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Research paper



Municipal Deposits in Ukraine during 2016-2018: Opportunities and Threats for Financial System

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Abstract

In the article the local authorities' temporarily free funds allocation policy in terms of banks, interest rates and regions was explored. The results of the research show that the largest amounts of deposits are concentrated in Donetsk and Dnipropetrovsk regions. The leader in deposit attraction is Ukrgasbank, despite the fact that it is just fourth in terms of net assets among state-owned banks. It can be stated that municipal deposits became an important source of liquidity for Ukrainian banking system. On the other hand some systemic threats for financial instability are related to the rapid growth of municipal deposits volumes due to decentralisation. Regulatory requirement for allocation of such deposits in state-owned banks reduces possibilities for fair banking competition. Also operational ineffectiveness of state-owned banks results in huge interest costs which are finally compensated by government capital injections from the state budget.

Keywords: *banking, deposits, local authorities, state-owned banks, systemic risk.*

1. Introduction

The financial decentralization reform from 2014 enhanced the growth of local budget revenues. Thus, the inflows grew by 2.3 times during 2017 compared to 2015 and amounted to 229.5 UAH bln (excluding intergovernmental transfers) [1]. The average annual growth rate reached 31%. The emergence of additional funds in local authorities (LAs), as well as the desire of funds managers to keep its value and receive additional income in the form of interest has caused an increase in bank deposits volume by almost 50 times (from 0,3 UAH bln as of July 1, 2014 to 14,6 UAH bln as of July 1, 2018).

Since, in accordance with the legislative requirements, local authorities have right to direct deposits only to state-owned banks, a discussion has emerged about the socio-economic consequences of such policy of the Ministry of Finance of Ukraine among the expert community. As we know, state banks annually receive billions of UAHs of capital injections from the state budget. On the one hand, the preferences given for non-efficient state-owned banks in terms of deposits of local authorities restrict market competition in the banking market, and on the other hand, de facto increase the flow of funds from the state budget to local ones through the payment of deposit interest.

The main goals of the research are to find out the facts and identify trends in the local authorities (LAs) deposits segment of bank deposit market for a deeper study of the effectiveness of using local budget funds in the process of decentralization.

2. Literature and legislation review

The bank deposits theme has always been popular among foreign and domestic economists. The papers of the following researches should be mentioned. B. Klein (1974) [2], who analyzed implicit deposit rates on demand deposits; Diamond and Dybvig (1984) [3] underlined the role of demand deposits in transmission mechanism, liquidity risk and bank run creation. Allen et al (2015) [4] compared the cost of equity and deposit financing for banks' capital structures. Brown et al. (2013) [5] provided empirical research based on withdrawals data of large EU banks during the financial crisis. Among ukrainian scientists working on bank deposit theme are Versal (2009) [6], Viadrova&Volokhata (2014) [7], Bereslavska (2013) [8] and Onishchenko (2014) [9]. However, lack of paper on more narrow branch of municipal deposits is observed. More popular is research of related topics, such as fiscal decentralization: Bird&Vaillancourt (2008) [10], Rodden et al (2003) [11], Bahl (1999) [12]; state-owned banks problems: Vovchak (2013) [13], Prymostka (2014) [14], Cornett et al (2010) [15], Bacchiocchi et al (2017) [16].

Our research will contribute to the theme on municipal deposits, which became important in Ukraine due to the high deposit interest rates, sufficient to substitute riskier investment alternatives. After fiscal decentralization local budget obtained additional financial resources that in conditions of insufficient planning of spendings are directed to the state-owned banks.

The terms and the process of deposit collection from local authorities are strictly regulated by Ukrainian laws. The right of local authorities to place temporarily free funds on bank deposit accounts is regulated by the Budget Code of Ukraine, Law of Ukraine "On Local self-government in Ukraine" and the Resolu-

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tion of the Goverment of Ukraine "On approval of the placement of temporarily free funds of local budgets in bank deposit accounts". In particular, according to this Regulation there are the following conditions for placement of funds on deposit accounts:

1. The approval by the local council of the corresponding decision.
2. Conclusion of a bank deposit agreement between a financial authority and a bank.
3.The definition in the bank deposit agreement between a local financial authority and a bank of mandatory conditions regarding the right of a depositor to return a deposit or a part thereof on the first demand of the depositor and on the prohibition of indisputable write-off by the bank of funds from the deposit account of the municipal financial authority;
4.The absence on the date of the placement of temporarily unpaid overdue payables for the corresponding fund of the local budget, except that which arose as a result of lack of funds from subventions from the state budget and budgets of other levels.
5. Absence on the date of placement of temporarily free funds of the general fund of the local budget of unspent medium-term loans received from the funds of the single treasury account in the current budget period.
6. Placement on a competitive basis of temporarily free funds in banks in which the state owns 75 or more percent of the authorized capital.
At present, there are four banks that meet these requirements: PJSC "State Savings Bank of Ukraine" (hereinafter - Oschadbank), PJSC "UkrGasBank" (hereinafter - Ukrgasbank), PJSC "State Export-Import Bank of Ukraine" (hereinafter - Ukreximbank), JSC CB "PrivatBank" (hereinafter - PrivatBank).
In May 2018, the Procedure for temporarily free funds allocations of local budgets through the purchase of government securities was approved and became effective. We expect that the emergence of an alternative tool can reduce the interest of local authorities in directing free funds on deposit accounts.

3. Methodology

The analysis of municipal deposit accounts balances was carried out for the period from June 1, 2016 to June 1, 2018. Five periods (duration of six months) were analyzed in total. Since as of January 1, every year, the balance of funds on depository accounts of local governments is absent (with the exception of deposits in liquidated banks), because the local governments can allocate deposits with a duration of one year, for analysis the beginning of the six months were shifted by one month (01.06 and 01.12). Data for research were provided by the State Treasury of Ukraine in terms of individual deposits of each local budget on a monthly basis.

4. Empirical findings

4.1. Local authorities' deposits dynamics during 2014-2018

According to the published data of the State Treasury Service, as of June 1, 2018, the volume of deposits allocated by local budgets amounted to 15.7 UAH bln (7.2% of the sum of local budget expenditures for the corresponding period). At the same time 286 local budgets have allocated funds on deposit accounts with banks, accounting for 3% of their total number. The average value of a deposit account of the local budget is 55 UAH mln.
The most significant increase occurred in 2016 - balances on deposit accounts increased 34 times compared to the same period of 2015. If in 2014-2013 the balance of deposits amounted to less than 1% of the expenditure of local budgets, then in 2018 they reached 6%.

Donetsk (3.9 UAH bln) and Dnipropetrovsk (2.2 UAH bln) regions have the largest investments, and relatively large deposits are in the Kharkiv region (1.1 UAH bln). Local governments of Cherkassy, Volyn and Zhytomyr regions are most actively placing deposits (33, 28 and 24 budgets, respectively), but their volume is relatively insignificant (0.3-0.8 UAH bln).

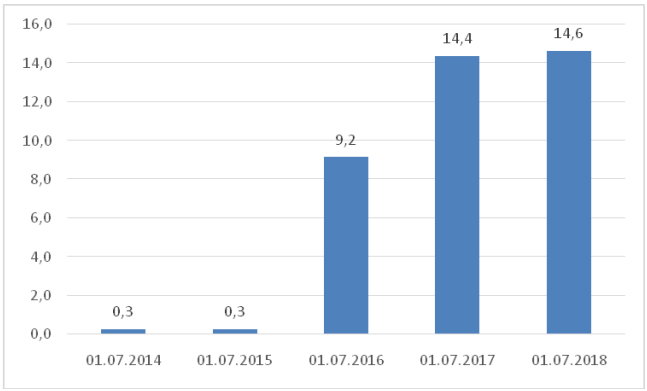


Fig. 1: Municipal deposits dynamics during 2014-2018, UAH bln

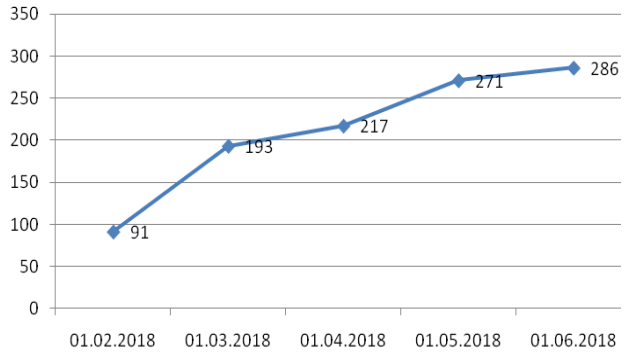


Fig. 2: Quantity of local authorities with municipal deposits, jan-may 2018

The given data testify to an increase in the number of LAs that have taken advantage of the right to allocate funds on deposit accounts since the beginning of the year. Thus, as of May their number has increased more than three times compared with January 2018.

4.2. Local authorities' deposits in the unsolvent banks

Some of the municipal deposits allocated by liquidated banks, in particular:

• "Arma" (decision of the National Bank of Ukraine (NBU) dated February 19, 2010);
• "Bank Dnister" (decision of the NBU dated 13.03.2010);
• Bank "European" (decision of the NBU dated August 19, 2009);
•"Zakhidinkombank" (decision of the NBU dated August 19, 2009);
• "Zemelny Bank" (decision of the NBU dated July 30, 2010);
• "Imexbank" (decision of the NBU dated May 21, 2015);
•"InPromBank" (decision of the NBU dated 01.06.2011);
•"Ukrainian Financial Group" (decision of the NBU dated 21.02.2010).
However, such deposits do not have a significant impact on the system and is only 2% of the total balance on deposit accounts as of July 1, 2018.

4.3. Deposits of local authorities: breakdown by banks

The choice of the study period 2016-2018 is due to a sharp increase in the balance of municipal deposits due to the positive effect of fiscal decentralization. However, even during this period there was an increase in the volume of deposits. The largest in-

crease in deposits balances took place from 01.05 to 01.12.2016 - by 3 UAH bln, or 40%. During the last 12 months there has been a slowdown in the build-up of depository portfolios of LAs (Fig. 3, 4).

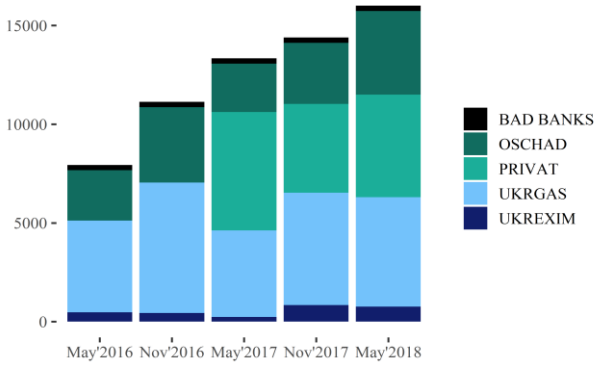


Fig. 3: Municipal deposits volume: breakdown by banks, UAH bln

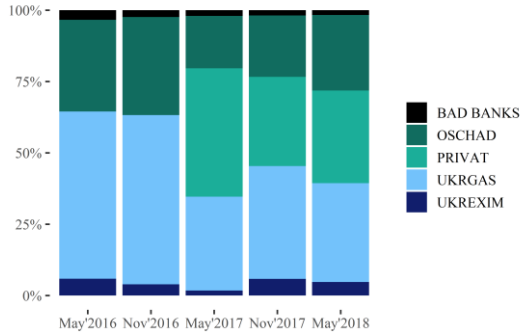


Fig. 4: Municipal deposits structure: breakdown by banks, %

Prior to the nationalization of PrivatBank, LAs held deposits in three state-owned banks (excluding deposits in liquidated banks): Ukrgasbank, Oschadbank and Ukreximbank. However, after the inclusion of PrivatBank in the list of banks, which are allowed to hold deposits of local governments, already in May 2017, it became the leader by this indicator, actually "taking away" part of the market of all other banks.

The largest shares were lost by Ukrgasbank and Oschadbank. In our opinion, the possible reasons for the popularity of PrivatBank among LAs are: a) higher deposit rates compared with competitors immediately after nationalization (see Figure 7); b) convenience of obtaining banking services; c) the developed network of the bank (it has 2 215 branches, Oschadbank - 3 127 branches) [17].

However, in the course of six months, a certain correction took place: Ukrgasbank restored its leadership position in the municipal deposits market; Oschadbank and Ukreximbank also increased their deposit balances, while PrivatBank gradually reduced its market share. As of 1.06.2018, the distribution of municipal deposits' balances is as follows:

• Ukrgasbank-5 545 UAH mln, 328 deposits (35% of the market);
• PrivatBank – 5 198 UAH mln, 239 deposits (33% of the market);
• Oschadbank - 4 235 UAH mln., 245 deposits (27% of the market);
• Ukreximbank -759 UAH mln, 19 deposits (5% of the market).

In our opinion, low rates of Ukreximbank are due to the undeveloped network of branches (69 departments as of 01.04.2018) and a strategy focusing on corporate segment [18].

Thus, the market for municipal deposits is divided between four banks with state capital, which, on the one hand, guarantees the return of deposits, in contrast to the previous negative experience of cooperation with already abolished domestic financial institutions, and, on the other hand, state preferences affect not only competition in the banking market, but also increase the burden on the state budget due to the low operational efficiency of the banks surveyed. At the same time, there are a number of private banks, including European ones, whose reliability and effectiveness have been verified by the financial crises of previous years.

4.4. Deposits of local authorities: breakdown by regions

Deposits of local budgets by regions are unevenly distributed. The maximum amounts of deposits are concentrated in the budgets of Donetsk (4 UAH bln), Dnipropetrovsk (2.2 UAH bln) and Kharkiv regions (1.2 UAH bln). However the absence of deposits in existing banks in the Kyiv budget is noticed. This may be due to the requirement of the Procedure for placing temporarily free funds of local budgets on deposit accounts in the absence of the date of the allocation of temporarily free funds of overdue accounts payable for the relevant fund of the local budget.

In fig. 5, 6 shows the balance of deposits by regions and banks at the beginning and end of the period under investigation. Decoding of the code of the administrative units is given in Annex 1.

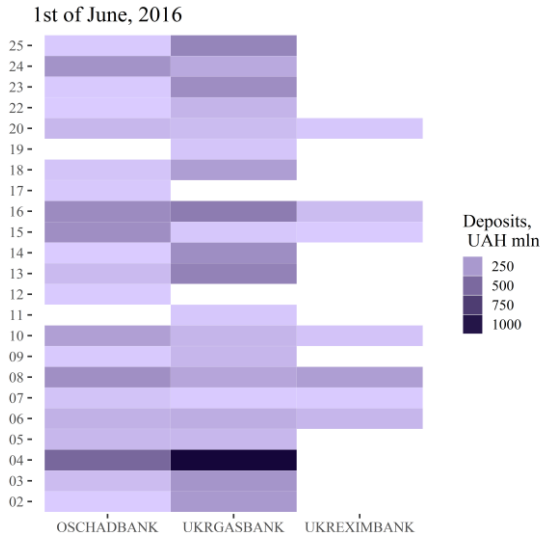


Fig. 5: Municipal deposits breakdown by banks and regions, UAH mln, as of June 1st, 2016

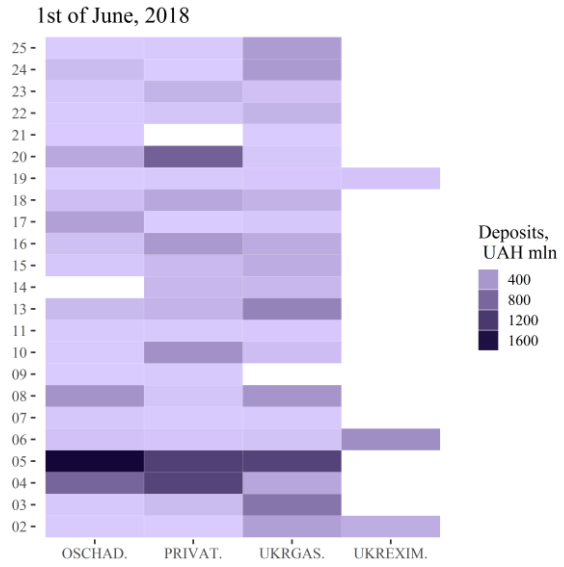


Fig. 6: Municipal deposits breakdown by banks and regions, UAH mln, as of June 1st, 2018

As noted above, in 2016 only three banks were eligible to receive municipal deposits; in 2017, PrivatBank was included in the list.

As of May 2016, local communities from 21 regions allocated deposits in Oschadbank and Ukrgasbank, LAs of 7 regions had deposits in Ukreximbank. The given data testify to the prevailing diversification of deposits in the context of banks. Thus, in 2016, only four regions had deposit accounts in one bank: Kirovograd and Ternopil regions - in Ukrgasbank, Luhansk and Rivne regions - in PrivatBank. The remaining regions allocated deposits in two or three banks. In particular, local authorities of Zhytomyr, Zakarpattia, Zaporizhzhia, Odesa, Poltava and Kharkiv regions saved money in all authorized banks.

Top 5 regions that allocated deposits in Oschadbank, as at 01/06/2016:

• Dnipropetrovsk region - 22 deposits totaling 514 UAH mln (of which 12 deposits amounting to 495 UAH mln are located in the Dnipropetrovsk Region Council);
• Zaporizhzhia region-1 deposit of 300 UAH mln (allocated by the Zaporizhzhia Regional Council);
• Odesa Region - 2 deposits totaling 306 UAH mln (of which the Odesa city council placed a deposit amounting to 299 UAH mln);
• Poltava Region - 5 deposits for a total amount of 325 UAH mln (of which 1 deposit is formed by the Poltava City Council for the amount of 166 UAH mln);
• Chernivtsi Region - 6 deposits for a total amount of 281 UAH mln (of which 3 deposits amounting to 276 UAH mln are created by the Chernivtsi City Council).

Top 5 regions that opened deposits in Ukrgasbank, as of June 1, 2016:

• Dnipropetrovsk Region - 51 deposits for a total amount of 1 UAH bln (of which 12 deposits of the Dnipropetrovsk Region Council amounting to 495 UAH mln);
• Lviv Region - 7 deposits totaling 370 UAH mln (of which 4 deposits in the city of Lviv amounting to 355 UAH mln);
• Poltava Region - 6 deposits for a total amount of 401 UAH mln (one of them is 1 deposit in Poltava city in the amount of 199 UAH mln and Gorishni Plavnina 100 UAH mln);
• Cherkassy region - 19 deposits for a total of 311 UAH mln (of which 2 deposits of Cherkasy city for the amount of 258 UAH mln);
• Chernihiv region - 39 deposits for a total amount of 355 UAH mln (of which 37 deposits in the city of Chernihiv for the sum of 340 UAH mln).

The tendency to allocate funds to various banks at the region level increased in 2018 – there was no aregion that held deposits in one bank, whereas three regions (Vinnytsia, Zhytomyr, Ternopil) placed deposits in all banks authorized by the state. Most regions were clients of three banks - Oschadbank, PrivatBank and Ukrgasbank.

Significantly reduced the number of regions holding deposits in Ukreximbank - from 7 in 2016 to 3 in 2018. Possible explanation that the attraction of deposits is not a priority region of this bank. Thus, according to the Charter, its activities are aimed primarily at supporting the activities of export-oriented producers. Instead, the remaining banks in the Charter among the priority regions of work indicated the attraction of deposits from a wide range of legal entities and individuals **[**19**]**.

Top 5 regions that allocated deposits in Oschadbank, as of June 1, 2018:

• Dnipropetrovs'k region - 30 deposits totaling 814 UAH mln (of which 7 deposits Dnipropetrovsk Region Council amounting to 730 UAH mln);
• Donetsk Region - 14 deposits for a total amount of 1.7 UAH bln (including 5 deposits from the Donetsk Regional Council amounting to 1 UAH bln);
• Zaporizhzhia region - 2 deposits for a total amount of 437 UAH mln (one of them is a deposit of Zaporizhzhya Region Council amounting to 430 UAH mln);
• Rivne Region - 7 deposits for the total amount of 334 UAH mln (of which 4 deposits from the Rivne Region Council amounting to 295 UAH mln);
• Kharkiv region - 39 deposits for a total amount of 266 UAH mln (out of which 8 deposits in the city of Kharkiv amounting to 200 UAH mln).

Mykolaiv region authorities have no deposits in Oschadbank.

Top 5 regions that have allocated deposits in PrivatBank as of June 1, 2018:

• Dnipropetrovsk region - 35 deposits totaling 1.1 UAH bln (including 2 deposits of the Dnipropetrovsk Regional Council amounting to 550 UAH mln);
• Donetsk Region-10 deposits totaling 1.1 UAH bln (including 5 deposits of the Donetsk Regional Council amounting to 1 UAH bln);
• Kyiv region - 12 deposits for the total amount of 453 UAH mln (out of them 4 deposits of Boryspil city in the amount of 270 UAH mln);
• Poltava region - 10 deposits for the total amount of 457 UAH mln (including 3 deposits of Poltava city for the amount of 376 UAH mln);
• Kharkiv Region - 35 deposits for a total amount of 848 UAH mln (of which 17 deposits of the Kharkiv Regional Council amounting to 811 UAH mln).

Kherson region authorities have no deposits in PrivatBank.

Top 5 regions that have opened deposits in Ukrgasbank, as of June 1, 2018:

• Volyn Region - 43 deposits totaling 675 UAH mln (of which 24 deposits of the Volyn Regional Council amounting to 602 UAH mln);
• Donetsk region - 7 deposits totaling 1.1 UAH bln (including 5 deposits of the Donetsk Regional Council amounting to 1 UAH mln);
• Zaporozhye region - 1 deposit for the amount of 422 UAH mln (Energodar city);
• Lviv Region - 9 deposits totaling 380 UAH mln (including 6 deposits, Lviv for the amount of 555 UAH mln);
• Chernivtsi Region - 9 deposits for a total amount of 565 UAH mln (including 1 deposit in Chernivtsi for a sum of 260 UAH mln).

There are no deposits of the Ivano-Frankivsk region in Ukrgasbank.

4.5. Interest rates changes of local authorities' deposits

During 2016-2017, there was a general tendency to reduce deposit rates, partly due to the NBU's effective monetary policy for inflation targeting and macrofinancial stabilization after the crisis of 2014-2015. However, with the fourth quarter of 2017, the trend is maintained by increasing the NBU key rate, which, in turn, stopped a further drop in deposit rates in general on the market. However, in the segment of municipal deposits concentrated in four-state banks, a significant drop in the average rate of 4% continued, causing significantly lower interest income compared to previous periods for the local authorities. The reasons for this phenomenon, which are most likely to change the institution's deposit policy, require further study.

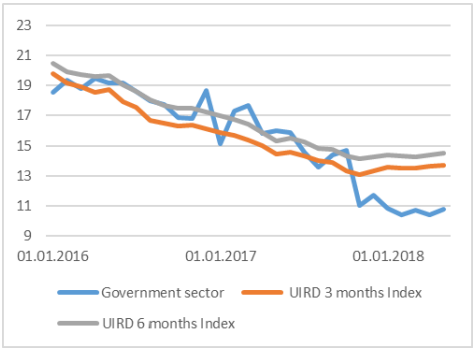


Fig. 7: Dynamics of the deposit rates and NBU key rate during 2016-2018

Figure 7 illustrates the dynamics of the distribution of deposit rates for municipal deposits during the investigated period. It also indicates a significant decline in municipal deposit rates during the first five months of 2018, although part of the LAs retained deposits for abnormally high exposures (as indicated by points above the top of the main data area). The significant variation of rates in 2017 (as indicated by the breadth of the main data area) is due to the PrivatBank's entry into the market with high deposit rates (see Figure 8).

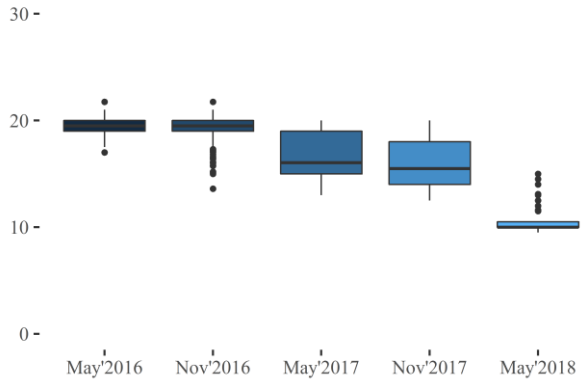


Fig. 8: Deposit rates of the municipal deposits during 2016-2018

During the reviewed period, rates on municipal deposits decreased almost twice - from 20% in May 2016 to 10% in May 2018. Possible reasons: lower inflationary pressure and inflationary expectations, restore confidence in the banking system, reduce the country's risks, clean up the banking system from unreliable banks that held high deposit rates, as a result of which other banks disappeared incentives to price competition.

A more detailed structure of rates in terms of banks and investigated periods was considered.

Data show that during 2016-2017, Oschadbank, Ukrgasbank and Ukreximbank simultaneously adjusted the rates on municipal deposits. Thus, in May 2016, they stayed at about 20%, during 2017 - the first half of 2018, there was a further decline - in May 2018 they were about 10%. Excludes Ukreximbank, whose rates are 3% higher than their competitors.

PrivatBank, appearing in the market in 2017, has set higher rates in comparison with other banks - at the level of 18%. This is due to the effort to diversify the resource base and the historically high cost of attracting deposit funds. Such a strategy allowed PrivatBank to rapidly increase the volume of municipal deposits and became the second player in this segment of the deposit market, replacing Oschadbank to the third position (see Figure 9).

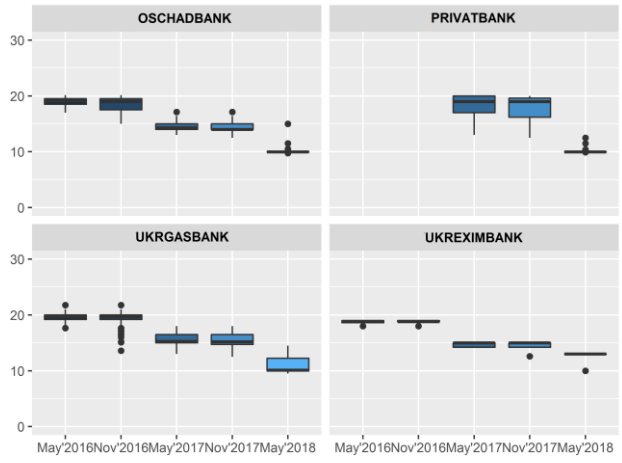


Fig. 9: Municipal deposit rates: distribution by banks during 2016-2018

Table 1. Codes of the regions used in charts

Codes	Regions
01	Autonomous Republic of Crimea
02	Vinnytsya Region
03	Volyn region
04	Dnipropetrovs'k Region
05	Donets'k Region
06	Zhytomyr Region
07	Zakarpattya Region
08	Zaporizhzhya Region
09	Ivano-Frankivs'k Region
10	Kyiv Region
11	Kirovograd Region
12	Luhans'k Region
13	Lviv Region
14	Mykolayiv Region
15	Odesa Region
16	Poltava Region
17	Rivne Region
18	Sumy Region
19	Ternopil Region
20	Kharkiv Region
21	Kherson Region
22	Khmelnytsky Region
23	Cherkasy Region
24	Chernivtsi Region
25	Chernihiv Region
26	The City of Kyiv
27	The City of Sevastopol

5. Conclusions

Over the past years, the tendency towards the transfer of funds from local authorities to deposit accounts in four state-owned banks of Ukraine, characterized by low operational efficiency, high level of asset distress and weak corporate governance, has intensified. Thus, as a result, the interest earned by local communities is generated by investing in the development of state-owned banks from the state budget.

The situation outlined causes two negative externalities for society: firstly, funds placed on deposits may be distracted from the implementation of socio-economic projects at the local level, and secondly, the pressure on the state budget is increasing due to the need to support the state banks.

Ukrgasbank turned to be the leader in municipal deposits segment in Ukraine. At the same time, in the general deposit market, its share is the smallest among the rest of the state financial institutions, and it's network is 13 times less than Oschadbank and 9 times than PrivatBank. Taking into account the intentions of the Ministry of Finance of Ukraine to begin the full privatization of Ukrgasbank already in the current year, significant changes can be expected in this segment of the deposit market, provided that the existing legislative requirements for deposits allocation are maintained only in banks with a state interest of at least 75%.

PrivatBank is the second financial institution in municipal deposits market, which entered this segment right after nationalization, and caused the market share redistribution. While Ukrgasbank retained its leadership position, Oschadbank moved from second place to third during the analyzed period. The smallest share belongs to the Ukreximbank, what can be explained by its corporate strategy without focusing on deposit market.

Deposits of local authorities are heterogeneously distributed by regions. The maximum amounts of deposits are concentrated in the budgets of Donetsk (3.9 UAH bln), Dnipropetrovsk (2.2 UAH bln) and Kharkiv regions (1.1 UAH bln). The absence of deposits in banks in Kyiv municipal budget has to be admitted.

Positive phenomenon for state budget and banking systems was the leveling of abnormally high rates that PrivatBank dictated to its competitors during the first year after nationalization. The overall decrease in the cost of municipal deposits reduces incentives to diversify the financial resources of local budgets.

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