POLICY BRIEFING 07|2020

German Economic Team

UKRAINE

Banking Sector Monitoring Ukraine

Assessment of past reforms and COVID-19 impact

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Summary

General assessment

- Ukraine's banking system has undergone a fundamental reform process, resulting in a much more sound, yet also smaller sector.
- The current COVID-19 crisis presents new challenges to the sector, similar to the situation in other countries

Development of main banking sector indicators

- **Number of banks** stabilized at 74 after years of many bank closures
- **Market share** of state banks surged during the clean-up process and currently stands at 54% of total assets (39% of loans)
- **Financial intermediation** of bank assets and lending to the real sector have not improved materially over the last few years, and lag behind peer countries
- **Loan growth** has turned negative after some revival during 2017-19
- **Capital adequacy ratio (CAR)** signals with 22% of RWA a very stable sector
- **Profits** are recorded in the sector since 2018, as provisioning came to a halt
- **Share of non-performing loans** is still very high at 49%, but with gradual downward tendencies before COVID-19 hit the country

Introduction

Banking sector monitoring:

- Regular review of key trends in the banking sector indicators in order to assess the overall health of the banking sector

General part:

- Analysis of key indicators of aggregate banks' balance sheets, both over time and in relation to peer countries
  - Slides No. 1 - 11

Special issues:

- Special topics that became relevant over the last twelve months:
  - Slides No. a - e

Structure

General part

1. Bank assets in a regional context
2. Number of banks
3. Market shares
4. Concentration
5. Lending to the real sector
6. Loan growth
7. Non performing loans (NPLs)
8. Deposits
9. External debt
10. Capital adequacy ratio
11. Return on assets
12. Interest rates

Special issues

a) New banking law

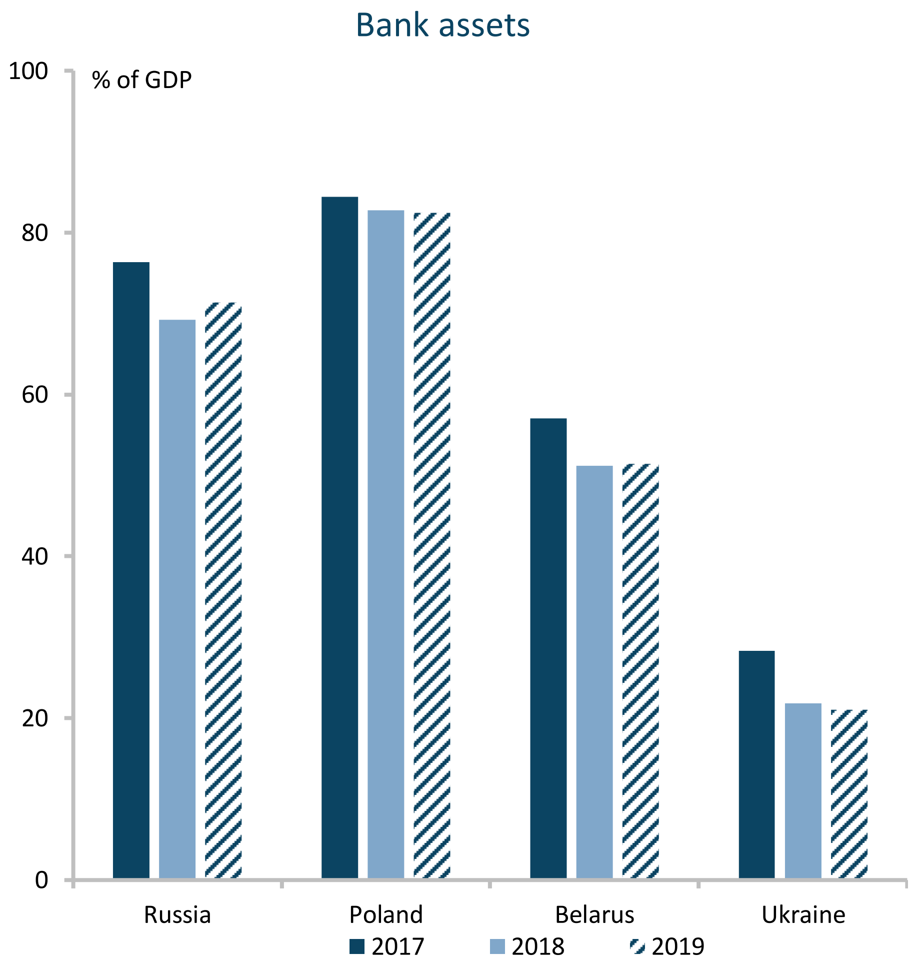
b) 5-7-9-loan programme

c) Split law and non-bank financial institutions

d) Current and future COVID-19 impact

e) Central bank independence

1. Bank assets in a regional context

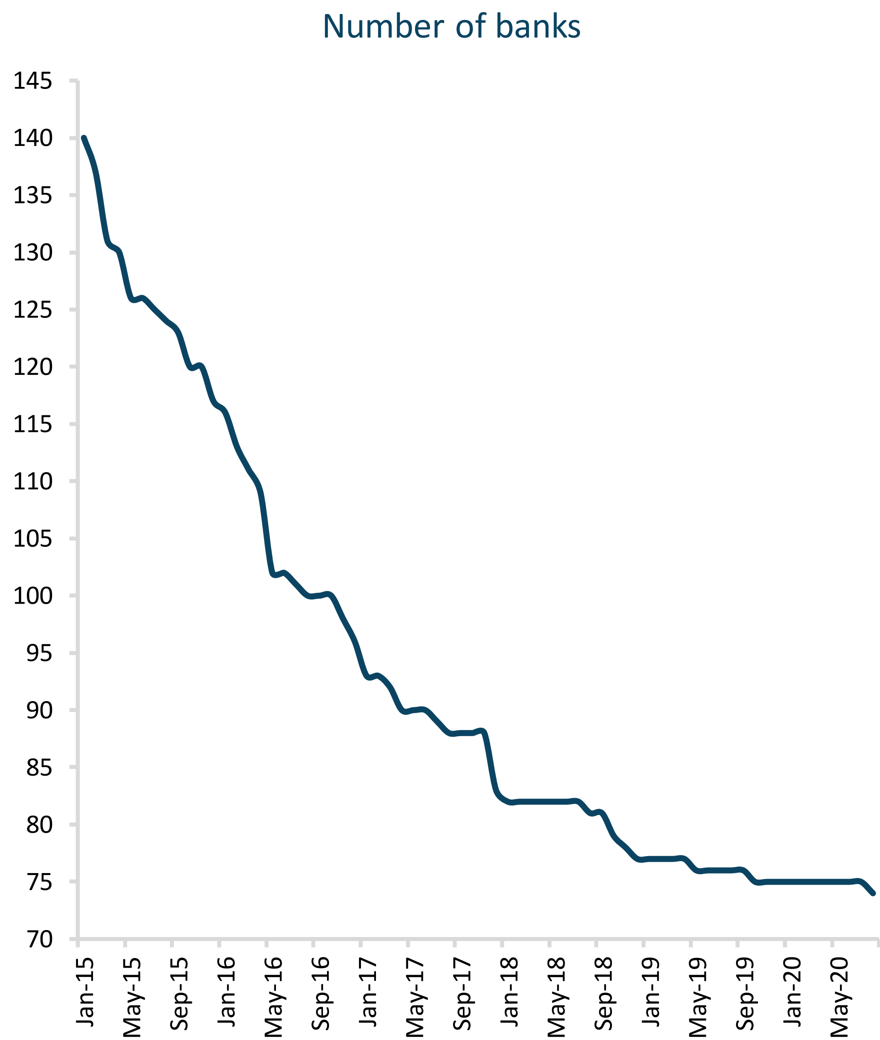


Source: Own calculations based on IMF data; Note: Bank assets are net of provisions on NPLs

- Following the bank reform process, and the formation of high provisions required on legacy of NPLs, the Ukrainian banking sector remains much smaller than in neighbouring countries
- After a steep fall over 2014-2015, bank assets have increased over the last years in absolute terms, but they have grown slower than nominal GDP, resulting in a declining asset-to-GDP ratio

➢ **Very low and still declining bank penetration**

2. Number of banks



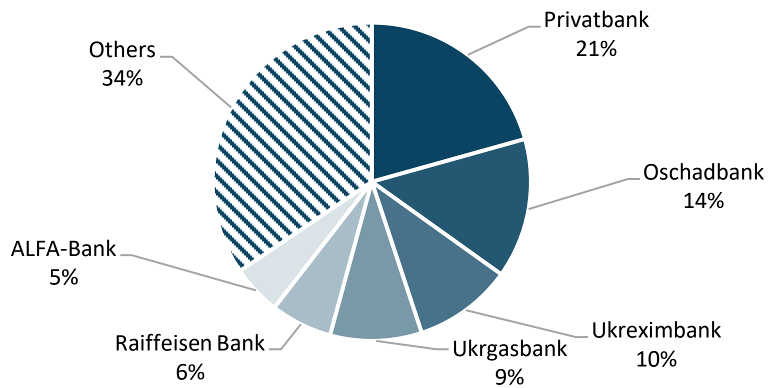
Source: NBU, own adjustments

- Closure of Bank Arkada in Aug-20 was first closure since 2018 (VTB bank due to court decision against the Russian owners of the bank)
  - Merger of Ukrsotsbank with Alfa completed in October 2019
  - No liquidity problems due to COVID-19 so far
- Liquidation of many banks closed during the previous years is still ongoing
  - Over 50 banks still in liquidation
  - However, liquidation of 28 banks in 2019, and 9 more in 2020

➢ **Number of banks relatively stable**

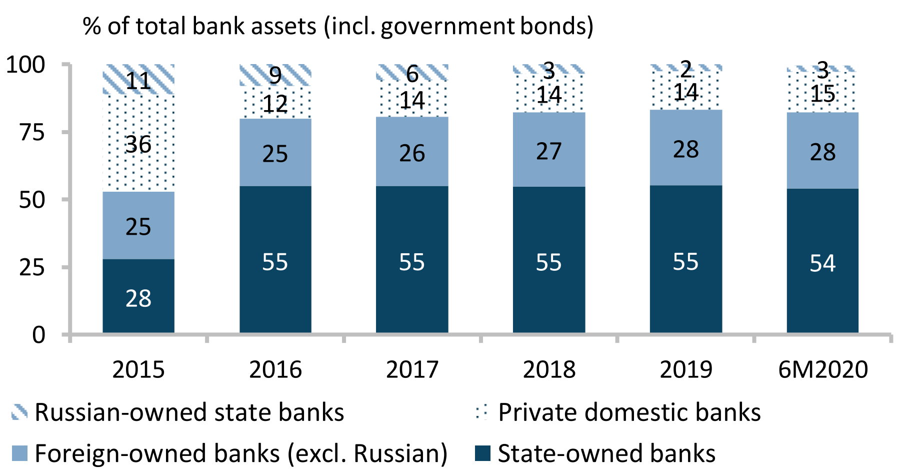
3. Market shares

Market share of banking sector assets



Source: NBU, July 2020; note: assets net of provisions

Market share by ownership



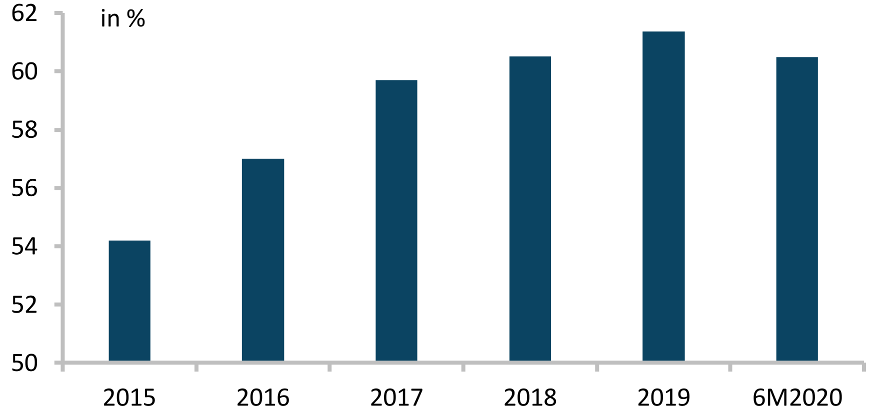
Source: Own calculations based on NBU data RZB; note: assets net of provisions

- State-owned banks remain dominant in the banking sector
  - Asset share is currently at 54%, higher, than in the last few years
  - Balance sheets are tilted towards government bonds and NPL levels are high
  - Market share in loans is much less at 39%
- Russian banks continue their exit from the Ukrainian market
  - Sanctions prevent an immediate exit through sale

➢ **State banks dominate the market in terms of total assets, but less in loans**

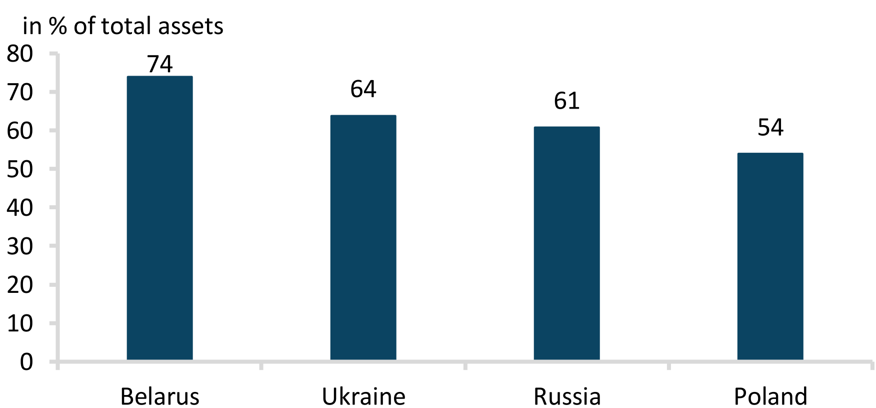
4. Concentration

Asset share of Top-5 banks over time



Source: Own calculations based on NBU data; note assets net of provisions

Top-5 banks: international comparison



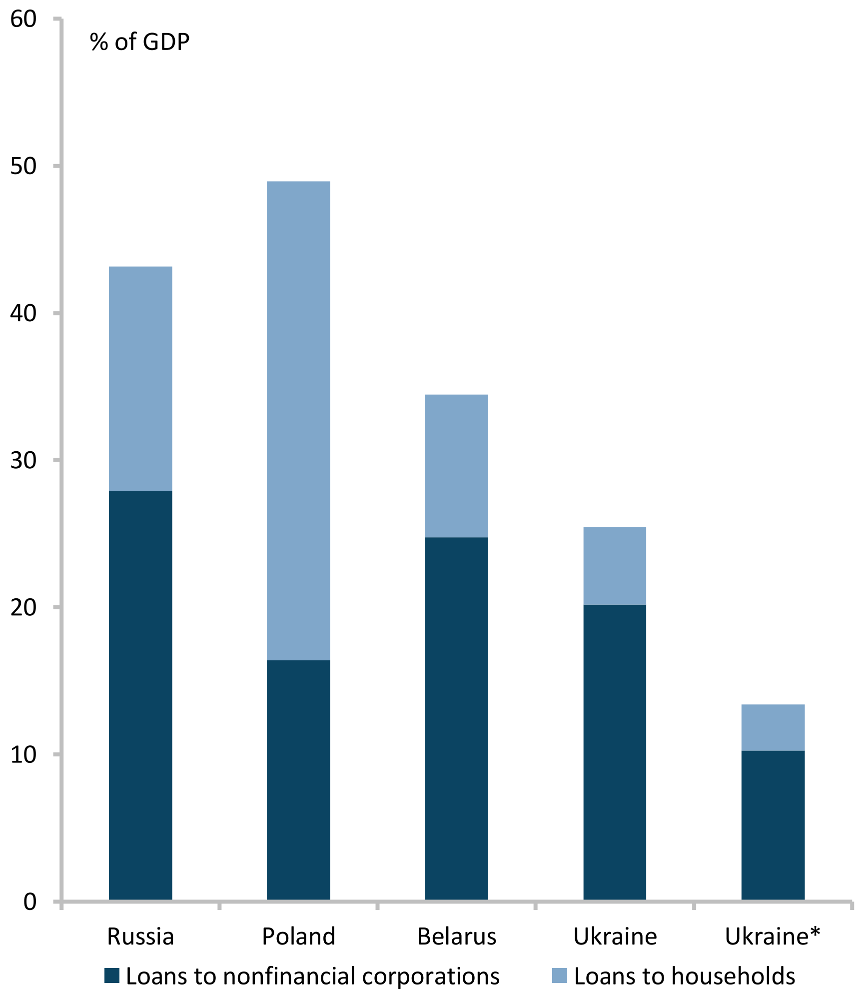
Sources: Countries' national banks, 6M2020, note: gross assets

- Asset share of Top-5 banks increased during 2015-20, as banks left the market
- Market concentration is quite similar to neighboring countries
  - However, four of Top-4 banks are state-owned in Ukraine

➢ **Concentration has been increasing gradually, in line with international peers**

5. Lending to the real sector

Loans to households and nonfinancial corporations

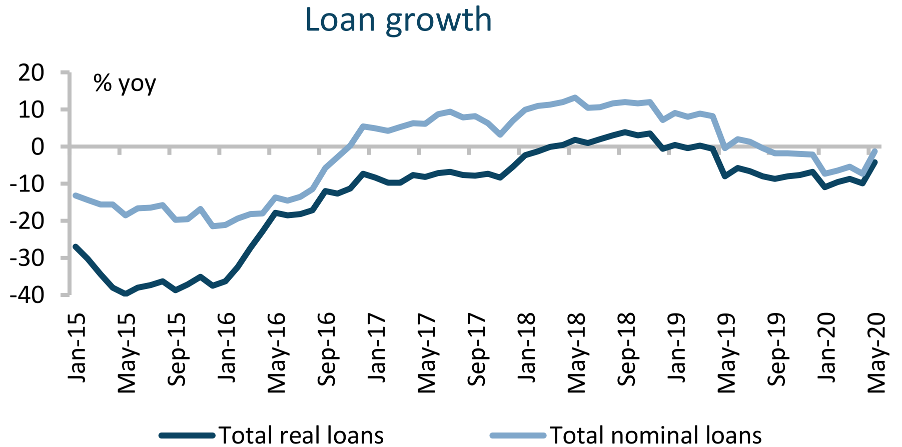


*Source: Own calculation based on IMF and NBU data; * Loans net of NPLs*

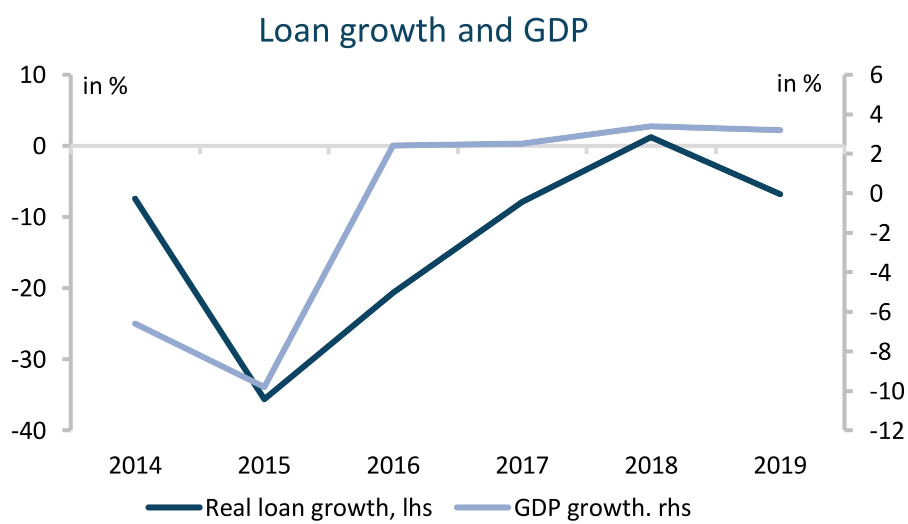
- Government bonds remain a significant part of the bank sector balance sheet (over 20% of total bank assets)
- Stagnant bank loan portfolio, especially to non-financial corporates
  - One reason is that "lending" to related parties was cut off by the regulator and requirements to loan risk assessment were increased
- As a result, loans to the real sector remain relatively small as compared to neighbouring countries
  - If we exclude NPLs, this amount remains still smaller

➢ **Low level of lending to real sector**

6. Loan growth



Source: Own calculations based on NBU and Ukrstat data; Note: FX adjusted, gross loans



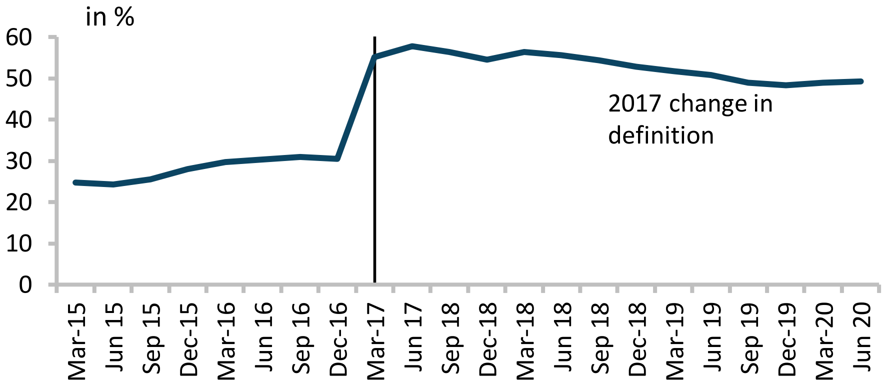
Source: Own calculation based on NBU data

- Bank loan portfolio is currently shrinking (both in nominal and real terms) due to
  - COVID-19 impact and the associated recession
  - Less loans to state-owned companies
  - Gradual workout of legacy loans through write-downs and some repayments
- Consumer lending “mini-boom” slowed by the end of 2019 and fizzled out during COVID-19

➢ **Loan portfolio is currently shrinking after some recovery during 2017-19**

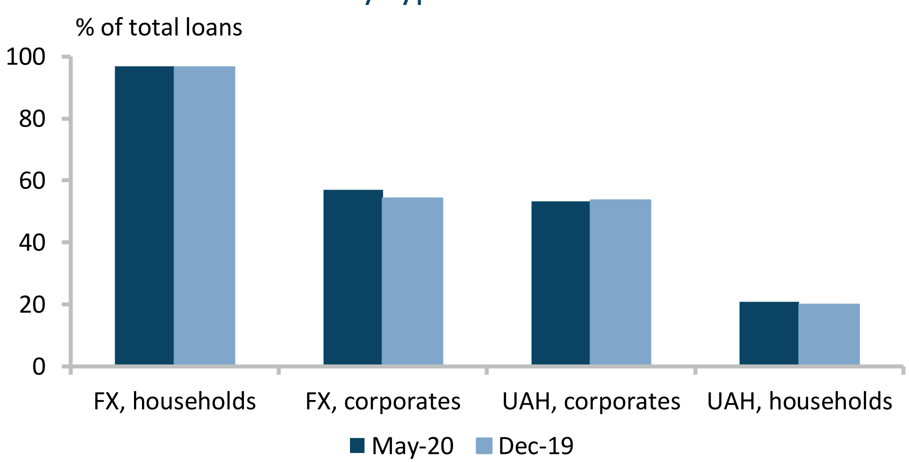
7. Non performing loans (NPLs)

NPLs as share of gross loans



Source: NBU

NPLs by types of loans

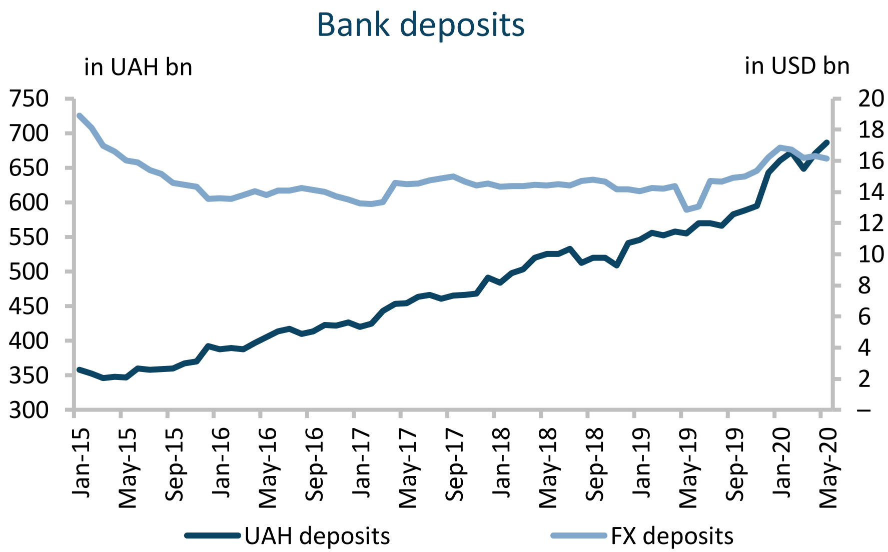


Source: NBU

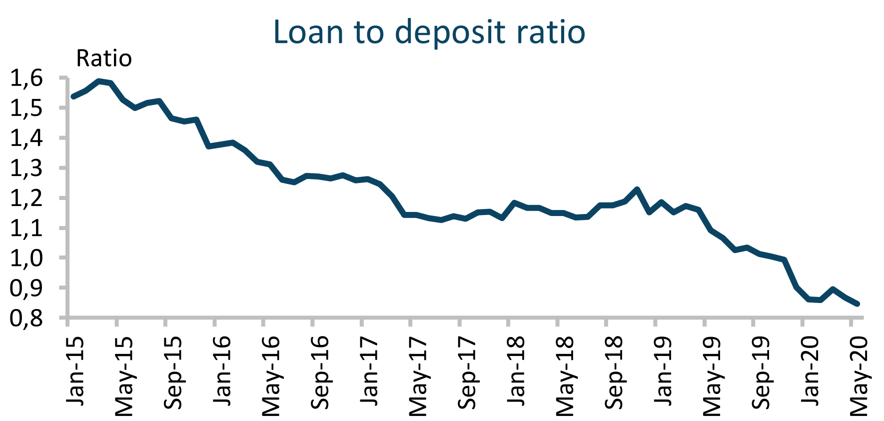
- NPLs at a very high level, but some very gradual downside movements until recently
- For the Top-3 banks (all state-owned), average share of NPLs to gross loans is 62%; Ukraine committed to NPL reduction strategies as part of the current IMF-SBA
- NPLs slightly increased over the last few months in 2020, but are expected to increase further as liquidity problems loom for certain borrowers
  - Key risk to watch
- According to recent NBU modelling, about 9% of banks' corporate loan portfolio may turn non-performing
- Payment delays have also increased for consumer loans

➢ **Gradual improvement of high NPL stock might be interrupted due to COVID-19**

8. Deposits



Source: NBU



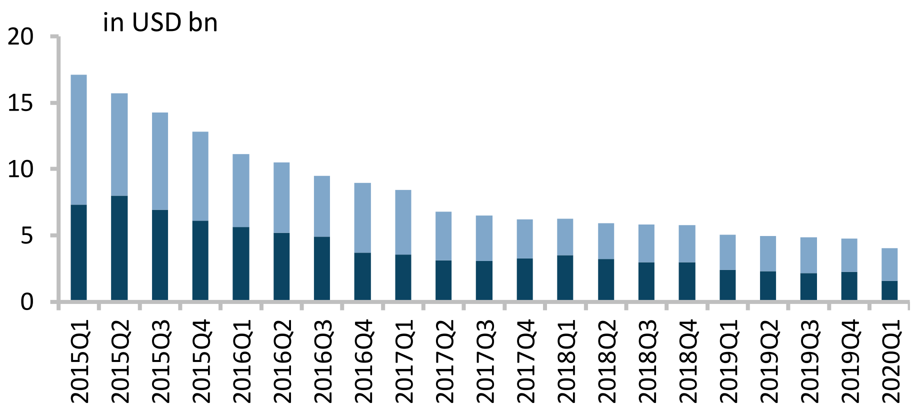
Source: Own calculations based on NBU data

- Bank deposits in Hryvnia continue to grow, despite the economic crisis
  - No run on deposits very positive
- FX deposits decreased only slightly
- Banks are nowadays funding their loans entirely by deposits
  - Huge difference to 2015 and before, when the loan-to-deposit ratio stood at almost 160%

➢ **Relatively stable development of deposits, which nowadays fund loans completely**

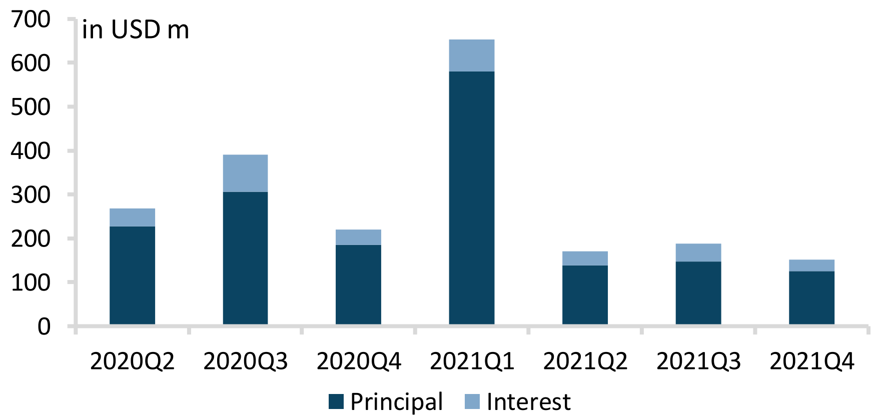
9. External debt

External debt of the banking sector



Source: NBU; Note: short-term/long-term debt at remaining maturity

External debt service schedule



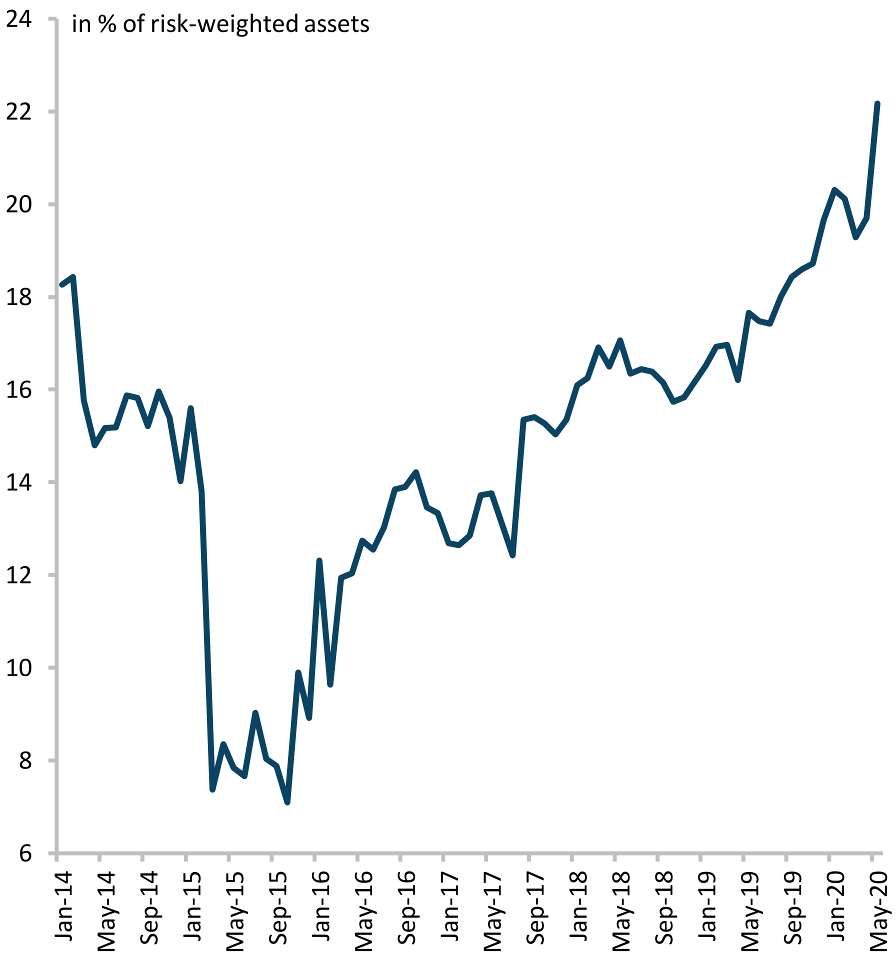
Source: NBU

- Banks remain focused on domestic sources of funding
- External debt continues to fall as liabilities become due, but at a slower pace than before
- Debt service obligations (principal and interest) are expected to fall below USD 200 m per quarter in 2021, if no new external debt is issued
- Share of external debt to total assets is currently around 5%

➢ **External deleveraging continues at a slower pace**

10. Capital adequacy

Banking sector capital adequacy ratio



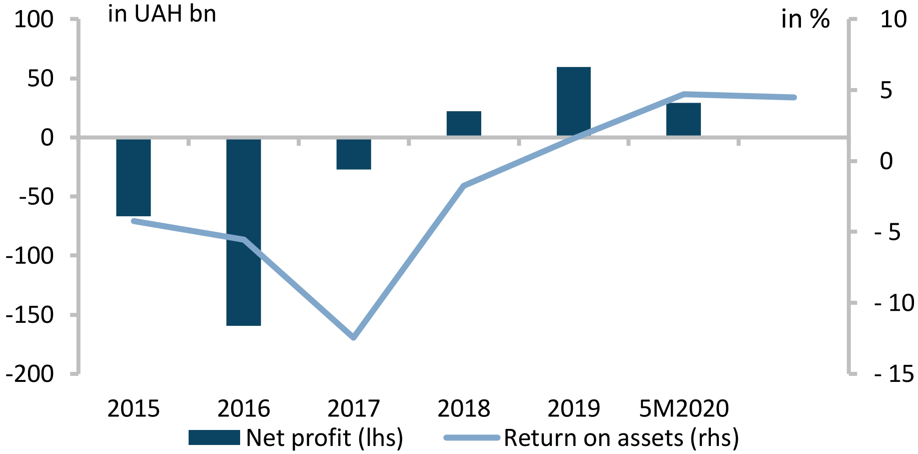
Source: NBU

- Significant improvements in capital adequacy, which contributed to financial stability, continued over the last years
  - Current CAR: 22% of RWA
  - October 2015: 7%
- So far, only limited COVID-19 impact observable
- Only two banks among the 14 banks deemed systemically important report a CAR below 15%

➢ **Positive developments in terms of capital adequacy**

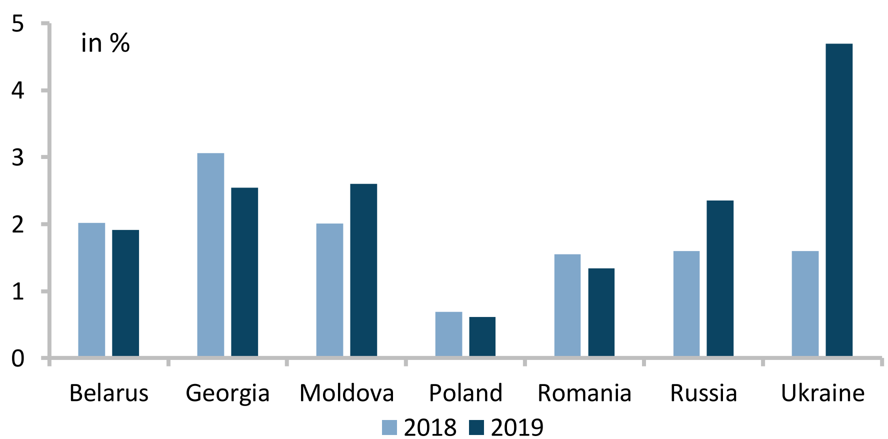
11. Return on assets

Banking sector profit and return on assets (ROA)



Source: NBU

Banking sector return on assets (ROA)



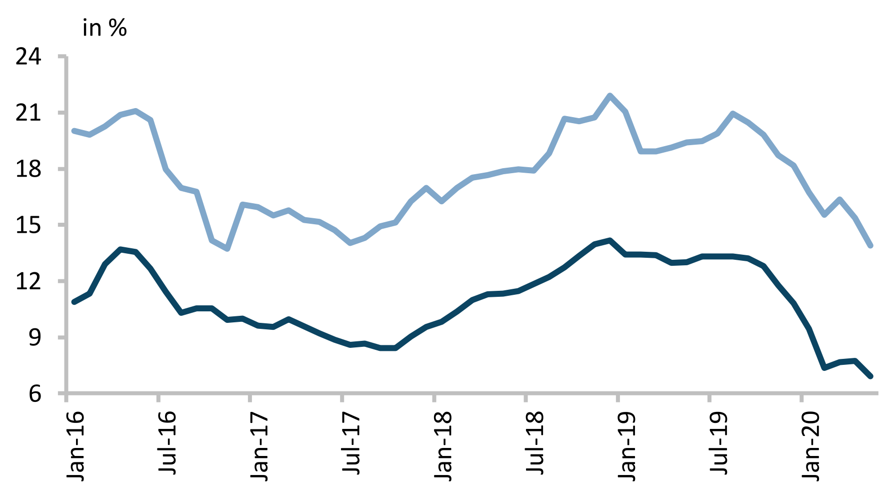
Source: IMF

- Banks finally returned to profitability in 2018, and remained profitable during 2019 and the first five months of 2020
- Banks increased their commission income and earned a healthy interest margin on their lending business
  - However, some of the profits is interest income on government bonds used to recapitalize state banks
- Build-up of loan-loss provisions was moderate over 5 months of 2020

➢ **So far, sector profitability has held up during COVID-19**

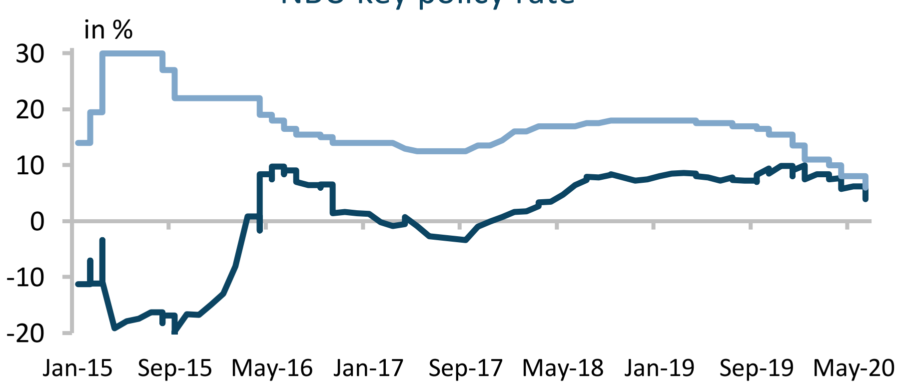
12. Interest rates

Interest rates on loans and deposits



Source: NBU

NBU key policy rate



Source: NBU, own calculations based on NBU and Ukrstat data

- NBU decreased the policy rate from 18% to 13.5% in 2019 and down to a historic minimum of 6% by June 2020
  - Ex post real rate decreased from 7.5% to 4% over the last 18 months
- Transmission into loan and deposit rates worked as well
  - Single-digit interest rates for Hrvnia household deposits for the first time in many years
  - No sign of pick-up in deposit rates due to COVID-19

➢ **Trend towards lower interest rates, driven by policy rate**

a. New banking law

Background:

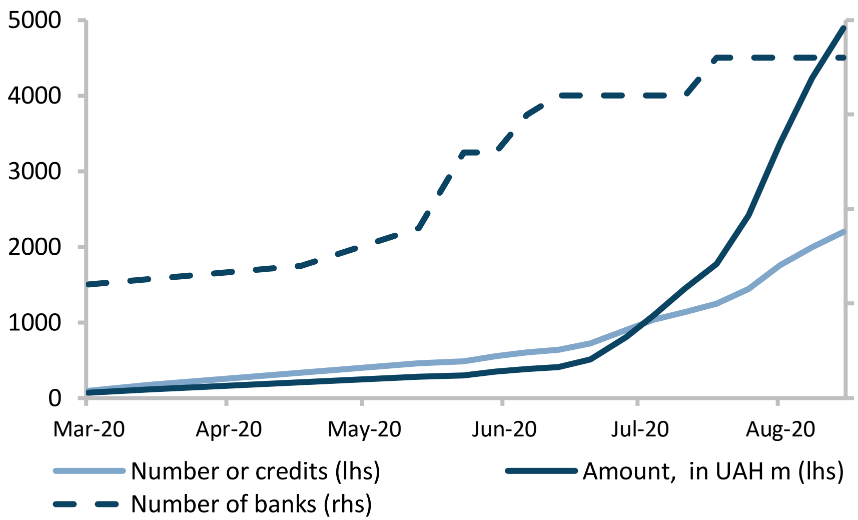
- The new law regulates numerous aspects of a banks’ insolvency resolution, including court proceedings, actions by the Deposit Guarantee Fund, details of a banks‘ nationalization, and defines the NBU‘s wider powers in banking supervision.
- This is a reaction to attempts by previous owners to get their insolvent banks back via local court decisions
- The law was a key prior action of the IMF‘s SBA programme and is effective since May 21, 2020.
- The main advocates of the law were the NBU and the IMF, while the strongest opposition came from MP groups aligned with Ihor Kolomoyskiy (previous co-owner of the nationalized Privatbank)
- The law includes the obligation for courts to proceed with the ongoing cases under the new legislation, disregarding the previous one, or to close the case in relevant sections.

Major features of new legislation:

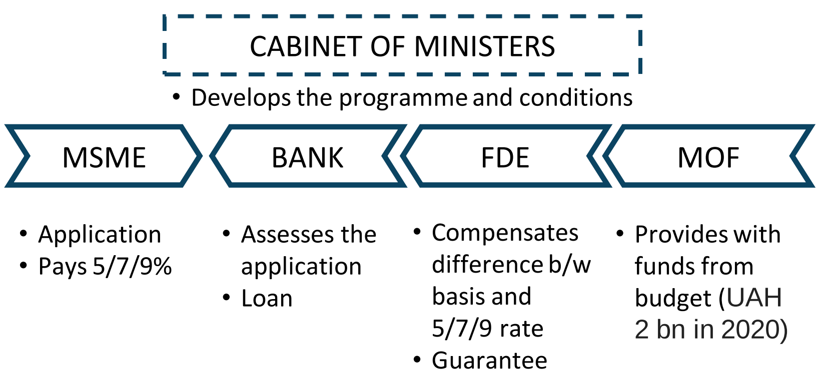
- An unlawfully liquidated bank cannot re-enter the market; its shareholders will get financial compensation instead
- The shareholder compensation procedure is quite complicated and involves international experts
- Banks liquidation, appointment of temporary administrator and other insolvency actions can not be suspended as a security for a lawsuit
- The NBU decides on the basis of ‘professional judgement’ on a bank’s management practices
- The regulations on administrative court proceedings against the NBU, Cabinet of Ministers, Ministry of Finance on banks’ insolvency cases obligate courts to use only official sources of information, with only a few exceptions.

b. 5-7-9-loan programme

Loans and participating banks (cumulative)



Source: MOF, MDETAU



Source: MOF, MDETAU

- Programme was established in Jan-20 and focuses on investment financing and current assets funding
- State Fund for Development of Entrepreneurship (FDE) compensates the difference between the basis rate (UIRD+3.5%, or +5.5% for startups) and loan interest rate and provides partial credit guarantees

Subsidized interest rates:

- 7% - if annual revenue does not exceed UAH 50 m; 5% if new jobs are created;
- 9% - UAH 50-100 m annual revenue;
- 3% - only during quarantine + 90 days after, for production of medicines and medical devices

Partial credit guarantees:

- 50% or 80% for medical production or startups

Process:

- The government provides FDE with funds from state budget;
- FDE signs contracts with banks;
- MSMEs apply for the programme;
- Banks evaluate applications according to certain conditions and make a decisions upon the loan provision;
- FDE provides guarantees and compensates the difference between the basis and compensating rate to the banks

➢ **Important instrument to address SME's access to finance**

c. Split law and non-bank financial institutions

- The split law adopted in September 2019 creates a new regulatory landscape for non-bank financial institutions (NBFI)
- Two regulators have split the functions of the third one (National Financial Services Commission), which is now to be liquidated
- The National Securities and Stock Market Commission now oversee pension funds and their administrators and construction financing funds
- The NBU will supervise the remaining segments: insurance, leasing, factoring, non-banking loans (credit unions, pawnshops, micro-credit and other financial companies)
- Overall, these market segments are somewhat non-transparent (some more so than others) and underdeveloped

Insurance market:
- 234 insurance companies
- Insurance penetration ratio: 1.4% of GDP (non-life: 1.3%)
- UAH 40.7 bn in total assets

Non-banking loan market:
- 684 non-banking lenders
- Loans issued (2019):
- Credit unions: UAH 2.7 bn
- Pawnshops: UAH 18.2 bn
- Financial companies: UAH 79.2 bn

Private Pension Funds:
- 63 pension funds and 22 fund administrators
- 860 thsd. clients
- UAH 2.9 bn assets (average of UAH 3.3 thsd.)

Factoring market:
- 642 licensed companies
- UAH 56 bn market volume in 2019

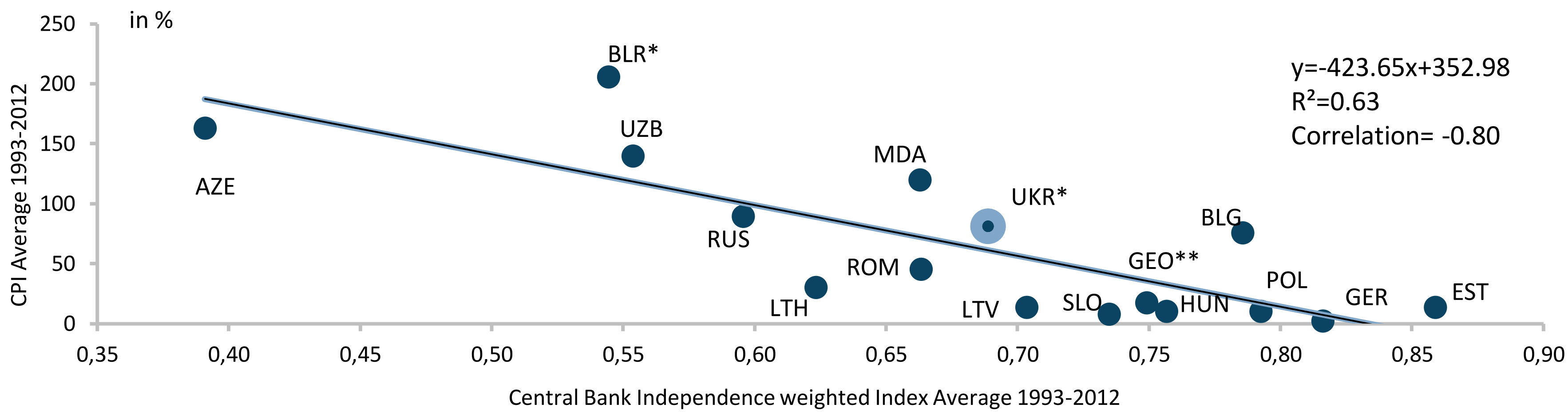
*last available data, mid or end 2019

d. Current and future COVID-19 impact

- Impact of COVID-19 on the banking sector:
  - Simultaneous negative global supply and demand shock, which hit the real sector so far
  - Key question: Spill-over to financial/banking sector likely, which would deepen the crisis?
- Ukrainian banking sector:
  - Due to past reforms, the sector has sufficient capital and liquidity and is well regulated
- Regulatory policy response:
  - NBU reacted quickly by:
    - Policy rate easing (supported by inflation below target)
    - Regulatory relaxation: postponed stress-testing, reporting deadlines and capital buffers introduction, cancelled on-site checks, sanctions are not applied to banks for failing to comply with CAR, liquidity and several other requirements
    - New long-term refinancing instruments: 5 years liquidity support at a floating rate
    - Borrowers support: proposed that banks offer credit holidays for those affected and/or special restructuring terms, provisions requirements on such loans are relaxed

➢ **Outlook:**
  - **Recession in 2020 will eventually lead to NPL issues, damaging the profitability of banks**
  - **However, wide-spread state-ownership and small size of the sector limit further damages**

e. Central bank independence



Source: IMF and Garriga, 2016; Note: *from 1994, **from 1995, inflation period average

- The resignation of the previous NBU governor, mentioning “political pressure”, put the issue of NBU independence into the spotlight
- The law “On the National Bank of Ukraine” tasks the NBU to ensure the stability of Ukraine’s currency as its main function. The law identifies the promotion of financial stability as the NBU’s second priority.
- Under the law, the NBU’s monetary policy must ensure and maintain price stability
- During the conduct of its activities, the NBU enjoys by law a high degree of independence; this is also a cornerstone of current and previous IMF support programme(s)

➢ **Both theory and empirics reveal that countries with independent central banks experience low and stable inflation rates, which are associated with higher economic growth and lower unemployment**

About the German Economic Team

The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. As part of the project we also work in other countries on selected topics.

In a continuous dialogue with high-level decision makers of the project countries, we identify current problems in economic policy and then provide concrete policy recommendations based on independent analysis.

In addition, GET supports German institutions in the political, administrative and business sectors with its know-how and detailed knowledge of the region's economies.

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