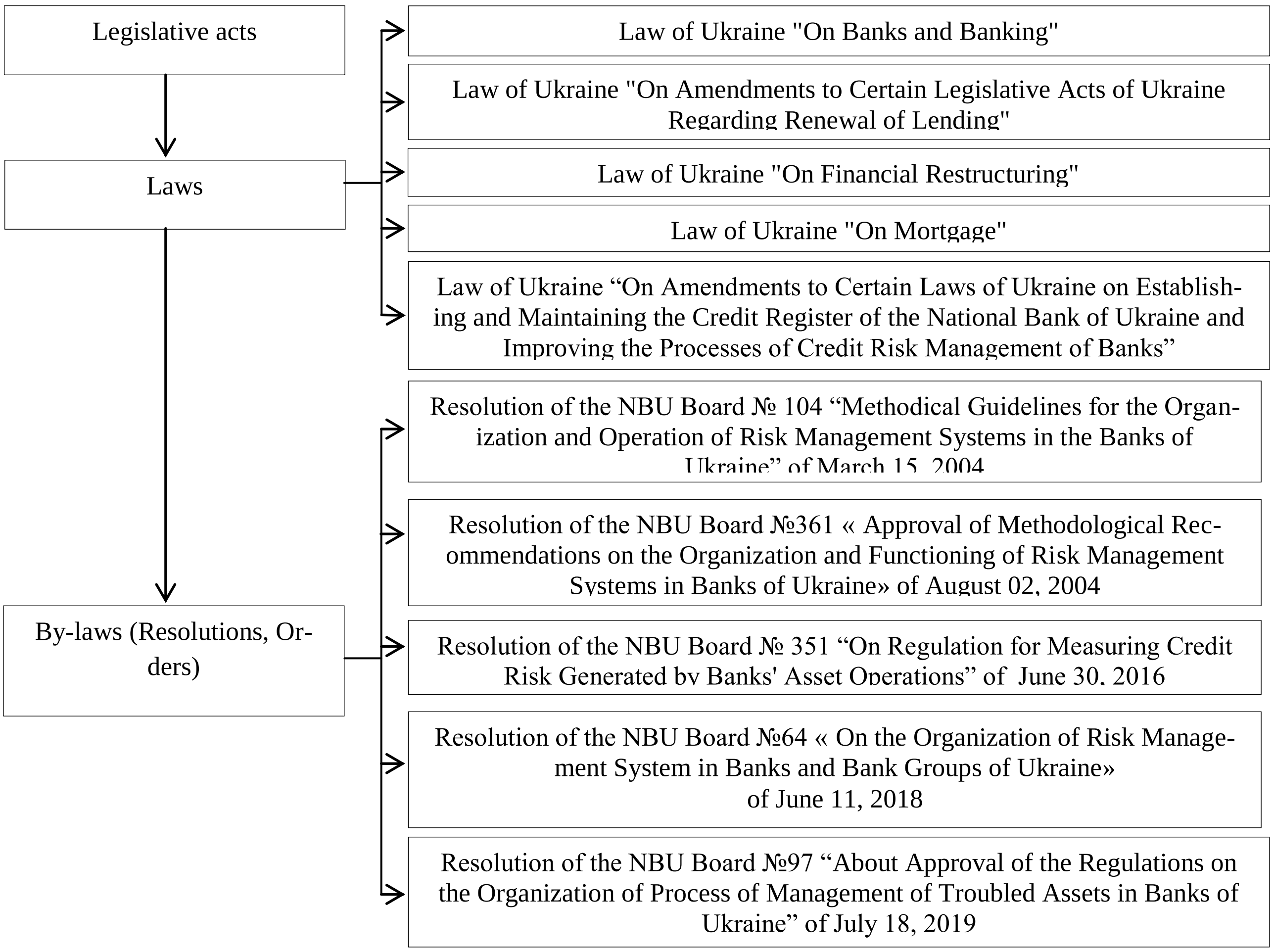

Fig. 3. Regulatory framework for managing NPL in Ukrainian banks
Source: Developed by the authors on the basis of [12]

The defining step towards the harmonization of national regulatory framework with European standards was the adoption by the NBU Board on June 30, 2016 of Resolution № 351 "On *Regulation* for Measuring *Credit Risk* Generated by *Banks*' Asset Operations". The adopted Resolution considers the recommendations of the Basel Committee on credit risk assessment and determination of expected losses from its implementation. It also deals with the procedures and criteria for the valuation of property used as collateral for loans [13].

In June 2018, the NBU established the requirements for the organization of a risk management system in banks, approving the Resolution of the NBU Board №64 "On the Organization of Risk Management System in Banks and Bank Groups of Ukraine". However, the experts argue that the NBU Resolution №64 is a major step forward in the development of the banking, but it does not provide a methodology for transforming risk assessment results into capital requirements. As, in 2014 - 2015, most banks lost a huge amount of capital due to deprivation of assets in temporarily occupied territories [14].

Another step towards harmonization of requirements for regulation of bad loans in banks with the recommendations of the Basel Committee was the establishment at the end of July 2019 requirements for banks to handle bad assets. These requirements are defined in the Resolution of the NBU Board № 97 "About Approval of the Regulations on the Organization of Process of Management of Troubled Assets in Banks of Ukraine". The Resolution outlines:

- the list of bad assets (potentially bad; non-working assets; recovered property that has become the property of the bank on the basis of realization of the rights of the mortgagor);
- the components of the bad asset management process (early response system; implementation of non-performing assets management instruments; asset management);
- the requirements for organizational aspects of bad assets management (availability of a three-year strategy and operational plan for reducing the level and volume of such assets; creation of a separate subdivision for dealing with non-performing assets; monitoring of process efficiency) [15].

The implementation of these requirements is aimed at organization the comprehensive process for bad assets managing, the control of which should be provided by the Board of the Bank. Furthermore, the implementation of an early response system should ensure early detection of potentially NPL and their management. The document also identifies the need for banks to develop a bad-based asset management strategy that, in addition, will provide realistic targets for reducing the level and volume of both non-performing assets and recoverable assets on the bank's balance sheet, as well as ways to achieve them [15].

As these mechanisms are already implemented in Europe, Ukrainian banks need just to adapt these practices.

Conclusions. The high level of bad loans of banks remains a major challenge for the banking sector of Ukraine, in particular in state-owned banks, and was caused by the financial and economic crisis of 2014-2016. Ukraine is the world leader in NPLs in the structure of banks' credit portfolio - it reaches 50%. World experience shows that the issue of reducing the share of bad loans in the banking sector depends primarily on the level of government regulation. In recent years, the NBU has made some steps in optimizing the regulation of bad loans according to the world standards. Mainly, by amending some legislation acts of Ukraine, developing regulations on the organization of risk management system, as well as the process of managing NPL in Ukrainian banks. These documents help to strengthen the control of bad loans by introducing international standards for its assessment. However, the NPLs decrease is extremely slow. As a result, considering the foreign experience, first of all it is necessary to improve the implementation of state mediation in the market of NPLs sale on the created platform for restructuring and attracting foreign investors; optimization the work of the credit register and the asset management company. The introduction of new mechanisms to reduce NPLs of banks will help to improve the banking system and to establish its effective functioning as a whole.

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