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Banking and Finance

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General overview of the banks M&A market in Ukraine in 2007

In terms of assets, Ukraine is one of the fastest growing countries in Eastern Europe. Loans, deposits and profitability of the banking sector in south-eastern Europe and Ukraine is now considered by international experts as an attractive banking destination. At the same time Ukraine's banking sector is still at the development stage and still has ample opportunities and scope for growth; the total market capitalisation of the banking sector is less than 10% total GDP. The potential for growth is strong in Ukraine, a country with about 46 million citizens who are only beginning to make use of classic banking services.

Through a succession of M&A deals launched in 2005, foreign banking groups bought some of Ukraine's largest banks at high prices. And while Ukraine's banking industry awaits a second wave of M&As, the new international players are fiercely competing with their Ukrainian counterparts, increasing competition and the quality of service. Newly acquired banks are backed by financial might and better access to credit from their parent groups abroad.

M&A deals and foreign investment brought new services and products that were previously poorly developed, or non-existent, for example the emergence of Internet banking - which gives clients the opportunity to use and pay for banking services much faster - and more wide use of traditional Western banking practices and tools.

The Ukrainian banking sector has a high level of concentration. According to expert opinion about 70 percent of the whole Ukrainian banking market is controlled by the 20 largest banks.

Again 2007 was a year of stable growth in the Ukrainian banking sector, marked by the continuing entry of major foreign players, bringing the aggregate share of foreign capital in the Ukrainian banking system to around 35% by the end of 2007 (based on net assets), and a new trend of mergers between Ukrainian subsidiaries of foreign banks (Unicredit Bank and HVB Ukraine, VTB Bank and Vneshtorgbank (Ukraine), and a number of smaller banking institutions in the same process).

The tendency towards consolidation in the Ukrainian banking market will remain strong for another few years. Many so-called "pocket banks", which have in the past served as private banks for the business groups that own them, will be sold to foreign banks, or will merge together with other regional banks after which they will be sold off to foreign banks.

2007 Ukrainian Banks M&A Deals

Dec.07	Bank Hapoalim (Israel)	Ukrinbank	$136 mln for 76%
Nov.07	Bank of Cyprus	Avtozazbank	$76 mln for 95%
Nov.07	SEB Group (Sweden)	Faktorial Bank	$120 mln for 97%
Sep.07	Commerzbank (Germany)	Bank Forum	$600 mln for 60%
Jul.07	UniCredit Group (Italy)	Ukrsotsbank	$2.2 bin for 95%
Jun.07	Societe General (France)	Ikar Bank	$35 mln for 100%
Jun.07	Sberbank (Russia)	NRB-Ukraine	$150 mln for 100%
May.07	Piraeus Bank (Greece)	International Comercial Bank	$50 mln for 78%
Mar.07	Martin Popular Bank (Greece)	Marine Transport Bank	$137 for 100%
Feb,07	KIT-Finance (Russia)	Radabank	$7.5 mln for <50%
Jan.07	Swedbak (Sweden)	TAS-Commertzbank	$753 mln for -100%
Jan.07	Volksbanken (Austria)	Bank Electron	$74 mln for -98%

There were 35 Ukrainian banks with foreign participation in early 2007, and 47 by the end of the year.

The development of the Ukrainian economy (increase in employment, growth in GDP, constant increase in foreign investment, economic liberalisation and high return on investment) causes both an increase in per head disposable income and a lack of alternative sources from which businesses can attract funds. This is because the Ukrainian equities market is rather weak, while the activity of Ukrainian and foreign investment banks and funds is small compared to that of the banking system.

General overview of finance tools used in Ukraine in 2007

Despite the collapse of the US mortgage market in 2007, which slowed down international capital markets, Ukrainian companies are still eager to access the global capital market in order to modernise their old assets and further expand their activities.

There are more and more Ukrainian businesses which, due to their financial market plans, are set to comply with universally recognised principles of business practice. These companies try to diversify the financial tools available to Ukrainian businesses.

Such financial tools as bilateral and syndicated loans, project finance structures, Eurobonds and depositary receipts are now considered as traditional tools, and companies are considering relatively new techniques such as IPO.

Syndicated and bilateral loans

The traditional financial tool is a bilateral or syndicated loan. This tool is applied when the Ukrainian borrower may provide the foreign bank or a syndicate with a sufficient security (guarantee (suretyship) of the parent company or beneficiary of the Ukrainian borrower, mortgage, pledge, assignment etc).

Syndicated loans remain an alternative to Eurobonds for borrowers seeking smaller amounts (average USD 75 million) for a term of one to five years. The floating interest rate for Ukrainian syndications has been competitive, with the overall cost involving participation fees and commission often being cheaper than Eurobonds, with a shorter period for arrangement.

Generally, loan participation notes (LPN) structures remain a good option for the businesses seeking long-term funds in large amounts. USD 100 million is considered the minimum amount for Eurobond placement.

The new Law On Securities and the Stock Market (effective as of 3 May 2006) removed the requirement of denomination of corporate bonds only in Ukrainian currency. However, the relevant provision remains in the Commercial Code, leaving it unclear as to whether a direct issue is now possible. According to Ukrainian law, Ukrainian banks can only borrow from foreign banks or financial institutions, and municipalities can borrow only from banks. Loans from foreign lenders must be registered with the National Bank of Ukraine. The NBU establishes an interest cap on the loans from foreign lenders. The maximum interest rate is tied to sovereign borrowings of Ukraine and covers not only the true interest but also extends to the lenders' fees, default payments and other payments, costs and charges provided the loan. The payments under the loan are subject to an interest cap applicable to the respective term of the loan. The registration of a loan amendment may be denied by the NBU if at the time of the amendment the interest rate under the loan exceeds the established cap. Foreign-sourced loans guaranteed by the Ukrainian government are exempted from NBU registration, and loans from the EBRD and other international financial organisations are not subject to the interest rate caps established by the NBU as well as do not require certain standard provisions (taking effect only after the NBU registration).

Project finance

Project financing tools are often applied by such financial institutions as EBRD or IFC. Such structures allow foreign lenders to mitigate the common risks by sharing them with the local borrower and repaying the loans with the project proceeds.

IPO

The IPO topic has recently become a very popular one. Due to the underdeveloped nature of the Ukrainian stock market there is no chance to raise significant funds in Ukraine and therefore local IPO is not attractive for Ukrainian businesses. Subsequently, it is the AIM of the LSE which is considered as the most perspective stock exchange for making initial public offerings by Ukrainian companies.

Taking into account the prohibition of denomination of Ukrainian stocks in foreign currency and oppressive applicable regulations by Ukrainian securities authorities (limitation for 25% of stocks to be placed), IPO of Ukrainian shares on international markets is performed via specially established intermediate foreign companies by placements of private depositary receipts "backed up" by Ukrainian assets. This SPV then injects capital into the Ukrainian company through capital contributions or loans. A number of legal issues connected with depositary receipts remain a challenge and require special attention (e.g., correlation between beneficiary holding of shares under the depository agreement and "true ownership" of shares under Ukrainian law, ambiguous proxy provision in the depository agreement regulating the management control of the issuer, currency control requirements related to payment of dividends, split voting right by a depositary at the shareholders meeting of a Ukrainian issuer). It is a common occurrence in Ukraine for the strict data disclosure rules and audited financial statements to require a deep restructuring of the Ukrainian issuer's business. Such restructuring has been announced by a great number of companies in Ukraine; however, unfavourable global financial market conditions seem to postpone plenty of Ukrainian IPOs.

Securitisation

This year saw the first cross-border securitisation of the mortgage portfolio of Privatbank (the notes are listed on the Irish Stock Exchange). Following this USD 180 million securitisation by Privatbank, a number of leading Ukrainian banks announced their intention to perform securitisation transactions in the near future with respect to consumer finance receivables. The issue of complicated rules on Ukrainian collateral, currency control and banking regulations remains, and their consistency should be tested in practice. There is another option to receive attractive financing alternative at a reduced cost of funds as a result of segregation of assets from the credit risk and higher credit rating of the securities issued by the relevant SPV.

Ukrainian stock market

It is worth mentioning that the Ukrainian stock market has grown rapidly in the past few years. There are several hundred traded companies, although the ten largest companies account for more than half of the market capitalisation. Despite its constant rapid growth, the Ukrainian equity market is very fragmented, lacks price transparency, and is illiquid. It is estimated that about 90% of securities transactions occur outside the organised market.

There are several stock exchanges in Ukraine, but almost all trading is now effected through the PFTS Stock Trading System (www.pfts.com/eng), which went electronic in 2005 and finally received stock exchange status in June 2006. Shares, domestic and external government bonds, municipal bonds, corporate bonds, Ukrainian treasury bills, savings certificates, investment certificates and other types of securities are traded through the PFTS.

Relevant Ukrainian legislation changes in 2007

Several banks were acquired by foreign citizens in 2005-2007 and more will follow. This logically brings modern technologies of international financing to the Ukrainian market and provides Ukrainian clients with a wide range of instruments for both banks and industrial companies.

Due to the provisions of Ukrainian law in many cases traditional Western legal financing techniques may not be applied in Ukraine and, therefore, they must be adapted and modified before they are implemented.

The National Bank of Ukraine showed its persistence in improving the regulatory framework for consumer lending and protection of consumer rights by issuing a number of clarifications and recommendations in 2007. However, in terms of the foreign currency control regime, many of the practical hurdles as regards foreign investments and cross-border flow of capital still exist and force the companies to invent new structures and schemes for financing.

Loans from non-residents

There have been two major changes in the foreign loans regulations in 2007.

Firstly, the NBU amended the rules for registration of loans from non-residents to Ukrainian borrowers (the NBU Resolution No. 270 dated 17 June 2004). In 2007 interest caps ranged, depending on the term, from 9.8 to 11% p.a. for fixed rate facilities and were three-month LIBOR plus 750bp for floating rate instruments. The NBU has changed the way the maximum interest rate cap will be calculated starting from 1 January 2008. In particular, the NBU will publish a maximum interest rate every 6 months calculated on the basis of an average spread between interest rates under sovereign and commercial borrowings on international financial markets and international ratings issued to Ukrainian companies. The NBU is obliged to notify commercial banks on changes of interest rates with at least one month's prior notice. Short-term borrowings (with less than one year's maturity) by banks will be subject to softer regulation from 1 January 2008 with the possibility of the funds transfer before registration and effectiveness not dependent on registration with the NBU.

Secondly, the NBU made amendments to certain regulations and has allowed international financial institutions, such as EBRD and IFC, to grant loans to Ukrainian borrowers in Ukrainian hryvnyas. For those Ukrainian companies that have no foreign currency proceeds, this is a great chance to receive financing at relatively low interest rates without being exposed to foreign currency risks.

Currency regulations

Foreign currency operations are mainly regulated by the Decree of the Cabinet of Ministers On The System Of Currency Regulation And Currency Control No. 15-93 dated 19 February 1993, as well as a number of regulations approved by the NBU. A number of foreign currency transactions may only be performed by Ukrainian entities if an individual license is obtained from the NBU. However, there has been an ongoing trend toward liberalisation and less restrictive currency rules, the most recent major development being the removal of the requirement that Ukrainian residents convert at least 50% of any foreign currency proceeds into local currency (hryvnya).

The main points to note about Ukraine's current exchange control regulations are:

- Payments under foreign trade contracts between a resident and a non-resident entity should be in foreign currency only.
- Payments in foreign currencies between residents in the territory of Ukraine are generally prohibited (with a few exceptions, such as bank loans).
- The purchase of foreign currency is subject to a 1% Pension Fund charge, which is withheld by the respective bank.
- Payments by Ukrainian residents for services rendered by non-residents under certain transactions

(supply of services, transfer of intellectual property rights and others) for amounts exceeding EUR 100,000 require conclusion from the Analytical Centre for Monitoring of External Commodity Markets that the fee for the services is reasonable and does not exceed market prices. If a conclusion is refused, a Ukrainian company must receive the consent of the NBU for effecting payments under the relevant contract.

Foreign currency can be purchased for the following main purposes:

- Payment to overseas suppliers of goods/works/services
- Payment of dividends, interest, royalties abroad
- Repayment of a hard currency loan registered with the NBU, and
- Purchase of hard currency denominated securities

Ukrainian companies (and individuals) are required to obtain a license from the NBU for a number of transactions, including the following:

- Cash investments abroad for the acquisition of fixed assets, intangible assets, corporate rights, securities and derivatives
- In-kind contributions and transfer of property to a foreign branch
- Opening bank accounts with foreign banks.

There has been a major change in the currency regulations in 2007. In particular, Parliament amended the Law On Procedure of Foreign Currency Settlements No. 185/94-BP dated 23 September 1994 and thereby prolonged the maximum term for foreign currency settlements from 90 days to 180 days. In the current wording (effective from 1 January 2008) it stipulates that proceeds of Ukrainian residents from export contracts must be credited to the exporter's Ukrainian bank account within 180 days from customs clearance (for goods) or date of services delivery. Similarly, prepaid goods must be imported and cleared through customs within 180 days of payment. Failure to do so can result in a fine of 0.3% of the amount due or paid for each day of delay. It also established a rule that a total amount of the fine may not exceed the amount due. Additionally, it is the Ministry of Economy of Ukraine (earlier - the NBU) which is now in charge of prolonging the mentioned terms. By the Letter No. 28-311/4677-13526 dated 24 December 2007 the NBU provided comments and clarifications as to the application of the new 180 days rule in transition period (end of 2007 - beginning of 2008).

Investment issues

According to Ukrainian law, foreign investments in Ukraine may be carried out in hard currency, in Ukrainian hryvnya (UAH), or in kind.

Participation by a non-resident investor in the creation of a company/or in a capital increase:

- Non-resident investors may transfer foreign currency from abroad directly into the current account of the Ukrainian company.
- Non-resident investors may make the payment into the current account of a Ukrainian company through an investment account, which non-resident investors may open with a Ukrainian bank.
- Non-resident investors can make investments in kind (as share capital).

Purchase of a stake in an existing limited liability company (LLC):

- Non-resident investors may transfer foreign currency from abroad directly into the current account of the seller, opened at a Ukrainian bank.
- Non-resident investors may open an investment account with a Ukrainian bank, transfer foreign currency into it from abroad and pay to the seller from this investment account. If required, non resident investors may convert foreign currency into UAH and pay UAH to the seller.

Purchase of shares of an existing joint stock company (JSC):

- The shares sale-purchase agreement is to be concluded with the participation of a securities broker.
- A broker's account must be used to channel funds into and out of Ukraine.
- Non-resident investors may transfer foreign currency from abroad directly into a broker's account opened at a Ukrainian bank and the broker will pay to the seller of the securities (if required the broker will convert foreign currency into UAH and then pay to the seller of the securities).
- A non-resident may open an investment account with a Ukrainian bank and transfer foreign currency into it from abroad with further transfer of foreign currency through a broker's account opened at a Ukrainian bank.

Offshore payments between two non-residents for a stake in a Ukrainian LLC or shares of a Ukrainian JSC are not prohibited, but require some additional paperwork and may raise few currency control issues for the future divestments and income (dividends) repatriation.

Registered shares, unlike bearer shares, are subject to registration with a registrar if issued in a documentary form. All transactions with bearer shares are subject to financial monitoring and special anti-money laundering procedures. JSC's shares must be transformed into non-paper shares at a custodian..

Therefore, opening a much discussed investor account is not obligatory in order to invest in Ukraine (in contrast to the practice which existed between 2004 and 2006).

Expected WTO accession

Parliament also passed a law permitting foreign banks to operate branch offices in Ukraine once Ukraine joins the WTO. It established the terms and conditions for accreditation by the NBU of the foreign banks' branch offices. Successful accreditation is a basis for performance by the branch office of banking activities. The term for the branch office accreditation is three months from submission of the complete package of documents.

Relevant Ukrainian legislation changes in 2007

Though Ukraine's banking sector is at the development stage, it has great opportunities and scope for growth. The banking sector is expected to grow further in the near future in all directions. In probability, the rate of growth for 2008-2009 will be slightly lower than in 2005-2007; more M&A activity is likely to take place in the sector, although it will be smaller in size. After all, more than 150 banks operate in Ukraine, many of which are too small to compete nationally. We shall definitely witness a consolidation in the banking sector on a regional level.

We shall see more and more often banks that are not present in Ukraine participating in the financing of top Ukrainian corporations via bilateral or syndicated loans. More Ukrainian companies will start raising funds abroad via issuance of Eurobonds, initial public offerings (IPOs), or private placements. Some of these funds will certainly be used to repay expensive local borrowings.

Top Ukrainian banks are already using external financing as the major source of their liabilities and will continue to do so. Ukrainian industrial companies will also benefit from bringing their structure and activity in line with recognised business standards.

All these trends will force banks to diversify their products and to industrialise their activity in order to survive in a highly competitive environment. The more Ukraine integrates into the world economic system, including the WTO and others, the more top world players, including banks, will be interested in investing. This will in turn facilitate negotiating, structuring and documenting those financial tools and techniques which are not currently widely used in Ukraine.

With the role of Western capital in the Ukrainian economy set to increase in the future, we shall witness a wider use and perfection of domestic banking and business practice, including a variety of complex financial structures.

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