Banking Sector Monitoring Ukraine

Robert Kirchner, Vitaliy Kravchuk

Berlin/Kyiv, December 2017
Summary

- Massive shrinking of the banking sector from 82% to 54% of GDP during 2014-16
- The number of active banks reduced further during 2017 to currently 86 (from 180 in early 2014), but at a lower speed than in previous years
- The nationalisation of PrivatBank at the end of 2016 removed a threat to financial stability, but came at a price:
  - Overall, the costs of the banking crisis amount to about 40% of GDP during 2014-17
  - 4 out of the Top-5 banks with a market share of 56% are now owned by the state
- Efforts to reduce high level of NPLs (56% of gross loans) are still essential, in particular for state-owned banks (PrivatBank: 86%, other banks: 58%)
- At the same time, the capital base has strengthened substantially, CAR has doubled from its lows, and banks show a (tiny) profit for this year
- Deposits are growing in local currency, and have stabilized in foreign currency
  - Deposit are now the main pillar of the funding base (80%), external deleveraging continues
- Lending is gradually recovering, certain segments like retail loans show good dynamics
  - Lending surveys suggest a continuation of this trend in the near future
- However, a sustainable lending recovery depends not just on capital and liquidity; structural issue like a better protection of creditors’ rights are to mention here
Content

Key indicators:
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 and currency structure
7. Non-performing loans (NPL)
8. Deposits
9. External debt
10. Capital
11. Interest rates

Special issues:
 a. PrivatBank
 b. Losses due to the Banking Sector Crisis
 c. Deposit Guarantee Fund
 d. Reform of State-owned banks
 e. How to restart lending

Annex: Bank sector statistics
1. Bank assets in a regional context

- If measured by bank assets as % of GDP, Ukraine’s banking sector was comparable to those of Poland and Russia in 2014.
- However, until 2016, bank closures and deleveraging of banks led to a massive shrinking in banking penetration.
  - Now significant gap to Russia and Poland, and overtaken by Belarus.
  - One should note that balance sheets in 2014 were inflated by non-disclosure of related party lending.
- External factors like FX depreciation kept the bank asset-to-GDP ratio from falling even further.

⇒ Over the last years, massive reduction in banking penetration, currently far below regional peers.
2. Number of banks

- The number of banks in Ukraine has reduced dramatically since 2014, albeit recently at a lower pace.
- Out of 180 banks operating in the beginning of 2014, 94 were declared insolvent or liquidated by the NBU and 5 were liquidated or reorganized voluntarily:
  - Out of temporary administration, 1 bank was sold, 2 banks were created as bridge banks and Privatbank was bailed out.
  - 1 new bank was registered in Feb 2014.
  - 3 banks remain under temporary administration (including two under court orders).
  - Two banks are expected to complete their merger during December 2017-March 2018.
- Thus, more than 50% of banks failed during 2014-2017.
- As of Nov-2017, 86 active banks remain.

⇒ Massive reduction in number of banks operating in Ukraine

Source: Own calculations based on NBU data
3. Market shares

- PrivatBank (nationalized at the end of 2016) is Ukraine’s largest bank with 20% market share
- Trailing PrivatBank are three other state banks (Oschadbank, Ukreximbank, Ukrgasbank), whose combined market share of 36% is significantly higher than that of the market leader
- The remaining banks account for less than 50% of banking sector assets
- State banks increased market share at the expense of private domestic banks; Western banks reduced market share until 2014, but now higher and stable

⇒ After the nationalisation of PrivatBank, the four biggest banks are state-owned with a market share of 56%

**Market share of total banking sector assets**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>PrivatBank</td>
<td>20%</td>
</tr>
<tr>
<td>Oschadbank</td>
<td>17%</td>
</tr>
<tr>
<td>Ukreximbank</td>
<td>13%</td>
</tr>
<tr>
<td>Ukrgasbank</td>
<td>6%</td>
</tr>
<tr>
<td>Raiffeisen Bank Aval</td>
<td>5%</td>
</tr>
<tr>
<td>FUBI</td>
<td>4%</td>
</tr>
<tr>
<td>Ukrsotsbank</td>
<td>3%</td>
</tr>
<tr>
<td>Sberbank</td>
<td>3%</td>
</tr>
<tr>
<td>Alfa-Bank</td>
<td>3%</td>
</tr>
<tr>
<td>UkrSibbank</td>
<td>3%</td>
</tr>
<tr>
<td>Others</td>
<td>23%</td>
</tr>
</tbody>
</table>

**Source:** Own calculations based on NBU data from September 2017

**Market share by type of ownership**

<table>
<thead>
<tr>
<th>Year</th>
<th>Russian-owned banks</th>
<th>Foreign-owned banks (excl. Russian)</th>
<th>Private domestic banks</th>
<th>State-owned banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>18</td>
<td>55</td>
<td>22</td>
<td>25</td>
</tr>
<tr>
<td>2014</td>
<td>19</td>
<td>47</td>
<td>22</td>
<td>25</td>
</tr>
<tr>
<td>2015</td>
<td>11</td>
<td>36</td>
<td>28</td>
<td>55</td>
</tr>
<tr>
<td>2016</td>
<td>9</td>
<td>25</td>
<td>25</td>
<td>56</td>
</tr>
<tr>
<td>9M2017</td>
<td>7</td>
<td>13</td>
<td>25</td>
<td>56</td>
</tr>
</tbody>
</table>

**Source:** Own calculations based on NBU data, RZB

**Note:** Russian-owned banks exclude Alfa Group banks
4. Concentration

- Bank failures as well as the expansion of state banks helped to increase the market share of Top-5 banks from 40% in 2013 to 61% in 2017
  - Only 3 from the Top-15 banks (2013) failed
  - But: 11 out of the next 15 banks failed
  - PrivatBank was declared insolvent in December 2016 but was bailed-out
- The increase of the concentration ratio of 21 percentage points over 4 years is much higher than in previous periods
  - The ratio was 32% in September 2008, i.e. it increased by only 8 percentage points until 2013

⇒ During the recent years, the pace of consolidation in the banking sector gained speed

**Assets share of Top-5 banks**

% of total bank assets

<table>
<thead>
<tr>
<th>Year</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>9M2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>39</td>
<td>43</td>
<td>47</td>
<td>47</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: Own calculations based on NBU data
5. Lending to the real sector

Private credit to assets ratio
- Credit to the private sector makes up 48% of banks’ assets
  - Claims on both corporates and households
- Low value compared to Poland (59%) and Russia (56%), but higher than Belarus (32%) where state-owned enterprises play a more important role
- Decrease by 6 percentage points over the last few years

Private sector credit to GDP
- Massive bank deleveraging (slide 4) lead to reduction in private sector credit from 60% to 39% of GDP

\[ \Rightarrow \text{Reduction in claims on private (real) sector by about a third} \]
6. Loan growth and currency structure

Loan growth
- Sharp decline in gross loans, both nominal and real, during 2014; stabilisation in 2015
- Decline reflected low demand, undercapitalisation and bank failures
- Over 2017, the loan book started to growth in nominal terms again (8.2% yoy)
  - Driven by local currency lending; FX loans still shrinking
  - UAH retail loans show strong dynamics (23% yoy)
  - Real loan book still shrinking

Currency structure
- The share of FX loans in banks’ portfolios almost doubled at the peak of the crisis, but is gradually going down

⇒ Slow recovery in lending, driven by local currency loans, which gradually reduces dollarization
7. Non-performing loans (NPL)

- Non-performing loans (NPLs) rose massively during the crisis to currently 56.4% of gross loans
  - NBU tightened loan classification, which contributed to a steep rise over 1H 2017

- Share of NPLs in the region (Q1/Q2 2017), according to national central banks:
  - Belarus 13.7%
  - Poland 4.1%
  - Russia 9.7%

- There are also significant differences in NPLs among different types of loans
  - Legacy FX retail book is almost completely non-performing (95%)
  - Corporate loans have a similar quota in both UAH and FX (around 56-59%)
  - Lowest share of NPLs in UAH retail loans

⇒ More than half of the loan book is non-performing; this is a central issue that needs to be addressed
8. Deposits

- After declining during 2014, slowing inflation, better protection and higher interest rates helped UAH deposits to exceed their nominal pre-crisis levels already in 2016
  - This steady process is ongoing
  - However, household deposits are still far below pre-crisis levels in real terms
- The role of deposits in the funding base (80% of liabilities in H1 2017) has significantly increased during the crisis
- FX deposits had less deposit protection (paid in UAH at an FX rate fixed at date of bank insolvency) and were subject to withdrawal restrictions. As a result, they stabilized in 2016 but didn’t recover strongly
- After rising initially, the loan to deposit ratio was brought down from 2015 onwards by a faster recovery of deposits than loans

⇒ Steady recovery of local currency deposits, while FX deposits bottomed-out at a low level
9. External debt

- Previously, an important funding source apart from deposits
- Massive external deleveraging during the crisis: Down from USD 22.5 bn (Q4 2013) to USD 6.8 bn (Q2 2017) as banks were closed, non-resident deposits were withdrawn and some of the debt (e.g. subordinated loans) was converted into capital during recapitalisation
- The share of short-term external debt (e.g. under 1 year of remaining maturity) is relatively unchanged at about 50%

⇒ No end to external deleveraging in sight

Source: NBU
Note: short-term/long-term debt at remaining maturity
10. Capital

**Capital adequacy ratio (CAR)**
- High CAR pre-crisis reflected also under-reporting of problem loans
- In 2014/15, asset quality went down sharply and banks were forced to increase provisioning
- Closure of the most problematic banks and successful process of recapitalization helped to double CAR during the last two years

**Profitability**
- In 2014/2015, the sector exhibited large losses, which posed a constant drain on capital
- In 2016, these losses reduced significantly, but were overshadowed by the nationalisation of Privatbank at the end of the year (UAH 165 bn loss out of UAH 192 bn total)
- In 9M 2017, banks had profits of UAH 1.4 bn

⇒ After very difficult years 2014/15, recapitalisation efforts and closure of insolvent banks boosted capital adequacy
11. Interest rates

Loan and deposit rates
- Nominal interest rates on UAH loans and deposits moved higher during the crisis, reaching almost 24% on loans.
- Since early 2015, gradual reduction in interest rates observable, currently 15% on loans and 7% on deposits.
- State-owned banks played an important role in transmitting lower policy rates into lending rates.

Monetary policy rate
- After emergency hikes in 2015 to 30%, the NBU decreased interest rates in line with slowing inflation to a level of 12.5%.
- Recently, inflation above target forced the NBU to hike the monetary policy rate to 13.5%.

⇒ Clear trend of declining interest rates only recently interrupted by a hike in the NBU policy rate.
a. PrivatBank

- PrivatBank was nationalized at the end of 2016, thereby removing a potential threat to the whole financial system.
- Due to massive losses (UAH 165 bn in 2016), bank was recapitalised by the state in several steps, and certain creditors were bailed in:
  - So far, about UAH 140 bn were injected
  - Bail-in of creditors of UAH 29 bn (currently disputed in courts)
- Changes to corporate governance:
  - New supervisory board with international participation
  - Currently search for a new CEO and development of a new strategy for the bank
- So far no break-through in restructuring the related-party, non-performing loan portfolio:
  - Switch to collection of impaired loans

⇒ Nationalisation of PrivatBank was a necessary step, but much work remains to be done.

PrivatBank capital injections

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount (UAH bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>19/12/2016</td>
<td>Bail-in</td>
</tr>
<tr>
<td>28/12/2016</td>
<td>Bail-out 1/2</td>
</tr>
<tr>
<td>24/02/2017</td>
<td>Bail-out 2/2</td>
</tr>
<tr>
<td>12/07/2017</td>
<td>Recapitalisation*</td>
</tr>
</tbody>
</table>

Source: Own calculations
Note: * The government approved a total amount of UAH 38.5 bn, of which only UAH 22.5 bn was injected.
b. Losses due to the Banking Sector Crisis

The crisis in the banking sector caused losses to different stakeholders, e.g.:
- Non-insured depositors in failed banks
- Taxpayers through state recapitalisation of banks, insured deposits, etc.

So far (October 2017), we estimate cumulative losses since 2014:
- Fiscal: 15% of GDP
- Non-fiscal: 23.5% of GDP
- Total: 38.5% of GDP

The fiscal costs are much higher than during the banking crisis 2008 (4.5% of GDP), but don’t reach the levels of well-known cases of Iceland, Ireland, Turkey and Greece (27-44% of GDP)

⇒ Losses of almost 40% of GDP due to the banking crisis among different stakeholders
c. Deposit Guarantee Fund

The Deposit Guarantee Fund (DGF) takes over resolved banks and pays out insured deposits
- Majority of pay-outs done in 2015
- So far, UAH 92 bn were paid out on a cumulative basis since 2008

Asset recovery is a central function of the DGF, which needs to be done quickly, efficiently and in a transparent manner
- Challenge in a weak legal environment

A new way to sell assets is ProZorro.Sale (sister project of the renowned public procurement platform, backed by Transparency International):
- Increased transparency, and ultimately recovery value
- New “Double Dutch” electronic auction
- Significant increase in sales versus last year

Main challenge for DGF is asset recovery
d. Reform of State-owned banks

- State-owned banks dominate the banking sector now (56% market share)
  - Even higher share in retail deposits (62%)
- At the same time, these banks have the highest NPL ratios
- Short-term challenges:
  - How to run them independently on a purely commercial basis?
  - Concerns regarding competition?
- Medium-term challenges:
  - Prepare for eventual privatisation
  - Amend “Strategy for state-owned banks” (2016) to address these challenges
    - Install supervisory board with majority of independent members

⇒ Reducing the share of state-owned banks remains major medium-term challenge
e. How to restart lending

- Progress in bank capitalisation and the ample liquidity situation are important requirements for a recovery in lending
- Indeed, the loan book is growing again and lending surveys suggest a continuation of the trend, in particular for retail loans
- However, a strong and sustainable pick-up in lending won’t happen without addressing NPLs, which are linked to creditors’ rights
  - Strengthening of corporate insolvency framework
  - Implementation of out-of-court debt restructuring; restructuring under Law “On financial restructuring” showed limited success so far
  - Recent court reform may help court cases to move faster

⇒ Fundamental changes to protect creditors better are needed to restart lending
# Annex: Banking sector statistics

## Balance sheet data

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total assets</strong> (EUR m)</td>
<td>115700</td>
<td>68462</td>
<td>46537</td>
<td>44063</td>
<td>41531</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>8,2</td>
<td>-40,8</td>
<td>-32,0</td>
<td>-5,3</td>
<td>-9,0</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>83,9</td>
<td>83,0</td>
<td>61,4</td>
<td>51,5</td>
<td>46,8</td>
</tr>
<tr>
<td><strong>Total loans</strong> (EUR m)</td>
<td>72384</td>
<td>45423</td>
<td>26605</td>
<td>19337</td>
<td>17241</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>9,8</td>
<td>-37,2</td>
<td>-41,4</td>
<td>-27,3</td>
<td>-28,7</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>52,5</td>
<td>55,1</td>
<td>35,1</td>
<td>22,6</td>
<td>19,4</td>
</tr>
<tr>
<td>Loans to legal entities (EUR m)</td>
<td>59244</td>
<td>37842</td>
<td>22894</td>
<td>16672</td>
<td>14511</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>11,3</td>
<td>-36,1</td>
<td>-39,5</td>
<td>-27,2</td>
<td>-30,7</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>43,0</td>
<td>45,9</td>
<td>30,2</td>
<td>19,5</td>
<td>16,4</td>
</tr>
<tr>
<td>Loans to households (EUR m)</td>
<td>13140</td>
<td>7580</td>
<td>3711</td>
<td>2665</td>
<td>2730</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>3,6</td>
<td>-42,3</td>
<td>-51,0</td>
<td>-28,2</td>
<td>-15,5</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>9,5</td>
<td>9,2</td>
<td>4,9</td>
<td>3,1</td>
<td>3,1</td>
</tr>
<tr>
<td>Loans in foreign currency (EUR m)</td>
<td>25022</td>
<td>21059</td>
<td>13946</td>
<td>9336</td>
<td>7792</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>2,2</td>
<td>-15,8</td>
<td>-33,8</td>
<td>-33,1</td>
<td>-36,6</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>18,1</td>
<td>25,5</td>
<td>18,4</td>
<td>10,9</td>
<td>8,8</td>
</tr>
<tr>
<td>Loans in foreign currency (% of total loans)</td>
<td>34,6</td>
<td>46,4</td>
<td>52,4</td>
<td>48,3</td>
<td>45,2</td>
</tr>
<tr>
<td><strong>Total deposits</strong> (EUR m)</td>
<td>63661</td>
<td>37343</td>
<td>28565</td>
<td>30428</td>
<td>29510</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>12,2</td>
<td>-41,3</td>
<td>-23,5</td>
<td>6,5</td>
<td>0,9</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>46,2</td>
<td>45,3</td>
<td>37,7</td>
<td>35,6</td>
<td>33,3</td>
</tr>
<tr>
<td>Deposits from households (EUR m)</td>
<td>40021</td>
<td>21980</td>
<td>14973</td>
<td>15363</td>
<td>14840</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>14,0</td>
<td>-45,1</td>
<td>-31,9</td>
<td>2,6</td>
<td>0,3</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>29,0</td>
<td>26,6</td>
<td>19,7</td>
<td>18,0</td>
<td>16,8</td>
</tr>
<tr>
<td><strong>Total loans</strong> (% of total deposits)</td>
<td>113,7</td>
<td>121,6</td>
<td>93,1</td>
<td>63,6</td>
<td>58,4</td>
</tr>
</tbody>
</table>

## Structural information

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of banks</strong></td>
<td>180</td>
<td>142</td>
<td>117</td>
<td>96</td>
<td>90</td>
</tr>
<tr>
<td>Market share of state-owned banks (% of total assets)</td>
<td>18,0</td>
<td>22,0</td>
<td>28,0</td>
<td>55,0</td>
<td>56,0</td>
</tr>
<tr>
<td>Market share of foreign-owned banks (% of total assets)</td>
<td>27,0</td>
<td>31,0</td>
<td>36,0</td>
<td>34,0</td>
<td>32,0</td>
</tr>
<tr>
<td>Market share foreign-owned banks ex. Russian (% of total assets)</td>
<td>19,0</td>
<td>17,0</td>
<td>25,0</td>
<td>25,0</td>
<td>25,0</td>
</tr>
</tbody>
</table>

## Profitability and efficiency

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Return on Assets (RoA)</strong></td>
<td>0,1</td>
<td>-4,1</td>
<td>-5,0</td>
<td>-15,0</td>
<td>0,1</td>
</tr>
<tr>
<td><strong>Capital adequacy (% of risk weighted assets)</strong></td>
<td>17,6</td>
<td>14,0</td>
<td>8,9</td>
<td>13,3</td>
<td>13,1</td>
</tr>
<tr>
<td><strong>Non-performing loans (% of total loans)</strong></td>
<td>12,9</td>
<td>19,0</td>
<td>28,0</td>
<td>30,5</td>
<td>57,7</td>
</tr>
</tbody>
</table>

*Source: Own calculations based on NBU data; loans and assets are net of provisions*
Contacts

Robert Kirchner
kirchner@berlin-economics.com

Vitaliy Kravchuk
kravchuk@ier.kiev.ua

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
www.beratergruppe-ukraine.de
Twitter: @BerlinEconomics