

Banking sector recovery continues, but risks remain

Banks operating in Ukraine have considerably improved their performance during the last few years. While the sector as a whole recorded a record loss of UAH 160.5 bn in 2016 (after the nationalisation of PrivatBank, the biggest bank in the country), the corresponding figure for the first eight months in 2019 is a profit of UAH 44 bn, also in part due to a turn-around in PrivatBank.

The massive clean-up of the system, which cumulated in the nationalisation of PrivatBank, seems now largely to be over. The number of banks - currently 75 - is quite stable. Reforms improving the corporate governance of state banks and the supervision of the non-banking sector (the “split law”) have been enacted, which is a positive sign.

However, risks remain. The still high level of NPLs (53% of gross loans, in particular concentrated in state banks) needs to be addressed. Furthermore, recent events that threaten the nationalisation of PrivatBank raise new question marks, as this was considered the key cornerstone of the whole banking sector reform.

Stable number of banks

The comprehensive banking sector reforms conducted since 2014 resulted in a massive drop in the number of banks active in Ukraine. While 180 banks were operating in the country in late 2013, this number went down to 75 currently, as more than 100 banks failed, were closed or left the market voluntarily. However, during the last number of months, the number of banks remained quite stable, dropping only slightly from 77 (in January 2019) to 75 currently. Specifically, only one bank failed during 2018-2019. The process of a speedy and massive clean-up of the system has thus come to a halt.

Number of active banks

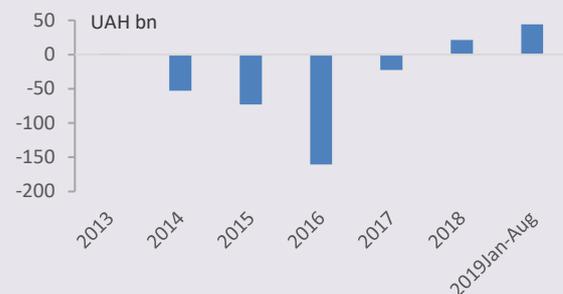


Source: NBU, own adjustments

Turn-around in profitability

Another interesting feature observed over the recent months is the sector-wide return to profitability. During 2014-2016, the banking sector as a whole recorded massive and increasing losses, as can be seen in the following figure. This development cumulated in 2016, when the sector lost UAH 160.5 bn (USD 6.3 bn). This was solely due to PrivatBank, which was nationalised in late 2016, and which was responsible for a loss of UAH 176 bn.

Banking sector profit



Source: IMF FSI

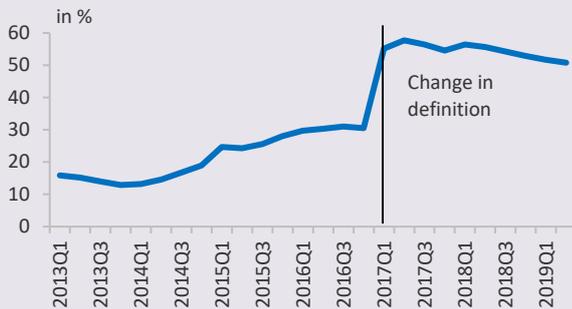
2018 marked the first year of profits (UAH 21.2 bn), a number which was already surpassed during the first eight months of 2019 (UAH 44.3 bn). This positive trend is due to high interest rates (on both government bonds and loans) as well as a reduced need for forming loan-loss provisions. Currently, the profitability of the sector as measured by return on assets (ROA) is roughly comparable to other countries in the region, after many years of sub-par performance.

PrivatBank contributed to this turn-around, as the bank booked a net profit of UAH 12.8 bn last year, of which 90% was distributed as dividend to the state as shareholder. The bank is currently on track to top these developments – during the first half of 2019, the net profit surged to a record UAH 18.3 bn.

Non-performing loans: Still an unresolved problem

Unfortunately, where there is light, there is also shadow. One outstanding problem relates to non-performing loans (NPLs), which still exceed at 52.9% half of gross loans. This is a very gradual improvement over the previous years, but remains a key challenge going forward. The bad loans are concentrated in state banks, while domestic private and foreign banks fare significantly better in this regard.

NPLs as share of gross loans



Source: NBU

One very important financial sector reform of 2018 was related to improving corporate governance in state-owned banks (SOBs). In each supervisory board, independent (incl. foreign) members will form a 2/3 majority, shielding the bank from political interference. After transparent selection procedures, independent board members for PrivatBank, Oschadbank and Ukreximbank were appointed in June 2019. In the future, it is expected that these boards will help to improve the situation regarding NPLs.

The momentum in financial sector reform continued into this year, when the new Parliament approved the so-called “split law” earlier this month. The approved law was a key demand of the IMF and liquidates the National Financial Services Commission and delegates the authority to supervise the non-banking financial institutions (e.g. insurance companies, credit unions) to the National Bank.

Legal uncertainty around PrivatBank

While the bank has been turned around operationally, there have been worrying developments in the legal sphere. The nationalisation of 2016 was also the beginning of a number of legal battles taking place simultaneously in Ukraine, the UK, and recently also the US. The main parties involved are the former shareholders, the government (Ministry of Finance, NBU) as well as the bank itself under the new management.

Some recent court verdicts by local courts in Kyiv (which are being appealed) threaten the nationalisation process, which was and is supported strongly by the international community, including foremost by the IMF. Furthermore, the NBU recently went public with a strong statement condemning a number of systematic attacks on its ex-Governor, Valeria Gontareva, who was deeply involved in the PrivatBank nationalisation. The events in this sphere need to be watched closely, as the bank is systemically important, and cost taxpayers an amount of UAH 155 bn (currently USD 6.4 bn) so far.

Conclusion and Outlook

The banking sector recovery is picking up steam, supported by financial sector reforms. Banks are profitable, domestic currency loans growing, and the share of bank financing in investments is rising (albeit from a very low base). These are all very positive signs.

At the same time, the legal battle and the recent events around the nationalisation of PrivatBank show that recovery process is not over, and subject to a risk of reversal. Domestic and international stakeholders must be aware of the paramount importance of the reforms conducted over the last few years, which came at a high price, but were worth every penny.

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The group advises the Government of Ukraine on economic policy issues since 1994. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.



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