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Banks in Ukraine Bleed Capital as Violence Shuts Branches in East

By Alexander Panin

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Ukraine's largest lender, Privatbank, on Monday suspended operations in Donetsk and Luhansk, citing the threat to the lives of its employees from heightened criminality.

Several banks have halted operations in turbulent eastern Ukraine since the beginning of the week, fearing for the safety of their clients amid flaring violence and reports of assaults on offices.

Meanwhile, Ukraine's banking system, weak before the crisis, is suffering increasing outflows of foreign capital, banking analysts said.

Most banks resumed operations on Tuesday as violence abated, but the continuing conflict between pro-Russian separatist groups and the Ukrainian military is putting banks, both local and foreign, at risk.

"Ukraine's banking system has been highly dependent on foreign capital, a large portion

of which is Russian," said Yelena Fedotkova, an analyst at PSB Research, a Moscow-based financial consultancy.

While the staggering economy — Ukraine was deep in recession even before Kiev erupted in protest last December — means the country has long been a risky investment for banks, mounting instability is triggering more capital outflows, she said.

Ukraine's largest lender, Privatbank, on Monday suspended operations in Donetsk and Luhansk, citing the threat to the lives of its employees from heightened criminality. Privatbank said in a statement on its website that it had shuttered its doors after separatists who say they want independence from Kiev raided 14 of its branches and stole 11 of the bank's armored transport cars, though it added that no money was stolen.

The raids against Privatbank followed the appointment of its co-owner, billionaire Igor Kolomoisky, as the head of Dnipropetrovsk region, Donetsk's neighbor. Kolomoisky has remained staunchly pro-Ukrainian, and Dnipropetrovsk has so far avoided the chaos that has engulfed other regions.

Privatbank reopened most of its branches on Tuesday, as Ukrainian military forces pulled back from their attempts to storm towns held by separatists. About 60 offices, or more than half of the bank's branches in Luhansk region were operating on Tuesday evening. Several branches in safe areas in the Donetsk region have also opened, the bank said.

Privatbank is not the only bank caught up in the violence. Ukraine's state-owned Oschadbank briefly suspended some services in the Donetsk region on Monday, while the subsidiary of Russia's Alfa-Bank in Ukraine on Tuesday suspended services in two towns in the region.

Russia's biggest bank, state-owned Sberbank, also said its Ukrainian subsidiary had temporarily shut its doors in Slavyansk in the Donetsk region but that operations resumed on Tuesday.

There were no known assaults on the Sberbank's offices or ATMs, a spokesperson for the bank in Ukraine said.

The unrest is likely to add impetus to a rush to get banking capital out of Ukraine. A report published last month by the Ukrainian Credit Rating Agency, or UCRA, said a substantial amount of foreign capital left the country's banking system last year and warned the trend could continue if the current economic and political situation remains dire.

While at the start of 2013 the share of foreign capital in Ukraine's banking system was almost 40 percent, this figure decreased to 34 percent by the beginning of 2014.

"A number of Western and Russian financial institutions may exit [the Ukrainian] market," the report said, even if they have to sell at a heavy discount. According to the UCRA, potential losses of subsidiaries of foreign banks working in Ukraine would be small enough for their parent companies to absorb.

Russian banks have a strong presence in Ukraine — Alfa-Bank, Sberbank, VTB and state-owned VEB, which controls Ukrainian Prominvestbank, are among the 15 largest banks in Ukraine.

"Representatives of nonresident banks working in Ukraine that are also present in Russia have said they incurred losses in Ukraine, although the rates [of interest they charge on their loans] were high to compensate for this," Fedotkova said, adding that foreign capital will probably continue to exit the Ukrainian banking system in the short-run to avoid risks.

"The funds may start to return as the situation stabilizes, but this is unlikely to happen soon," Fedotkova said.

Other analysts, however, disagreed, saying a recovery in Ukraine's banking system may not be so far away, facilitated by the presence of the International Monetary Fund.

"Bankers are temporarily frightened and will transfer their finances to a safe place until things cool off," said Vasily Solodkov, director of the Higher School of Economics' Banking Institute.

"But eventually the situation will get back to normal and Ukraine's banking system will only benefit from the association with Europe and the structural reforms the country will have to go through in return for the loan from the International Monetary Fund," the analyst said.

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