THE ASSESSMENT OF NON-PERFORMING LOANS IN UKRAINIAN BANKS CREDIT PORTFOLIO

Inna Taranukha
Taras Shevchenko National University of Kiev

Abstract

The influence of foreign capital inflows on expanding of lending processes in Ukraine is analyzed in the article. Volume of non-performing loans and loan loss provisions, formed in the Ukrainian banking system during the period 2005-2011, are estimated.

Key words: non-performing loans, banks with foreign capital, loan loss provision

Introduction

The loan portfolio analysis is a very important part in the bank’s credit management, which involves the systematic study and supervision of banks’ credit activity. It allows to assess the quality and composition of bank loans in the dynamics, in comparison with the performance in the whole banking system. This analytical work is a highly efficient method that enables banks to efficiently use the data on the status of the loan portfolio for decision-making by various departments of the bank.

To maximize the profitability of credit portfolio banks should carry out continuous monitoring through permanent tracking of signals that indicate possible complications concerning repayment of the principal or interest by the borrowers within the agreed maturity. But regardless of level of the credit monitoring and efficiency of methods of the loan portfolio management all banks somehow face the problem of loan defaults.

The most important indicator which characterizes the doubtfulness of the loan portfolio is the share of overdue loans in the whole bank’s credit portfolio. Overdue debts most clearly indicate the existence of problems in the loan portfolio of the banking institution, because it is a direct reflection of the borrower’s problems and his inability to repay the debt to the bank.

Analysis of recent researches and publications indicates that in the scientific literature sufficient attention is given to the analysis of trends in bank lending and to the evaluation of doubtfulness of the loan portfolios, particularly among researchers working on this topic are V. Mishchenko (2009); A. Moroz, M. Savluk, M. Puhovkina (2008); I. Nidzelska (2009); M. Timoshenko (2010); L. Laeven, F. Valencia (2008); R. Matousek, B. Sergi (2005); C. Schalast (2011); R. Shrieves, D. Dahl (1992); M. Sorge (2004); G. Von Peter (2004) and others.


The purpose of the article is to explore the trends of the bank lending development, to assess the changes of problem loans and the volume of the reserves created for lending operations and their as of today state.

The object of the investigation is the structure of credit portfolios of Ukrainian banks and the approaches to loan loss provisions forming.

The objectives of the investigation are:
- to investigate the structure of Ukrainian banks' credit portfolio and reveal the share of non-performing loans;
- to estimate the share of foreign capital in Ukrainian banking system and to identify its influence on the banking system development;
- to expose the share of corporate and retail loans in total bank loans;
- to investigate the dynamics of loan loss provision in the Ukrainian banking system;
- to compare bank’s non-performing loans to total gross loans (%) in certain European countries.
There were used different methods of the investigation in the work: a system approach; analytic approach; comparative analysis.

**Results**

The foreign banking expansion was commonplace during the economic growth, which we saw in the last years before the crisis in 2008 and during recovery. Since 2001 the number of banks with foreign capital increased from 22 to 53, including a 100% foreign capital - up to 22 banks.

Foreign capital takes increasingly important place in the Ukrainian banking system. Expansion of the foreign banks had a number of positive effects on the development of the banking system of Ukraine:

- the growth of credit exposure to the economy by lowering the credit cost;
- enhancement of effective competition on the banking services market and expanding the range of high quality banking products;
- improving the diversification of risks through the use of advanced technologies for their insurance;
- more active transition to international standards of supervision and regulation of the banking practices;
- upgrade qualifications of bank employees;
- reduction of the cost of financial resources;
- deployment of advanced banking technologies.

The trends in the number of banks with foreign investments and the share of such investments in the Ukrainian banking system are reflected in Fig. 1.

About 12 % (22 banks) of the total number of banks which have the National Bank of Ukraine license for performing of banking operations are in the total ownership (100 % of the share capital) of foreign investors. As it is seen from Fig. 1, for the last 6 years the number of banks that has foreign investors in the structure of owners has increased in more than 2 times from 23 at the beginning of 2006 to 53 banks as of 01.03.2012. The share of foreign capital since 2005 has grown from 9.6 % to 41.6 % as of 01.03.2012 (in 4.33 times), that affords ground to state that the position of foreign capital is strengthening and this increases the dependence of the Ukrainian banking system from foreign investors.

![Fig. 1. Dynamics of foreign capital in the Ukrainian banking system](Source: developed by the author on the basis of National Bank of Ukraine)

Concerning the real changes that have occurred under the influence of foreign capital, it should be noted that the inflow of foreign capital to the banking sector has led to a rapid expansion of the proposals of credit resources. During the period of 2005-2008, the credit portfolio of the Ukrainian banking system has been increasing by at least 50 % every year (Fig. 2), primarily owing to cheap foreign loans.
Fig. 2. Dynamics of the loan portfolio and the share of overdue debt in the banking system of Ukraine (Source: developed by the author on the basis of National Bank of Ukraine)

Statistics of banks activity in Ukraine indicate that by 2008 a steady decline in the share of bad loans in the loan portfolio was traced and a significant improvement in the structure of the loan portfolio of domestic banking institutions was observed. At the beginning of 2008, NPLs accounted for only 1.3% of total credit portfolio and in absolute terms it amounted to 6.4 billion UAH.

The financial crisis 2008 led to hasty growth of troubled debts. According to statistics of the National Bank of Ukraine, the period of most active growth of overdue debts was in 2009, during this period their level increased in 3.9 times. This was due both to the growth of the absolute amount of arrears, as a share of total loan portfolio increased by 7.1 percentage points - to 9.4% from 2.3% at the end of 2008, as well as with a gradual decrease of the size of loan portfolio as a result of almost complete suspension of issuing new loans.

In 2010 in a certain extent because of the high effect of the comparison base and also due to the improved economic situation, growth in the balance of overdue loans slowed to 21.3%. However, their share continued to grow, reaching its highest value in November 2010 – 14.0%. Increase in bad loans of the residents after November 2010 almost stopped. This can be explained, on the one hand, by the beginning of the stabilization of the economy, on the other hand – by the intensification of sale agreements of the loan portfolios and first steps of banks towards the resumption of lending (from the second half of 2010, the loan portfolio began to grow gradually). With that, banks with Ukrainian capital, which are included to the financial-industrial groups, most actively overtook the loan portfolio (National Bank of Ukraine Bulletin, 2012).

In 2011 growth in overdue loans was restrained by higher requirements to the borrowers and strengthening the risk assessment by the banks. During that year, the dynamics of overdue loans was diverse, but in general the results of 2011 were the balance of overdue loans decreased by 5.6 billion UAH or 6.5%, and as of 01.01.2012 amounted to 79.3 billion UAH. As of 01.03.2012, the value of this indicator increased to 81.7 billion UAH and 9.9% in relative terms.

If we consider the dynamics of lending in Ukraine in general, it can be argued that previously upward trend in lending businesses and individuals was observed, the peak of which was in 2008, and in 2009 was characterized by suspension in rates of growth of originated loans (Fig. 3). If in 2008 the balance of loans to the economy increased by 72.0%, in 2009 there was a decrease in lending to the economy by 1.5% as one of the most negative consequences of the financial crisis, and at the same time as its deepening factor. The greatest reduction in lending took place in the household sector.

Fig. 3. Dynamics of loans to businesses and individuals (Source: developed by the author on the basis of National Bank of Ukraine)
As it can be seen from Fig. 3, about 90% of the total loans are loans granted to legal entities and individuals, so further the consideration and evaluation of non-performing loans will be focused on this particular component of the loan portfolio of the banking system, as we suppose that most problems in the activity of these sectors triggered the rapid growth of overdue of banks loans during the crisis.

Taking into consideration the significant share in the total amount of outstanding debt, the most significant impact on the downward trend of overdue loans in the period of overcoming the crisis was made by the non-financial corporations (NFC) sector. In 2011 the balance of overdue loans of this sector decreased by 10.8 billion UAH, or 16.5%, and as of 01.01.2012 amounted to 54.7 billion UAH.

Concerning terms the largest decline was observed for overdue loans up to 1 year - by 6.0 billion UAH or 23.8%, and from 1 year to 5 years - by 5.9 billion UAH or 16.3%. Overdue loans of non-financial corporations with maturity over 5 years increased by 1.1 billion UAH or by 26.0%.

Fig. 4. Overdue loans of non-financial corporations by maturity (Source: developed by the author on the basis of National Bank of Ukraine)

By currencies in 2011 overdue loans granted in foreign currency significantly decreased - by 7.7 billion UAH or 23.3% - to 25.4 billion UAH, and their share in the total amount of overdue loans of non-financial corporations decreased by 4.1 percentage points - to 46.4% (Fig. 4). Overdue loans in local currency for the period of 2011 decreased by 3.1 billion UAH or 9.6%, and as of 01.01.2012 amounted to 29.4 billion UAH.

Fig. 5. Overdue loans of non-financial corporations by currency (Source: developed by the author on the basis of National Bank of Ukraine)

As a result of 2011 by types of economic activity over a half (58.7%) of the reduction in the total amount of overdue loans by 6.4 billion UAH in non-financial corporations sector was caused by trading enterprises (Table 1). Reduction of overdue loans occurred for almost all types of economic activities.
At present, accurate data on the actual volume of overdue loans generated in the Ukrainian banking system, are missed.

In our opinion, the official statistics, which is published by the National Bank of Ukraine, does not show the objective view of the current level of troubled banks loans. Banks do not take into account the value of troubled loans, which in fact may appear already overdue and be above the official rate in at least 2 times, and for some banks - even more, also banks may understate the figures of existing overdue loans. This is because banks for some reason are not interested in displaying in the submitted reports the data on actual quality of loans granted by them. Presenting in reports troubled and overdue loans available on the books may cause the client attrition and unplanned outflow of credit resources, complication of the access to interbank lending, worsen performance measures in reports and, in the issue, may lead to the application of a sanctions by NBU.

Therefore, Ukrainian banks are tend to the window dressing, that is, to the method of hiding actual information about the overdue loans. The part of such debt is sold to companies, to which funds to purchase overdue debts are provided by these banks.

Also, conclusions on the level of troubled loan portfolios of the banks can be drawn by the capacity of reserves for possible losses on credit operations reflected in the balance sheets of banks and by the coefficient of securing of credit exposure by reserves.

Ukrainian banking institutions in their reports share lending operations into the following categories: "standard", "under control", "substandard", "doubtful" and "bad". Classification of credit operations is performed depending on the financial position of the borrower, the maintenance for principal and interest, the level of assurance of lending transaction. Reserves for specific lending transaction is calculated based on the category of this transactions, collateral taken on it and the provision ratio. Banks performs the assessment of the debt maintenance by the borrower on monthly basis.

Ratio of reserves for lending characterizes the quality of the bank’s loan portfolio, and the average size of reserves required for each unit of loans. Positive trend of this indicator is the reduction of its value.

According to the NBU before 2008 the trend for the reduction of the ratio of reserves for lending transactions was traced. But the financial crisis 2008 has led to a rapid increase in this ratio, and the period of the most active growth of reserves made for possible losses on lending transactions was in 2009. During this period their level increased by 2.2 times in the banking system of Ukraine (Table 2). This was due to the growth of the absolute amount of non-standard loans and with a gradual decrease in lending. According to the NBU, as of 01.03.2012, the total reserves for loan impairment in 176 banks totaled to 119.1 billion UAH, or 14.5%, and the total reserves of the 17 largest banks – to 107.0 billion UAH or 23.0% in relation to the outstanding loans. This indicates of the retention of the low quality of the loan portfolio of the banking system of Ukraine.

Table 1. Overdue loans to non-financial corporations, by types of economic activity (Source: developed by the author on the basis of National Bank of Ukraine)

<table>
<thead>
<tr>
<th>Economic activity</th>
<th>Residual overdue loans (beginning of the year), UAH billion</th>
<th>Y-o-Y change, %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010</td>
<td>2011</td>
</tr>
<tr>
<td>agriculture</td>
<td>3.2</td>
<td>3.3</td>
</tr>
<tr>
<td>manufacturing industry</td>
<td>11.5</td>
<td>16.6</td>
</tr>
<tr>
<td>construction</td>
<td>6.0</td>
<td>7.8</td>
</tr>
<tr>
<td>trade</td>
<td>20.5</td>
<td>24.3</td>
</tr>
<tr>
<td>miscellaneous</td>
<td>11.2</td>
<td>13.6</td>
</tr>
<tr>
<td>Total</td>
<td>52.4</td>
<td>65.6</td>
</tr>
</tbody>
</table>

Table 2. The dynamics of loan loss provision in the Ukrainian banking system (Source: developed by the author on the basis of National Bank of Ukraine)

<table>
<thead>
<tr>
<th>Date</th>
<th>Total Ukrainian banks</th>
<th>Total 1 group of major banks in Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Credit portfolio, UAH billion</td>
<td>Loan loss provision, UAH billion</td>
</tr>
<tr>
<td>01.01.2005</td>
<td>97,197</td>
<td>6,367</td>
</tr>
<tr>
<td>01.01.2006</td>
<td>156,385</td>
<td>8,328</td>
</tr>
<tr>
<td>01.01.2007</td>
<td>269,294</td>
<td>12,246</td>
</tr>
<tr>
<td>01.01.2008</td>
<td>483,368</td>
<td>18,477</td>
</tr>
<tr>
<td>01.01.2009</td>
<td>792,244</td>
<td>44,302</td>
</tr>
<tr>
<td>01.01.2010</td>
<td>747,348</td>
<td>99,238</td>
</tr>
<tr>
<td>01.01.2011</td>
<td>755,030</td>
<td>112,965</td>
</tr>
<tr>
<td>01.01.2012</td>
<td>825,320</td>
<td>118,941</td>
</tr>
<tr>
<td>01.04.2012</td>
<td>823,181</td>
<td>119,125</td>
</tr>
</tbody>
</table>
Official data on reserves for loans not fully reflect the quality of bank loan portfolios. It is unfavourable for the management of the banks to acknowledge the debt problem because, according to the regulations of the NBU, it should be covered with adequate reserves. Provisioning in large amounts causes losses that shareholders of banks are forced to compensate by the increase of in authorized capital. According to analysts the level of troubled debts in some large banks is 30, 40 and even over 50 %. And the average level of troubled debts in the banking system is not less than one third of the loan portfolio.

But at all points of time series created reserves for possible losses on lending operations covered overdue debts on loans, particularly in the period of 2005-2009 – by more than 2 times, and during the period of overcoming the consequences of the crisis starting from the 2009 reserve ratio to overdue loans amounted to about 140 % (Table 3).

<table>
<thead>
<tr>
<th>Date</th>
<th>Overdue loans, UAH billion</th>
<th>Loan loss provision, UAH billion</th>
<th>Loan loss provision to overdue loans ratio, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.01.2005</td>
<td>3,145</td>
<td>6,367</td>
<td>202.4</td>
</tr>
<tr>
<td>01.01.2006</td>
<td>3,379</td>
<td>8,328</td>
<td>246.5</td>
</tr>
<tr>
<td>01.01.2007</td>
<td>4,456</td>
<td>12,246</td>
<td>274.8</td>
</tr>
<tr>
<td>01.01.2008</td>
<td>6,357</td>
<td>18,477</td>
<td>290.7</td>
</tr>
<tr>
<td>01.01.2009</td>
<td>18,015</td>
<td>44,502</td>
<td>247.0</td>
</tr>
<tr>
<td>01.01.2010</td>
<td>69,935</td>
<td>99,238</td>
<td>141.9</td>
</tr>
<tr>
<td>01.01.2011</td>
<td>84,851</td>
<td>112,965</td>
<td>133.1</td>
</tr>
<tr>
<td>01.01.2012</td>
<td>79,292</td>
<td>118,941</td>
<td>150.0</td>
</tr>
<tr>
<td>01.01.2013</td>
<td>81,712</td>
<td>119,125</td>
<td>145.8</td>
</tr>
</tbody>
</table>

A significant increase in provisions for credit operations of 2008-2009 caused deterioration of loan portfolios of banks, rather, increasing debt problem loans. The latter, in turn, was formed under the influence of macroeconomic factors, and in the absence of the crisis of effective systems of risk management in the Ukrainian banking institutions. A significant increase in reserves for lending operations in 2008-2009 was caused by the deterioration of loan portfolios of banks, to be more precise, by increasing of troubled debts. The latter, in turn, was formed under the influence of macroeconomic factors, as well as a result of the absence in the before crisis period of the effective systems of risk management in Ukrainian banking institutions.

To pay attention to the situation with non-performing loans in certain emerging countries, which was caused by the global financial crisis 2007-2008, the data on the share of non-performing loans in these countries and trends of their rapid growth during 2008-2011 are presented in Figure 6. According to the World Bank Fig. 6 shows that in 2008 the situation with non-performing loans in Ukraine, Russia, Poland and Kazakhstan was similar, as the share of these loans was between 3.8-5.1%. But due to the crisis and to the rapid growth of the troubled debt on loans in 2011 in Kazakhstan NPLs were amounted to 26.3%, which is the highest rate among the analyzed countries. Non-performing loans in Ukraine in 2011 increased to 15.4% according to the World Bank, but this figure is higher by 5.8% compared to the data that were published by the National Bank of Ukraine, which, in turn, indicates the non-transparency of the situation with non-performing bank loans in the country. In Russia and Poland NPLs due to the crisis increased approximately in 2 times. In Belarus, the situation with non-performing loans was most stable and in 2011 NPLs represented only 3.1% of loans.

Fig. 6. Bank non-performing loans to total gross loans (%) in certain European countries (Source: developed by the author on the basis of World Bank, 2012 and PWC, 2011)
Conclusions

The inflow of foreign capital into the banking system became a significant impetus to the development of lending in Ukraine. This facilitated the expansion of lending due to availability of cheaper resources for banks with foreign capital.

At the same time, the deepening crisis in the world economy in 2008-2009, lead to a decrease in credit portfolio volumes of Ukrainian banks due to the deterioration in loan servicing by individuals and legal entities. This led to an increase of problem loans, and forced banks to form loan loss provisions in larger amounts, which negatively affected banks' liquidity.

Accordingly, the contrary processes can be observed in the banking system nowadays: the inflow of foreign capital has slowed down due to unfavorable credit conditions. In future, a decline in the share of foreign capital in the banking system of Ukraine is seen as more likely trend.

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NEVEIKSIŲ PASKOLŲ VERTINIMAS UKRAINOS BANKŲ KREDITŲ PORTFELIJE

Inna Taranukha
Kijevo Taraso Ševčenko nacionalinis universitetas

Santrauka

Svarbiausias rodiklis, charakterizuojantis banko paskolų portfelių abejotinumą, yra pradelstų paskolų dalis visame paskolų portfelėje. Pradėdinius paskolos parado bankinės institucijos paskolų portfelio problemas, kadangi jos yra tiesioginis skolintinkų problemų ir jų nesugebėjimo grąžinti paskolų atspindys. Paskolų portfelo analizė leidžia įvertinti banko paskolų kokybę ir sudėties dinamiką, lyginant su visos bankų sistemos veikla.

Užsienio kapitalo įprastai į bankų sistemą tapo reikšmingu postūmimu skolinimo plėtrai Ukrainoje. Kreditavimo procesą palengvino pigiesi bankų su užsienio kapitalu finansiniai ištekliai. Straipsnyje analizuojamas užsienio kapitalo įprastų poveikis skolinimo procesą plėtrai Ukrainoje. Abiejotinų paskolų dalis portfelio įvertinama galių nuostolių rezervais, suformuotais bankų balansuose, ir sudarytų rezervų blogoms paskoloms dengti santykiai su paskolų portfeliu.

Straipsnyje įvertinta neveiksnės paskolų apimties ir bankų rezervai galimiems nuostolams padengti Ukrainos bankinėje sistemoje 2005-2011 m. laikotarpiu.