Credit Cards in Ukraine.

Macro-economic conditions in Ukraine

Compared to other East-European transitional countries, Ukraine is a relative late-comer onto the credit card market scene -- first Visas and MasterCards were not issued until 1996, and the market had not had a real chance to develop until after the financial crisis of 1998. This reflects Ukraine's overall experience with transition, which has been one of the most difficult and protracted in the former Soviet block. The recession and the fall in real GDP that occurred in all of the transitional countries starting in 1990-1991 continued in Ukraine until 2000 – the first year economy showed any positive growth. As a result of the recession, real GDP in 1999 was only 40.8% of its 1990 level. Even in 2005, after 6 years of strong economic growth (in 2004 it surpassed 12%, taking Ukraine to the lead among the CIS countries), Ukraine's real GDP was still at less than 2/3 of its pre-transitional level.[1]

Starting in 2000, Ukraine embarked on a period of economic growth, when real wages were rising at a rate of between 15% and 24% annually. And it continues today. According to the Ukrainian State Statistical Committee, economy grew 6.2% during the first nine months of 2006, which was the highest growth rate in all of Eastern Europe. Inflation was registered at 5.2%. Real nominal income rose 17.8%. Average nominal wage increased during this period to 993.61 UAH, which is 32.2% higher than during the same period last year. It is now twice as high as the living minimum income in Ukraine (496 UAH). Disposable income grew a record 41% in 2005 comprising 298 billion UAH or 6,360 UAH per capita.

Growth of personal incomes was accompanied by intensified retail banking activity. While in 1999-2001, loans to individuals hovered around 5% of the total loans, starting in 2002, this number jumped to 7.9% and next year – to more than 13%.[2] At the end of 2005, the volume of loans to individuals constituted 25% of total bank loans. The volume of deposits held by Ukrainian banks grew by 59.9% in 2005 and reached 132.9 billion UAH, and household deposits grew faster than deposits of organizations (75.9% and 43.8% respectively).[3] The volume of bank loans grew by 61.9% to 143.4 billion UAH. And again, the volume of consumer loans grew much faster than the volume of corporate loans, increasing 2.3 times from 14,8 billion UAH at the end of 2004 (4,808 billion UAH in the city of Kiev) to 33.5 billion UAH by the end of 2005 (9,730 billion UAH in the city of Kiev), whereas corporate loans only grew 49% reaching 109.9 billion UAH by the end of 2005. By September 2006, the volume of lending to households almost doubled, reaching 62.4 billion UAH (17,3 billion UAH in Kiev alone).

Who are potential cardholders and how many are there?

In the West, it is the middle class that is traditionally viewed as the target audience for mass consumer credit markets. However, transitional specifics of the post-communist region make any estimates of the size of the middle class difficult. Figures published by different sources vary, sometimes significantly, and usually spark lively academic debates about which criteria to use. Objective estimates, which usually consider such characteristics as income, education and occupation are contradictory because whole categories of people may have high level of education but low income (doctors and teachers working in the public sector), or nonprofessional occupations but high income. Those analysts that insist that all three criteria must obtain for someone to belong to the middle class, as a result come up with estimates that are too low. For example, Kiev Gorshenin Institute conducted a general representative survey of Ukrainians in April of 2007 and estimated that only 8.9% of Ukrainians belonged to the middle class. [4] Subjective estimates also vary wildly, and in general are problematic because respondents may report their aspirations -- hardly a useful measure of the potential market for credit cards. According to the same survey by Gorshenin Institute, a third of respondents self-identified as the middle class. Kiev Razumkov center, which only surveys self-ascribed status, reported that 46.5% of Ukrainians claimed they belonged to the middle class in 2002. In 2005, one of its leading researchers reported that about 62% of Ukrainians identified themselves as belonging to the middle class (and 30% indicated they belonged to lower class).[5] According to the Word Bank data, the national poverty rate (estimated as 1813 UAH per person per year) fell significantly from 32% in 2001 to less than 8% in 2005. At the same time, the rate of IT ownership and use continues to climb. The World Bank reports that in 2005 there were 256 telephone main lines, 366 mobile subscribers (up from 17 in 2000) and 97 Internet users per 1000 people. PCs were owned by 38 out of 1000 people and 96% of the population was covered by mobile telephony.[6]

The Structure of the Retail Banking.

Ukrainian banking sphere remains heavily concentrated in the capital city of Kiev. By January 1 2007 there were 169 banks licensed by the National Bank of Ukraine to perform financial activity, and 100 of them were registered in Kiev.

The two leaders of the retail banking market are Privatbank and Raiffeisen Bank Aval (a product of a recent purchase of the second largest Ukrainian bank by the Austrian-based retail bank). For instance, they claim 15.2 bln UAH and 11.6 bln UAH respectively in household deposits, and 11.6 bln UAH (18%) and 10.5 bln UAH (16%) respectively in loans to individuals.

Their closest followers in the household deposit market, Prominvestbank, Oshchadbank (former Soviet retail bank, an equivalent of Russia's Sberbank) and Ukrsots, report 7.6 bln UAH, 7.5 bln UAH and 5.1 bln UAH respectively. In the market for consumer loans, the two leading banks are followed by Ukrsibbank (9.8 bln UAH), Ukrsotsbank (7.0 bln UAH) and OTP bank (4.6 bln UAH).

But in the market for plastic cards, the definite leader is Privatbank, claiming over 12 million cards (30.5% of the total), with Raiffeisen Bank Aval and Nadra sharing the second place with 5.5 million and 5.2 million cards (13.8% and 13.2% respectively). Market shares of the next three banks, Prominvestbank, Ukrsibbank and Ukrsotsbank are less than 6% each. Retail banking in Ukraine is not as concentrated as it is in Russia. In Russia, Soviet-period state-owned giant Sberbank accounts for more than 50% of the consumer credit market, and attracts more than 60% of household deposits. In Ukraine, top two consumer lenders control 34% of the market, and top three card issuers control 57% of the market. But just 2 years ago, in 2004, top 5 card issuers controlled 53% of the market.

Privatbank is also the largest acquirer, with more than 27,000 merchants' POS terminals. Raiffeisen Bank Aval is distant second with 4,351 POS terminals.[7]

All of the leading retail banks are part of the "largest banks" group of 15 (based on the classification of the National Bank of Ukraine).

Foreign Capital

Foreign capital continues to play an increasingly more important role in the banking sphere of Ukraine, more so than in most other ex-Soviet countries. According to the latest data from the National Bank, 40 banks out of 173 operating on the territory of Ukraine have some foreign capital, 18 of them are 100% foreign-owned. Foreign capital now comprises close to 30% of the combined statutory capital of the banking sphere (up from 9.6% at the beginning of 2005) (Ukrainian National Bank 2007). With the purchase of Aval bank (the second largest by assets, capital and household deposits) by the Austrian-based Raiffeisen Bank (7th largest in Ukraine) in 2005, the Raiffesen Bank Aval became the largest banking group in Ukraine (combined share in the market's total banking assets amounted to 11.9% as of July 1 2005).[8]

In addition, Ukraine's recent interest in organizing credit bureaus, prompted several leading credit bureaus to pay promotional visits to the Ukrainian Banks' Association and to several large banks. Visa Inc. has recently reported that it would support the "Global Credit Bureau Program" of the International Financial Corporation to help establish credit reporting in developing and emerging markets. The target countries include Brazil, Bulgaria, Nigeria, the Philippines, Romania, Ukraine, the United Arab Emirates, and Vietnam.[9]

The Structure of the Credit Card Market

As of January 1, 2007, 111 Ukrainian banks were members of domestic and international payment card systems. Total number of payment cards, issued by Ukrainian banks in 2006 (effecting at least one transaction within a year) increased by 31% from 24.8 million to 32.5 million pieces. This puts Ukraine in the second place in East and Central Europe by the number of issued cards after Russia. In 2004, Ukraine was third but has since overtaken Poland. In 2000, Ukraine was in the 12th place in the CEMEA region by the number of Visa cards issued.[10] In 2006, Ukraine is in the third place after Russia and South Africa.

If only credit Visa cards are considered, Ukraine is in the second place in the CEMEA region after South Africa with approximately 1.5 million cards (Russia is behind with only 0.5 million but a population three times that of Ukraine).[11] In 2006, the number of cards per capita in Ukraine increased to 0.69, which is higher than in Russia and Poland, and comparable to that of Hungary, the Czech Republic and Slovakia. Only the small countries of Slovenia, Lithuania and Estonia have significantly higher cards per capita indices (1.43, 1.04 and 0.89 in 2005) in the East and Central European region.

In 2006, the number of transactions with payment cards issued by Ukrainian banks increased by 41% and equaled more than 458.6 million (a little over 14 transactions per average card per year), while transaction volume increased by 53% to 152.6 UAH billion (4,695 UAH per card per year).

The majority of cards issued by Ukrainian banks are **international-brand debit cards** (Visa Electron and Cirrus/Maestro issued by MasterCard). Unlike Russia, Ukraine was fairly late to start issuing cards. By the time large Ukrainian banks initiated their card programs, international brands were active all over the East European region, and rather than reinventing the wheel with their local card brands, Ukrainian banks joined existing card networks. There are two local interbank card brands in Ukraine: UkrCard, which claims 40 banks as its members, most of them medium or small in size and none of them among card market leaders,[12] and NSMEP (National System of Mass Electronic Payments, promoted by the National Bank), claiming 34 banks as its members,[13] again none of the top issuers, which seem to only issue Visas, MasterCards and, sometimes, AmEx.

Debit cards dominate, with only 7 million cards offering overdrafts and credit lines by the beginning of 2007.[14] Not surprisingly, cash withdrawals also dominate over non-cash payments. The volume of non-cash payments comprises only 3% of the total transaction volume. But the number of overdraft and credit cards is growing fast, adding between 250 and 350 thousand credit cards monthly.[15] This growth is positively correlated with the rise in the relative volume of non-cash purchases in the total card volume. While the volume of cash withdrawals increased by 51 055 UAH million (53%) and equaled 147,597 UAH million, the volume of cashless payments grew by 1853 UAH million (58%) and amounted to 5,049 UAH million (equivalent of $1 million).[16] Another factor in the growth of non-cash payment volume is banks' investment in non-cash payment technology: in 2006, the number of POS terminals on the territory of Ukraine increased 46%, while the number of ATMs only increased 30%, and the number of imprinters decreased 11%. Although Ukraine is making progress, in comparison with other CEMEA countries it is far behind South Africa (with $12 billion worth of purchases) and Russia (with about $4 billion worth of purchases, where volume of cashless transactions comprises 9% of the total, according to Lu Naumovsky[17]).

Marketing and Pre-Screening for Overdraft and Credit Cards.

The main route of card distribution in Ukraine has been salary projects -- setting up an agreement with an enterprise to have all its employees' salaries directly deposited to the bank and issuing cards that are used to access salary accounts (Guseva 2005). These have typically been debit cards, but recently more and more banks are offering 50%-70% overdrafts on those cards. Salary projects solicited the help of employing organizations in disseminating cards to individuals via bi-level networks, those that contain nodes of two different levels, both individuals and organizations (Guseva 2008). But this did not compromise banks' ability to control uncertainty because individuals were firmly anchored in organizational structure, and their regularly paid wages guaranteed repayments.

Ukrainian banks have only recently started issuing credit cards. In 2004 when the interviews were conducted, there are very few banks that issued cards with a credit line, and predominant majority of those credit lines were collateralized. So-called "blank" (unsecured) credits were only issued to VIP clients.

Those banks that offered cards with credit lines conceived of them as mixtures of two products bundled together – consumer loans and plastic cards. Consequentially, two units of the bank were responsible for approving applications and servicing card accounts: plastic card departments supervised the technical side of the process (generating PINs and monthly statements, monitoring transactions, etc.), while credit departments focused on risk management (pre-screening applicants, figuring out the size of the credit line, working with "problem" accounts). The process of applying for a credit card involved filling out two applications to be processed simultaneously: one for a plastic card and the other for a consumer loan. To be approved for a consumer loan and therefore for a card with a credit line the applicant typically would have to either be connected to the bank (for example, as an owner or a senior administrator of the bank's corporate partner or large corporate client) or be willing to provide a collateral or a guarantee. Most commonly, banks accepted deposits as such security provisions (size of the loan varying between 50% and 100%), but some also stated that non-liquid collateral (a new foreign-made car, for instance) or even 3rd person guarantees (including those from employers) could also be accepted.

The banks we interviewed differed significantly on their risk management strategies. Some preferred to take a cautious approach claiming that they "don't work with people 'from the street'," underscoring the importance of having a tie to the bank (even as attenuated as being an employee of the bank's corporate client) as a basis for card issuing. They were practicing 'preventive' strategy with a goal to minimize late payments, defaults and fraud. As a result, such banks claimed that their default rate was close to zero: *"We give loans to those that will definitely pay." "We do not have any defaults because credit cards are issued to people with whom the bank has stable relations."* Stable relations in this case gave banks assurance that even if there are problems with repaying borrowed amounts, individuals would be willing to honestly communicate with the bank and work out an acceptable repayment schedule rather than lie or disappear. The strategy that relies on social ties would be severely limiting had it not been for salary projects, which now routinely carry overdraft features. But most careful banks mandated formal guarantees even in the case of salary projects. In one, for example, we were told that the enterprise was required to formally guarantee repayment, or if it could not, the risk of non-payment could be insured by an affiliated insurance company (with an average premium of 1.5% of the size of overdraft).

Others banks, on the contrary, pursued what can be termed a 'compensatory' strategy arguing that "*anybody can get a loan as long as they make a deposit*." This approach made consumer loans and credit cards available to a larger, more inclusive group of potential customers that did not necessarily have to be affiliated with any organizational bodies. Banks believed that collateral would either deter cardholders from breaching terms of the contract, or in any case, would compensate the bank for possible losses.

At the time that the interviews were conducted, the majority of banks pursued a largely "qualitative" approach to pre-screening analysis and decision-making. They relied on case-by-case manual verification of application information, on personal recommendations (formal or informal) and on first-hand impressions of applicants by credit officers, while delegating ultimate decision-making on overdrafts and credit limits to credit committees -- boards of several bank experts representing different bank divisions. As one of our interviewees tellingly responded to the question whether any mathematical formulas were used by the credit committee, "*we do not use formulas; after all we are not launching rockets*." Granted, many banks were only tentatively entering retail banking at that time having previously established themselves as large corporate banks, and were only dealing with a small number of applications (several a week) making such a labor-intensive approach viable.

In 2006, the largest card issuers started to widely market credit cards that no longer required potential cardholders to have a deposit in the same bank. Such cards typically offer modest "base-line" credit lines – from 500 UAH (approximately $100) to 2000 UAH ($400). Some banks offer much higher credit lines. Bank Nadra, for instance, offer uncollateralized credit lines up to 3 times one's monthly salary, or even up to 6 times the monthly salary if it is directly deposited to the bank. As a result, owners of electron cards (Visa Electron Credit and MasterCard Electronic can get credit limits up to 2500 UAH), those who apply for classic cards (Visa Classic and MasterCard Mass) can request up to 10,000 UAH credit limits and so forth up to 50,000 UAH on platinum cards. To verify monthly wage banks usually require an employer-procured confirmation of the size of one's compensation for the past 6 months. Credit cards issued by the largest issuers, Privat, Raiffeisen Bank Aval and Nadra, offer grace periods from 30 to 45 days.

The change in marketing meant that banks were suddenly faced with a large number of strangers with no ties to bank officers. It challenged banks to improve methods of screening and controlling cardholders, to move from time-consuming case-by-case verification and decision-making to more standardized methods, which allowed processing applications and arriving at decisions *en masse*.

Representatives of only two banks among the fourteen we interviewed claimed that their specialists were developing scoring models, but in 2004 they were not used yet. Experian and few other foreign vendors of scoring solutions repeatedly visited Ukraine making presentations on the virtues of credit scoring, and trying to get banks to buy their products. None of the banks interviewed admitted purchasing anything from them.

A few banks reported using a point system, where they attempted to formalize characteristics of applicants. Superficially, point systems resembled scoring in that qualitative characteristics were quantified (and banks usually referred to their point systems as "scoring"). But unlike true scoring, variables and weights in point systems were developed by banks experts based on their experience and common sense rather than based on statistical analysis of past data. Besides, variables and weights were changed only rarely, usually in response to exogenous changes, such as passing of new laws or market conditions changes. Several banks provided details of their point systems: they focused on social status, financial conditions and applicants' past history. In some cases, they also included subjective evaluation of applicants by the officers accepting applications (they are called "credit inspectors" and in one of the banks they were referred to as "unqualified psychologists," emphasizing their knack at seeing applicants through). Point systems were developed in-house, sometimes based on the information about point systems used in other banks (a by-product of interfirm mobility) or presentations by foreign developers of scoring models. Surprisingly, despite their promise of helping banks standardize, rationalize and expedite processing of applications, point systems rarely replaced the tried-and-true case-by-case analysis. While not reaching a pre-determined cut off point may have lead to a rejection of an application, final decisions were made by credit committees. The total number of points was only one of the factors committee members considered.

One of the central challenges of pre-screening is getting around the problem of bad data. Income data is notoriously unreliable because many employers pay only a portion of workers' compensation as official "white" salary, the rest in cash or in some other way, which allows both employers and employees to lower their taxation burden.

It is important to know applicants' income because the size of the overdraft or credit line depends on it. Some banks only work with "white" income requiring applicants to submit an official pay stub from the employer. Others try to estimate total income (or its unreported portion) based on indirect proxies, such as place of work and job position. Credit inspectors claim that they have a general idea of how much different industries/specialties/positions should pay. Here they also take into consideration whether the applicant's specialty is common enough for employment not to be a problem in case he or she is fired from the current position. Consider, for instance, the difference between an attorney and a harp player. The latter would probably have significantly more difficulty finding another orchestra to play than the latter finding another firm to work for. Other proxies include education, and life style. The latter includes evaluations of appearance and manners (that most likely stand for honesty and overall status) as well as a more specific issue of consumption. For instance, in more than one banks credit officers ask prospective applicants where they take their vacations. The desirable response is somewhere abroad. But lying about this may not work, as credit inspectors are trained to probe further with questions about the specifics of foreign destinations. Based on the results of the interview, credit inspectors sometimes write short narratives where they can share their intuitive gut feeling about applicants. In some banks these evaluations are further formalized through point systems, in others used separately by credit committees when making the final decision.

A few banks asked applicants to state unofficial portion of their income and use it in their point system at a discount of about 20%. One uses a ratio of "white" portion to the total self-reported income in its point system, higher scores given to those with higher ratios.

In addition, pre-screening relied on various rules, also developed by bank experts. Besides streamlining pre-screening, rules play an important role to help control relatively inexperienced managers of regional branch offices.

State Involvement

The Ukrainian state had a long-standing interest in exerting a greater control over financial transactions and payments in order to increase economic transparency, reduce the size of the gray economy and improve tax collection. To reach these goals, it initiated two measures: the launch of a national card brand by the National Bank of Ukraine, and legislation of compulsory acceptance of cards by retail establishments of a particular kind and with annual turnover above the certain level.

The National Bank of Ukraine created the National System of Mass Electronic Payments – a multibank network of issuers and acquirers of local brand NSMEP cards. Unlike the majority of cards issued in Ukraine which have a magnetic stripe, NSMEP cards are smart (microprocessor or chip) cards. The National Bank argued that the adoption of this system would speed up payment settlements, increase the rate of non-cash payments in Ukraine, and attract significant cash resources of the population into banking circulation. Currently, only about 3% of the total volume of card transactions in Ukraine are non-cash payments.[18]

The pilot stage of the project was completed in 2004, and for more than two years the system has been fully in operation. As of May 30, 2007 it involves 34 banks, which issued almost 1.5 million cards, established 3 594 card-accepting terminals. One-day turnover (May 29 2007) is 45 million UAH. The accumulated total turnover of the system over the period of its operation is 39 billion UAH. [19]

In 2006, in an attempt to move from away from cash-based disbursements of stipends to college students, NSMEP-member banks carried out the program of issuing NSMEP cards in 7 universities across Ukraine. Eleven thousand cards were issued, and the intention is to gradually widen the program to include other schools. The "Student Card" program is viewed as the first step towards the implementation of the "Social Card" program, planned for 2007-2008, which intends to transfer payments of other state-provided social benefits (such as pensions, unemployment, disability and maternity compensation).

In 2006, national post office (Urkposhta) joined NSMEP as an acquirer, and NSMEP cardholders can now obtain cash, add cash to their cards or pay for services in its many braches. This is a particularly important move as post office branches are located all over the country, even in small villages, possibly giving NSMEP a leg up in comparison to traditional banks, which have to open branches if they want to reach to provinces and rural areas. Additionally, Kiev branch of telephone service provider Ukrtelecom, agreed to accept NSMEP cards. This would allow telephone users paying bills through Internet. NSMEP has just signed an agreement with the Service Center of Mobile Payments to enable mobile phone users to not only pay for mobile charges but also to use their mobile phones to manage their card accounts. In 2007, NSMEP is planning to carry out a pilot project of using cards for tax and customs paying purposes (National Bank signed agreements with the State Treasury and the State Tax Service).[20]

National Bank believes that NSMEP cards should be very attractive to use for both consumers and merchants. According to Vladimir Kharchenko, the Head of the Department of Methodology of Retail Payments of National Bank, annual per card expenditures on NSMEP cards is already much higher than it is for Visas and MasterCards, illustrating consumer demand. In 2006, it was 9,955 UAH for NSMEP cards, 5,257 UAH for Visa cards and 5,231 UAH for MasterCards.[21] Besides, he argues that merchants should prefer NSMEP cards to international brands for two reasons: first, unlike magnetic strip cards (and the predominant majority of Visas and MasterCards are magnetic cards), microprocessor cards allow to process card payments in an off-line regime, which is quicker and cheaper; second, merchant discount on transactions with NSMEP cards is 1%, while for Visas and MasterCards is two-to-three times more.

Representatives of international card brands, specifically, Europay/MasterCard Association (EMA) have been highly critical of the attempts by the National Bank of Ukraine to promote NSMEP cards in what EMA considers non-market administrative ways. This includes the initiatives to issue NSMEP cards to employees of state-owned enterprises and recipients of state and municipal benefits (students and retirees) or to have them accepted by the various state agencies (such as municipal transport, post-office and tax authority). For example, the program of the Kiev municipal government to create an automated system 'Social and transport card of a Kiev resident" for 2007-2009" contains a chapter entitled "Benefits of using mass electronic payment technology NSMEP." It promotes NSMEP cards as the only system suitable for this purpose. Meanwhile, NSMEP cards are not compatible with international EMV or ISO standards that Visa, MasterCard, AmEx and incidentally other local Ukrainian brands adhere to. To participate in this municipal program, banks would have to invest into separate equipment and technology solutions.

Another example concerns students cards – plastic cards issued to college students whose stipends are directly deposited to the issuing bank. As the salary card market was becoming saturated, banks-issuers turned towards students, establishing partnerships with several state colleges. In 2006, the Ministry of Education sent letters to colleges and universities to urge them to adopt NSMEP cards as student IDs and use them to disburse stipends. Banks that have been running student card programs were warned that they would not be allowed to continue working with universities unless they joined the NSMEP and transferred their student card programs to NSMEP platform. Those that refused lost their clients.

The number of issued NSMEP cards (1.5 mln) remains small compared to the overall number of cards issued in Ukraine (more than 32 million), the majority of which (70%-80%) are cards of international brands, Visa and MasterCard.

Besides supporting NSMEP, the state has been trying to popularize non-cash transactions, in particular, the more active use of cards in retail locations. According to several polls, one of the biggest barriers to the development of the credit card market is the precisely the small number of retailers that accept cards. Law #3120 On Payment Systems and Money Transfers in Ukraine, passed in October 2003, mandated card acceptance by retail/service organizations. In March 2006, the Ministry issued a decree specifying criteria, minimum turnover (currently at 5 mln UAH) and types of retailers, which will have to start accepting cards starting on July 1, 2007.

A new draft law # 2284 on cashless payments and the use of special payment means was registered in the Parliament in 2006. This draft law is intended to create additional means (including tax incentives) to increase the use of cards for non-cash payments. For example, it calls for greater popularity of directly deposited wages (salary cards) and cards with credit limit, promises profit tax reduction to retailers who sell more than a quarter of their volume on cards and similar incentives to individual card users. The National Bank insisted on the inclusion in the draft a provision that retailers be mandated to accept cards of at least three different cards brands (international and/or local), undoubtedly in an effort to ensure that NSMEP is accepted in addition to already popular Visa and MasterCard brands.[22]

According to the EMA, which was one of the principal lobbyists of increasing the use of cards in retail, the draft law was modeled after the state policy of encouraging card use and non-cash payments carried out in South Korea in 1998-2001. Following the 1997-1998 financial crisis, the South Korean government has been encouraging the spread of credit cards in an attempt to increase consumer spending to help the economy recover and to increase economic transparency and tax revenues. Consumers were enticed to spend by being offered tax breaks, and all household expenses of more than $35 had to be paid for by cards. Retailers with annual turnover of $18,000 or more were mandated to accept cards. Organizations that did, were given 20% tax breaks. Moreover, the state initiated a series of state lotteries for individual card users. As a result, in just three years Korean state budget revenues grew from $42 to $57 billion, the volume of non-cash payments increased 290%, and the size of "grey" economy reduced from 16% to 12% of the GDP.[23] Consumer lending also grew: credit card use has been rising at a rate of nearly 90% each year, an average Korean owning at least four credit cards. Between 1998 and 2002, the total value of credit card transactions jumped ten-fold, household savings rate declined from 23% to 10% while household debt nearly doubled.[24]

What EMA conveniently "forgets" in its report is that the spectacular South Korean consumer credit boom ended in just as spectacular bust. Throughout the three year long period, Korean banks and card companies saw few restrictions on the issuance of cards as neither their risk management strategies nor the adequacy of their reserves were closely monitored by the state regulatory agencies. Fiercely competitive banks desperate to increase their market share peddled credit cards on street corners without much or any verification of applicants' backgrounds or their current indebtedness. As a result, the number of delinquent accounts started to rise, and in late 2002 the South Korean household credit market collapsed under its own weight sending the whole economy into a downward spiral and calling for government bailout.[25] This is hardly an example Ukraine would like to emulate.

Interbank Information Sharing and the Development of Credit Reporting.

Similar to the Russian case, strict privacy clause of the Ukrainian banking law prevented banks from sharing information about their customers' account data with third parties. Cases of fraud were excluded from this protection enabling banks to create "black lists" but full-fledged credit reporting did not develop until the state legislated the formation of credit bureaus and conferred upon them the explicit right to collect and share client data.

In addition to the formal barrier, there was an informal barrier to the institutionalization of credit reporting in Ukraine. Banks suspected other banks would try to avoid disclosing full information, for instance, by keeping some of their most lucrative clients' accounts hidden. For this reason, many interviewees argued that the credit bureau had to be created by the state. All of them recognized the importance of credit bureaus, but had reservations about how the rules could be enforced. The state, they claimed, was the only agent that could effectively mandate full disclosure of information on the part of all the banks. Banks were equally concerned about regulating access to clients' financial information. They guaranteed confidentiality to their clients, but would be powerless to protect information from unauthorized use once it was passed to the third party. The state was also believed to be in a better position to guarantee information security because of its apparent impartiality. "Make us share information," one the interviewees summarized appealing to the state coercion and suggesting that incentives alone won't work. At least one of the interviewed bank officers disagreed with the proposition that the credit bureau had to be organized by the state, arguing instead that it had to be a commercial organization. If the state organized it, the process of getting information from the bureaus would be too bureaucratized, since the state would not have any incentive to work efficiently.

Even before the legislation of credit bureaus, there was a formal interbank black list, Exchange database, organized by the Association of Europay/Mastercard issuers (EMA). It operated via periodically emailed information about cardholders and merchants suspected or accused of fraud. It was used by some banks, but was not considered effective because the information there was neither complete nor updated, and only limited to fraud rather than involving late payments and defaults.

There is another black list that was initiated by the National Bank of Ukraine – the Single Information System for registering Delinquent Borrowers (CIS "List of Delinquent Borrowers") with the goal of increasing the reliability of the banking system and strengthening confidence in banks and the banking system. Upon joining the system, the bank is expected to provide regular information on clients who failed to make payments on time. The number of inquiries each member-bank can make during a working day is not limited. As of today, 127 banks participate in the CIS "List of Delinquent Borrowers," their combined assets of the banks amount to more than 75 % of the total assets of the Ukrainian banking system. Total number of banking institutions - CIS "List of Delinquent Borrowers" - participants equals 607 (including bank affiliated branches). There are currently 30,929 overdue debts registered in the CIS "List of Delinquent Borrowers" worth 4.31 billion UAH. Most of our interviewees knew about the "List" but claimed it was not very useful because both adding and obtaining information was time-consuming (inquiries were made based on a written request from the bank)

In 2003, a working group connected to the Ukrainian parliament prepared a draft law "On the organization of the formation and circulation of credit histories." The law was passed, signed by the president in 2005, and came into effect on January 30, 2006.

Today there are three credit bureaus in Ukraine, all three organized in the summer of 2005.The first bureau to be licensed was the **"Ukrainian Bureau of Credit Histories"** founded by the largest Ukrainian bank and the leader of retail banking Privatbank (based in the city of Dnepropetrovsk) and a foreign company BigOptima LTD, each partner contributing 50% of bureau's statutory capital of 29.2 тыс. UAH[26] (this seems to be in violation to the law, which sets the minimum at 5 million UAH). Today Ukrainian Bureau of Credit Histories claims to contain 10 million credit histories of both individuals and companies.[27] **"First Ukrainian Bureau of Credit Histories"** was organized by the Association of Ukrainian Banks, two insurance companies and 30 Ukrainian banks, with a statutory capital of 4.25 million UAH. Its founders claim 70% of the national retail lending market. **"International Bureau of Credit Histories"** was founded on equal terms by Ukrainian financial group TAS, National Association of Credit Unions of Ukraine and Icelandic Creditinfo Group[28] with a statutory capital of 5 million UAH. Creditinfo Group was organized in 1997 as a centralized repository of information on bad debts in Iceland, the nation of less than 300,000 people. Today Creditinfo operates in 11 countries, 7 of which are countries of the former Soviet block: besides Ukraine they are Bulgaria, the Czech Republic, Georgia, Lithuania, Romania and Slovakia. In the summer of 2006, it was announced that Creditinfo Group won a tender to provide a credit bureau system and relating services to the "First Ukrainian Bureau of Credit Histories" (FUBCH). Creditinfo Group was also offered to buy 9% of the bureau's shares.[29] As a result, FUBCH statutory capital grew to 5,050,000 UAH, and the Icelandic company became involved in two of the three currently operational credit bureaus in Ukraine. The plan by the International Financial Corporation was apparently abandoned.

Activity on card accounts is monitored, in large banks with their own processing – daily and in real time, usually with the use of an automated system that is tuned to look for particular "abnormal" activity patterns. Example of such "red flags" include several transactions close in time in the same location, purchases after a long period of no activity on the card, or transactions from certain countries like Thailand or the Philippines. But the main goal of such monitoring is to identify money laundering schemes and fraud. In the branches, especially the small ones, the same person can be monitoring overdrafts, credit lines on cards and loans. In the head office, these functions can be distributed between different divisions.

Although there are companies that specialize on collecting on unpaid debts, most banks claimed that their own security departments worked with late or non-payers, in one case even finding and pressuring relatives of a former client with an outstanding debt who fled abroad. Some reported using the court system, but most noted that this process was drawn-out (could take as long as 1 year) and would only be worth to recover losses above a certain level, or as a symbolic measure to warn potential defaulters. Representative of only one bank claimed that their bank took all cases of defaults to court and had decisions rendered quickly, usually within a month (though other banks mentioned the special ties that this bank had to the Ukrainian court system which must have assured quick and successful processing of their claims).

Ukraine does not have a personal bankruptcy law, but has been intently following the attempts to legislate it in Russia, where the Ministry of Economic Development and Trade has prepared a draft law and is about to present it to the government. [30]

The Future of Credit Cards.

One of the main weaknesses of the Ukrainian plastic card market is that cards are predominantly used to withdraw cash rather than pay at retail locations. Despite the massive campaigns to distribute cards through salary payment schemes, all that the banks achieved was to increase their depositors' base. Card-carrying workers seem to resist being turned into consumers who charge purchases on the card. This deprives banks of the merchant discount (a small percentage of each sale that the merchant pays to the bank for managing card acceptance at the shop), and more generally promotes retail banking but not consumer credit. Nor does it drive down the use of cash, or increase transparency of financial transitions, the two goals that the state is very interested to pursue.

The key barrier to the more active use of cards in non-cash transactions is a relatively small number of retail establishments furnished with POS-terminals. In the fight for a bigger market share, banks have been downplaying the development of card-acceptance among merchants. A comparison with Europe is revealing: 19,500 POS-terminals per 1 mln people in Spain, 13,000 in Italy and Britain, 12,800 in France, 7,200 in Germany, 3,000 in Poland, 720 in Russia and only 420 in Ukraine.[31] In part, this is a reflection of the fact that Ukrainian retail sector has not yet adequately developed the types of retail establishments where cards are most likely to be accepted, such as supermarkets, mega-markets and shopping malls. Existing retailers, in turn, are not eager to accept cards because electronic payments force them to make their turnover transparent for tax authorities.

Ukrainian consumers generally agree with this diagnosis – when asked to name the main factors that limit the use of cards in store, they mention insufficient number of merchants that accept plastic cards. [32] More specifically, 61% blamed the small number of stores where one could use cards, 49% -- insufficient number of cash registers equipped with POS-terminals in card-accepting retail locations, 19% mentioned that POS-terminals did not always work, or, perhaps, store assistants pretended they did not, and an equal number of respondents believed that retailers that accepted cards were located too far from where they lived. But other factors that were tied more to cultural rather than structural barriers were also mentioned. For instance, a long-standing habit of using cash for payments (only 6% of respondents claimed they were habituated to charging their purchases to a card[33]), or the central place that cash continues to hold in the incomes of Ukrainian households. 13% also agreed that existing stereotypes of consumer behavior were to blame because even those that were accustomed to using cards, mainly used them for large purchases, which they naturally did not do very often. Almost two-thirds (63%) of respondents suggested that increasing the number of card-accepting retailers would stimulate cardholders to use cards more often. About 1/3 (32%) believed that more people would use cards if retailers offered discounts on card purchases and made sure POS terminals always worked.

The Ukrainian state has been very interested in promoting non-cash payments in order to increase transparency, reduce the size of underground economy and increase tax revenues. It has already mandated card acceptance by merchants with a certain turnover and additional legislation fine-tuning this requirement is pending. July 1, 2007 is the start of the national program to install POS-terminals and promote card-acceptance all over the country.

Additionally, those particularly interested in promoting the spread of cards with credit limits (EMA or card multinationals) have been urging the state to consider implementing policies that promote lending by banks and spending by consumers as a means to encourage economic growth. In a report found on its website, EMA refers to the Korean lending boom of 1998-2002 as an example of a successful state policy, omitting the fact that it ended in an economy-wide crash and a governmental bail-out of the largest lenders.[34] Visa issued a report authored by its Korean representative Young-Chong Kim which stresses the positive aspects of popularization of credit cards among consumers and hails the Korean state policy of promoting credit cards and encouraging consumption as a positive example for other countries to emulate.[35]

It is clear to anyone familiar with the recent history of Korean retail banking that following their example to the letter is irresponsible if not dangerous. Excessively competitive banks can easily downplay the importance of risk management in pursuit of quick approvals and the ever-increasing number of cards and the volume of card spending. State policies directed to encourage lending and spending should be accompanied by the development of adequate means to help banks manage risks. Legislation and creation of credit bureaus are supposed to serve this goal. While Ukrainian credit bureaus are just starting to accumulate information, and cannot yet help banks verify one's credit history (and majority of borrowers do not yet have any credit history), current information is also very useful: it can help prevent borrowers from borrowing too much simultaneously from several banks.

The discussion above underscores the role of the state in promoting the credit card market. The state is particularly instrumental in mandating those elements of successful market development that cannot arise spontaneously due to various internal barriers. For instance, mandating of credit reporting helps overcome resistance of banks to share information with each other. Mandating card acceptance by merchants and (potentially) card use for particular kinds of transactions (municipal or utility expenses) can turn out to be critical for promoting non-cash payments. Incidentally, both types of legislation in addition to serving interests of the credit card companies also help the state reach its own goals: ensuring the soundness of the banking sphere, increasing transparency of transactions and raising tax revenues.

Methodology Appendix

Interviews with representatives of Ukrainian banks responsible for card programs were conducted in the summer of 2004. We interviewed 15 Ukrainian banks (we requested interviews from 19 banks, one declined, and we were not able to obtain agreement from 3 banks in time).

The banks varied according to the type of ownership:
State-owned – 1
Private without foreign ownership – 11
Private with foreign ownership of 50% or more – 3

They also varied according to size (based on the classification of the National Bank):
First group, "largest banks" – 5
Second group, "large banks" – 5
Third group, "medium banks" – 5

… and the size of assets:
In the top decile – 4

In the second decile – 6
In the third decile – 2
In the fourth decile – 1
In the fifth – 2

Representatives of 14 banks were interviewed in the main offices of banks in Kiev.

10 out 15 banks were among the top 20 holders of household deposits, and 9 out 15 were among the top 20 issuers of Visas and MasterCards.

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2 Schaechter, A. 2005. "Ukraine: Selected Issues." IMF Country Report # 05/20.

3 Unlike Russia, Ukraine managed to pass the law on deposit insurance shortly after the financial crisis of 1998. The law mandated the creation of the Ukrainian Household Deposit Guarantee Fund. Shortly after, 131 out of 155 registered banks belonged to the fund, which accounted for 81% of all household deposits.

4 Gorshenin Institute, http://www.fraza.com.ua/print/22.05.07/37505.html

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8 Reported on www.raiffeisenbank.co.yu on 21 August 2005

9 http://corporate.visa.com/md/nr/press264.jsp

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11 "Tsifry Visa protiv dokazatelstv Natsbanka," Kommersant-Ukraina, April 17, 2006. Retreived from www.ema.com.ua on May 31, 2007.

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19 http://www.ansmep.com.ua/

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21 "Mify o NSMEP kak sredstvo manipulyatsii soznaniem," Bankir 1(2007): 36-38. Retreived from www.ema.com.ua on May 31, 2007.

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26 http://www.creditinfo.com.ua/?PageID=1906

27 http://www.ubki.com.ua/index.html

29 http://www.cicr.cz

30 http://capitalinvest.com.ua/publication/2317/index.htm

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33 Another representative survey, by Gorshenin Institute, reports that 9.5% of respondents use plastic cards to pay for purchases, 33 http://www.fraza.com.ua/print/22.05.07/37505.html

34 “Razvitie beznalichnykh rasschetov. Chto gosudarstvo, torgovlya, bankovskaya industriya I platezhnye sistemy mogut sdelat vmeste?” Retreived from www.ema.com.ua on July 15, 2007.

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