CENTRE
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STRATEGY

WHAT SHOULD THE STATE DO WITH ITS BANKS?

Executive summary

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1 Executive summary

The nationalization of PrivatBank has already cost taxpayers UAH 139.3 billion, and each year UAH 10 billion of interest payments on domestic government loan bonds (DGLB) is added to this amount. However even this number is not final – there are several on-going trials, initiated by bondholders, former owners and owners of the deposit accounts, who have been recognized as related parties. It may cost the state dozens of billions more.

In 2016, the state has already developed the "The Principles of State Banking Sector Strategic Reforms" and was preparing strategies for the transformation and development of specific banks. But in December 2017, the nationalization of PrivatBank broke the plans, and the government had to start the process anew.

As a result of the nationalization, the state gained dominance in several segments of banking services: 56% of the assets and 75% of the card products are now with the state-owned banks. Dominant position of one owner can have a negative impact on the competition in the market.

How do State-Owned Banks Affect the Economy?

International experience shows that it makes sense for the state to become the owner of the banks, when market mechanisms do not work, i.e.in a " market failure". In such situation, the state bank creates a "unique social value" - a product or service that private banks cannot offer. There are two types of such values:

- Development banks exist in different countries and invest in the infrastructure. This area is of little interest to private banks due to high risks and a long payback period.
- Financial inclusiveness – the state banks provide banking services in remote / under- populated areas that the private banks do not reach.

There are two theoretical approaches - development one and political one – on what the state receives as a result of the bank ownership. Within the "political approach" instead of overcoming market failures, the state-owned banks may be inclined to finance political projects, credit state-owned enterprises, politically connected individuals and their companies. As a result, this can lead to the accumulation of bad debts and rise of populism of politicians at the expense of taxpayers.

What banks create a unique social value in Ukraine?

In the international practice, the following types of state-owned banks can be distinguished:

1. Universal banks - provide a wide range of services in different segments.
2. Victims of nationalization - , have been nationalized to avoid the domino effect, usually with a high level of distressed assets, most of them are also universal.
3. Development banks - finance the sectors that are critically important for the state.
4. Postal banks - provide financial inclusiveness by offering financial services in the geographical areas, which the private banks are not ready to reach.

Only the last two segments create a unique social value, while the first two operate in the same sectors, where private banks are present or may be present. All Ukrainian state-owned banks are universal. To date, the state owns four operating banks: Oschadbank, Ukreximbank, Ukrgasbank and PrivatBank. Although they do create a specific social value, but it is not unique and private banks play their role successfully in this field.

In Ukrainian context, the "Ukrposhta", may bring certain unique social value as the postal bank. It can provide the financial inclusiveness, thanks to its 100% coverage of the national territory.

What are the risks of the state-owned banks for the economy?

1. The state is not always an efficient owner, the decision making in the state-owned banks is often bureaucratized, affecting the flexibility and quality of the services.

2. The state can finance the budget deficit through the state-owned banks. It has a negative impact on macroeconomic stability and increases inflation risks.
3. The state finances its enterprises through the state-owned banks. Such direct support can be unjustified and would negatively affect competition in various sectors. Essentially, the state-owned enterprises are related parties for the state, and lending standards for them may be softer and much lower compared to the situation, when the same enterprises would be financed by the private banks.
4. The state can finance the business of particular politicians through the state-owned banks. The state banks become "captured" – the politicians get influence on the management, so that the banks provide loans to their business, or to the business of people close to them, on more favourable terms.

When the risks described above are realized, in addition to worsening of the competitive environment and corruption, it could be necessary to recapitalize the banks at the expense of taxpayers and get refinancing from the NBU.

Since the social value created by the state banks, is not unique, and the risks have already proved their materiality during the last crisis, the privatization is the right way to get rid of such risks in the long term. In any case it is necessary to make sure that the bank have undergone an effective corporate management reform and an efficient and strong independent Supervisory Board has been created. A specific sales strategy might be required for each individual bank.

Summary

The share of state-owned banks is 56% in terms of the assets. This situation is somewhat dangerous, because of the risks of inefficient corporate management by the state as the owner, as well as the corruption component. At present, Ukraine has no strategy for the development of state-owned banks. In addition, there is no specific function that only the state banks can perform.

The existing banking system in Ukraine requires a transformation, In particular, the state banks need to be privatized in the medium-term perspective. It is necessary to focus on selling Ukreximbank, Ukrgasbank and Oschadbank right now, and PrivatBank - in the longer term period, after resolving the issue of bad debts and lawsuits from the owners of bonds and former owners. The financial inclusiveness can be provided by Ukrposhta, and the international financial organizations could play the role of the development banks for Ukraine.

Centre for Economic Strategy was founded in May 2015 by Tomas Fiala, CEO of Dragon Capital, Ukraine's leading investment bank, Ivan Miklos, former deputy prime minister and minister of finance of the Slovak Republic, and Svyatoslav Vakarchuk, civic activist, musician. Centre for Economic Strategy contributes to the development of economic growth strategy for Ukraine, conducts independent analysis of the most important policy issues, and builds public support for reforms based on the following principles:

- Economic freedom (liberalization, deregulation, privatization)
- Free and fair competition
- Small but effective state
- Transparency and freedom of information
- Law enforcement and property rights protection
- Sound and sustainable public finance
- Knowledge-based economy

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