German Economic Team

UKRAINE

POLICY PAPER 04|2022

The banking sector in times of war: current situation and challenges

by Robert Kirchner, Garry Poluschkin, Maria Repko and Maksym Samoiliuk

In cooperation with

CENTRE FOR ECONOMIC STRATEGY

Berlin/Kyiv, May 2022

About the German Economic Team

Financed by the Federal Ministry for Economic Affairs and Climate Action, the German Economic Team (GET) advises the governments of Ukraine, Belarus*, Moldova, Kosovo, Armenia, Georgia and Uzbekistan on economic policy matters. Berlin Economics has been commissioned with the implementation of the consultancy.

**Advisory activities in Belarus are currently suspended.*

CONTACT

Garry Poluschkin, Project Manager Ukraine
poluschkin@berlin-economics.com

German Economic Team
c/o BE Berlin Economics GmbH
Schillerstraße 59 • 10627 Berlin
Tel: +49 30 / 20 61 34 64 0
info@german-economic-team.com
www.german-economic-team.com

Implemented by

Berlin Economics

Our publications are available under **https://www.german-economic-team.com/ukraine.**

About the Centre for Economic Strategy

The Centre for Economic Strategy is an independent research agency on public policy issues. The mission of the CES is to support reforms in Ukraine to achieve sustainable economic growth. The Centre contributes to the development of Ukraine's economic growth strategy, performs an independent analysis of the most important aspects of public policy, and works on strengthening the public support for reforms. It was established in May 2015.

Our principles:

- Economic freedom (liberalisation, deregulation, privatisation)
- Free and fair competition
- Reduction of the role of the state
- Information transparency and freedom of speech
- The rule of law and the protection of private property
- Healthy and stable public finances
- Knowledge-based economy

For more information on the CES, please contact Viacheslav Nozdrin, Director of Communications (tel.: (044) 492-7970, office@ces.org.ua).

Please visit our website www.ces.org.ua and follow the link on the social media facebook.com/cesukraine or twitter.com/ces_ukraine.

Centre for Economic Strategy

3 Dilova Street, Kyiv 03150, Ukraine

Tel.: +380 44 492-7970

office@ces.org.ua

CENTRE
FOR ECONOMIC
STRATEGY

Executive summary

Russia's ongoing full-scale war in Ukraine is causing severe losses, damages and sufferings on multiple levels: human, social and economic. With a part of the physical infrastructure and the capital stock destroyed, damaged or occupied, millions of people displaced, and important trade routes blocked, it is not surprising that the economy is shrinking at an alarming pace.

Against this sobering background, it is quite remarkable that Ukraine's banking sector is still operating in a stable mode, thereby supporting households domestically as well as those living abroad and those enterprises in the economy that are still working. Crucially, a bank-run has been prevented, and the trust in local currency deposits has been preserved.

What are the factors underlying this resilience? In our view, there are three main reasons for this development. First, the National Bank of Ukraine introduced a set of anti-crisis emergency measures at the start of the war and adjusted them over time. This relates to the introduction of a fixed exchange rate as new (temporary) anchor, coupled with the introduction of several FX and capital controls. Such measures are quite common in times of war as history shows. The temporary relaxation of certain prudential norms and the provision of sufficient liquidity to banks also helped to prevent a panic and ensure financial stability. Furthermore, the sector was already well advanced in terms of digitalisation (also due to the COVID pandemic), which made it easier to adapt to a new environment. The previous banking sector reforms after 2014 also contributed to the resilience of the sector, as they created a more stable, better governed banking system.

Still, it is already obvious that the ongoing war will create long-lasting scars and challenges in the banking sector. The eventual transition back to a flexible FX rate system without controls will need to be managed gradually, and in a prudent way. The current practice of (partly) monetising the budget deficit needs also to be abolished in this process. Once a sustainable peace has been achieved, the conduct of stress tests will reveal the true picture of the hit to banks' balance sheets. In case recapitalisation funds are required to deal with the expected surge in NPLs, international partners should contribute to their provision. But apart from dealing with bad debt caused by the war, the perspective of Ukraine and its partners should also be forward-looking, as new lending is needed to support the growth and recovery process in Ukraine. This new lending should be based on market conditions, with only selected government interventions in areas or segments where market failures can be expected.

Content

1 Introduction

Russia's ongoing invasion of Ukraine has caused and is causing immense human and social suffering and pain, and there is unfortunately no end in sight. In addition to that, in the economic and financial sphere, we are currently observing a huge and growing hit on economic activity (forecasts are deteriorating quickly and project a 35% to 45% decline of GDP yoy at the time of writing) and in parallel an immense damage to social and physical infrastructure, which is currently valued at more than USD 97 bn (KSE, 2022)[1] – a figure which keeps rising as the war continues.

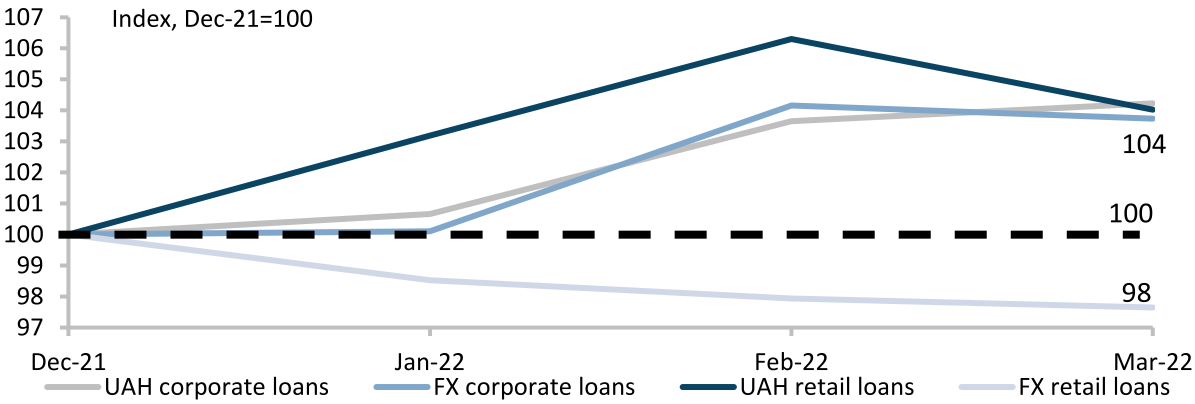
At the same time, the reason that the economy continues to function is in no small part also related to the ongoing operations of the banking sector, even under war conditions. The (perhaps surprising) resilience of the banking sector, its reasons, but also any future challenges as well as policy recommendations arising from these challenges are the topic of this paper.[2]

The structure of paper is as follows: In chapter 2, we review the current situation in the banking sector and determine the underlying main reasons for its resilience. The following chapter 3 takes a forward-looking perspective and summarises the main challenges caused by the war and provides some policy recommendations on how to address them.

2 The keys to resilience: current situation in the banking sector

The banking system of Ukraine has been facing an extraordinary pressure on its stability caused by Russia`s full-scale invasion of Ukraine. Currently, there are 69 banks operating after two Russian banks were liquidated in February 2022. Net assets in the sector have declined by 4% compared to the end of 2021 while both corporate and retail loans in Hryvnia remained relatively stable with some growth tendencies. The issuance of FX retail loans has declined.

Figure 1: Development of gross retail and corporate loans



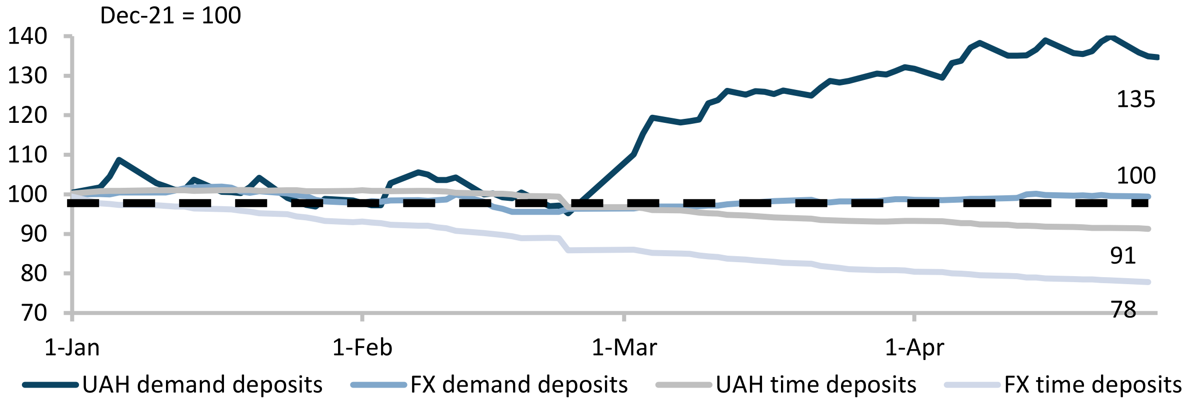
Source: NBU

[1] Infrastructure damage as of 19 May.

[2] The paper benefited from recent CES/GET webinar "Ukraine`s banking sector in times of war - main challenges and outlook" (28.04.2022) with a high-level panel of professionals and experts who shed light on these questions from different perspectives: private and state banks, the National Bank, IFIs and banking experts. The live recording is available here: Youtube.

On the funding side, deposit demand in Hryvnia has further increased while deposit demand in FX and time deposits in Hryvnia remained relatively constant. Thereby, it is **important to underscore that no major bank-runs on deposits have been observed.** The growth of deposit demand in Hryvnia reveals trust in the domestic currency, in the stability of the banking sector and in the continuation of business operations in Ukraine. Only time deposits in FX declined strongly by 22% compared to December 2021.

Figure 2: Development of retail deposits



Source: NBU

Nonetheless, banks recorded strong financial losses of UAH 10 bn in March driven by a spike in provisions on expected losses (NBU, 2022c). Adjusted policies of banks led to a decline of the capital adequacy ratio (CAR) to 16.5% in March 2022; a fall by 4.9pp compared to November 2021 and by 1.5pp to year end of 2021.

All in all, the sector is facing a challenging hit on profits and capitalisation **due to the war**. However, financial stability has been maintained so far as no major bank-runs occurred which is an important sign for the sector`s resilience. The following reasons can be attributed to its resilience.

- **The National Bank of Ukraine (NBU) introduced important anti-crisis emergency measures**

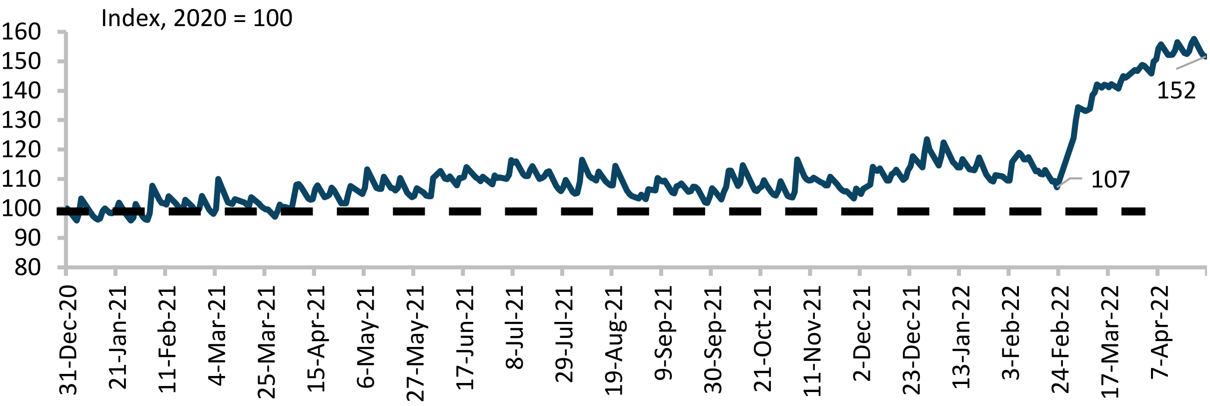
Just as the invasion started, the NBU passed an emergency resolution outlining the new rules for the banking system and FX market under martial law. The NBU announced a shift to a fixed exchange rate regime as of 24 February (with the pre-war rate of UAH/USD 29.25), and temporary cash withdrawal limits were imposed to prevent bank-runs. Restrictions on FX cash withdrawals and on FX sales to the public are still elements of capital controls due to the shortage of FX inflows to Ukraine`s businesses caused by massive export declines.

Thereby, the NBU has announced all its measures in a transparent way which contributes to stability within the sector. Furthermore, the publication of relevant monetary data continues, including on FX market interventions. Net sales amounted to ca. USD 4 bn (ca. 15% of current foreign reserves) between 24 February and the first week of May. As a fiscal gap of USD 5 bn per month is currently observed, international experts basically support the monetary budget financing conducted by the NBU so far though some academic discussion is ongoing on its extent (see IMF, 2022; Gorodnichenko and Churiy, 2022). Monetary budget financing was however not allowed by the NBU law and guidelines before the martial law was introduced.

Gradually, FX transactions with the public are partly resumed, however with restricted margins. While there are no restrictions on the ask price, the bid rate should be not less than the fixed rate (NBU, 2022a). The most recent FX control measures included the limitation of cash withdrawals abroad (up to UAH 50 thsd. per month) and lifting exchange rate restrictions for POS terminals purchases abroad. While painful for refugees and volunteers purchasing military equipment, these measures limit the speculations and help protecting the NBU's reserves, which are then used to support the critical imports.

At the same time, non-cash transactions were fully functioning, the NBU supplied banks with plenty of liquidity via refinancing loans and card payments (including abroad, involving the increasing stream of refugees) did not stop for a day. In March and April, the amounts of funds in individual accounts in Hryvnia increased by 22%, and cash did not become a major medium of exchange, as this usually happened during various wars in world history.

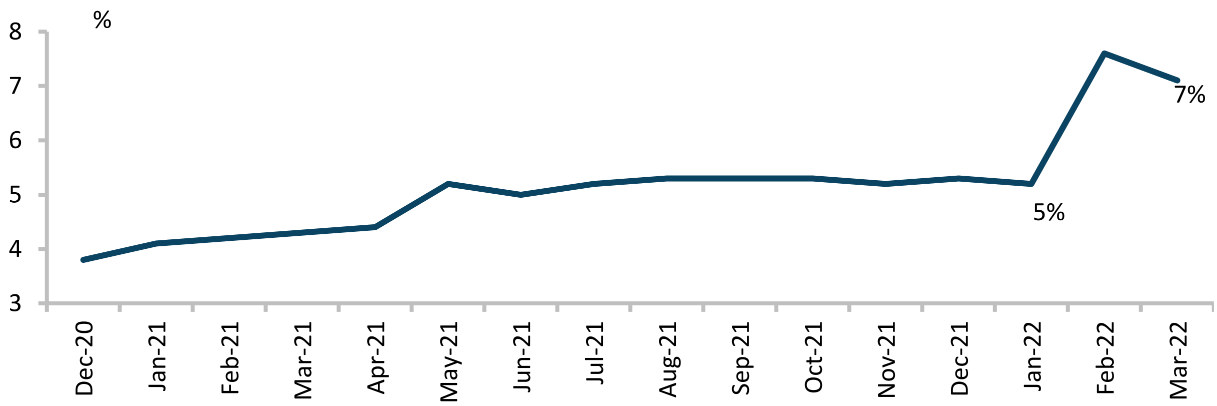
Figure 3: Amounts of funds in individual accounts in UAH



Source: NBU

Due to these measures, the share of the NBU`s funds in bank's liabilities increased by 1.8pp to 7.1% in Q1. Most of this refinancing was issued to state-owned and Ukrainian private banks.

Figure 4: NBU funds in banks' liabilities



Source: NBU

The remaining 69 operating banks have obtained temporary waivers from sanctions over most of NBU's regulations, so challenges remain here for the coming months. Overall, facing Russia`s invasion of Ukraine, the NBU has introduced different measures to stabilise the sector.

Different forms of capital controls have prevented bank runs so far, anchoring trust in the banking sector.

- **Higher agility obtained through digitalisation and COVID-related practices**

Ukraine`s dynamic IT sector supported the development of contactless card and NFC payments[3], for example via Apple Pay. In 2021, 44 banks in Ukraine offered Apple Pay technology, 9 more than in Poland. Even before Russia`s full-scale invasion, transactions with physical cards accounted for less transactions than with contactless cards and less than NFC payments. Ukrainians who are now forced to live abroad, keep operating and receiving payments using digital ways of bank communications and transactions.

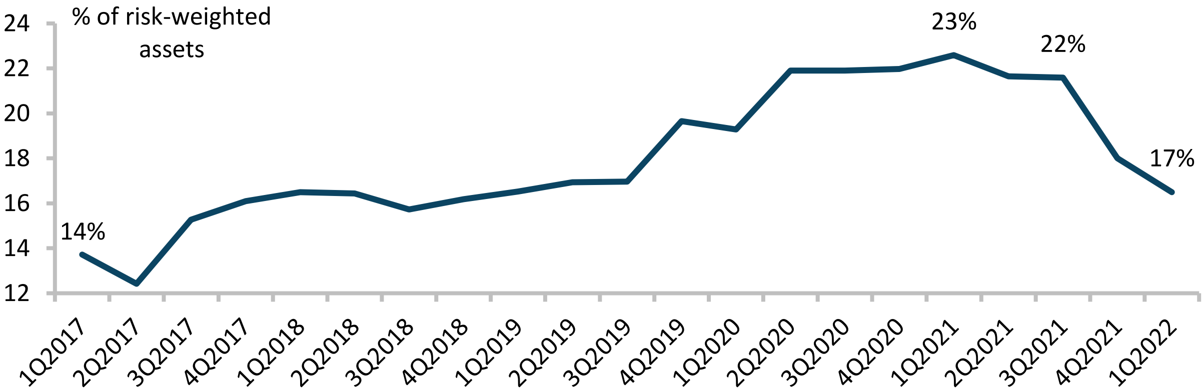
The COVID pandemic accelerated this dynamic as mobile work began playing an important role while commercial banks had to adjust to challenges caused by COVID lockdowns. Overall, the level of digitalisation as well as remote job opportunities are now supporting the sector in terms of the services provided.

- **The legacy of previous NBU banking sector reforms**

Reforms of corporate governance in Ukraine`s banking sector strengthened the role of supervisory boards as well as improved collegial decision-making processes. Based on these fundamental steps, a more powerful and independent role of the regulator, the elimination (or at least a serious decline) of related-party lending and a proper assessment of borrowers' credit quality were established.

Further measures included increased capital and liquidation requirements as well as regular stress tests that caused significant declines in the number of banks from 140 in Jan-2015 to 71 in Dec-21. The remaining banks have individually increased their net assets. As a result, the share of the sector to the total economy remained rather constant, but on a very low level of 38% of 2021 GDP. Poland`s banking sector`s net assets, for example, were equal to 97% of its GDP in 2021. Thus, the Ukraine's banking sector is quite small, but well capitalised even in international comparison.

Figure 5: The CAR in Ukraine over time



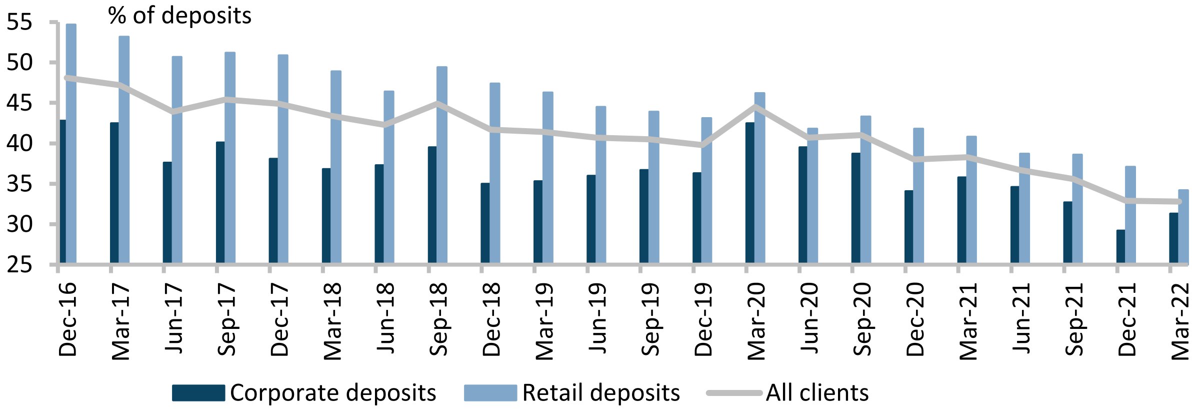
Source: NBU

[3] Near-field communication to exchange data between e-wallet and reader.

In March 2021, the CAR was 23% in Ukraine's banking sector, while it was 20% in Poland. Reform efforts also contributed to a strong reduction of NPLs, as well as increased competition from private banks which accounted for more than 53% of net assets in Feb-2022.

A declining share of FX deposits was a further element which brought resilience to the sector and opened the room for manoeuvre in case of sudden FX outflows. No banking crisis occurred despite the negative economic consequences of the COVID pandemic during 2020. De-dollarisation and a significant increase of the CAR in combination with increasing competition within the sector were important elements of an improved effectiveness in the market-based monetary policy transmission based on inflation targeting and a floating exchange rate regime (Ize and Yeyati, 2005; Zholud et al. 2019; Thornton and Di Tommaso, 2021; GET, 2020).

Figure 6: Share of FX deposits



Source: *NBU*

These policy reforms have boosted the NBU's credibility as a trustworthy independent monetary policy authority and regulator. Overall, Ukrainian banks accounted record-high profits of UAH 77.5 bn (USD 2.8 bn) in 2021, sufficient liquidity and capital. The accumulated profits in 2021 (which were not distributed) can now work as an important buffer against the current economic shock caused by the war.

Conclusion: Russia's invasion has put Ukraine's banking sector into a difficult position. Financial losses and declined capitalisation are observable. However, the sector has shown great resilience and it keeps operating in a stable mode. The banking sector has been maintaining high liquidity, and only two banks (of Russian origin) were liquidated. The reasons for such resilience are the decisive, transparent, and well-structured emergency measures taken by the NBU, together with the advanced digitalisation of the sector as well as previous market-oriented reforms.

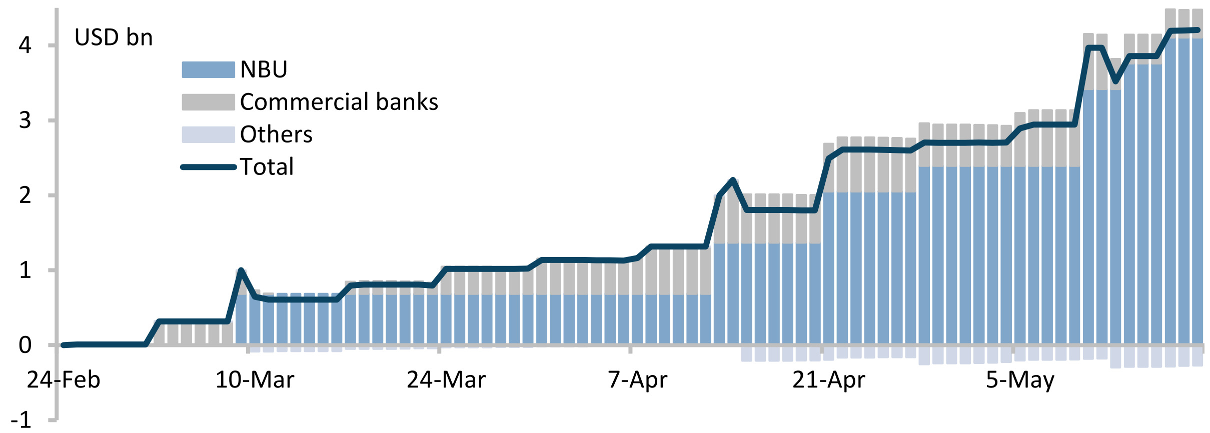
3 Challenges for the sector caused by the war and policies to address them

Even under a positive scenario of a quick end to this terrible war, there will be several major challenges that Ukraine's banking system and the regulator will face. The joint policy reaction by Ukraine and its international partners will likely shape the structure of the sector for a decade to come.

- **Monetary budget financing operations and FX market controls**

With the beginning of Russia´s full-scale invasion, the NBU has temporarily abolished its prohibition of monetary budget financing and started to heavily invest in government war bonds, which carries obvious inflationary risks. As of 18 May, the NBU purchases bonds amounting to USD 4.1 bn (at the official UAH/USD fixed rate) since the beginning of the invasion. As a result, the NBU has made up 81% of purchases since then and has increased its share of government bond holdings by 8pp to 38%. The already mentioned wide-spread FX market controls carry additional risks, especially in the longer term, as they prevent the economy from rebalancing and adjusting to a new situation.

Figure 7: Government bonds purchases by the NBU since 24 February



Source: NBU, note: at the official UAH/USD fixed rate

<u>Policy responses</u>:

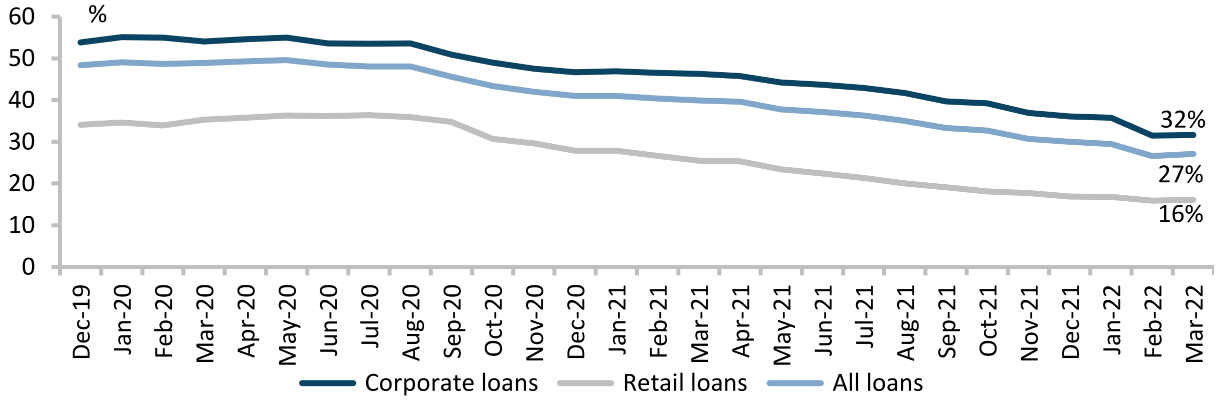
The medium-term inflationary dangers of monetary budget financing are obvious, and well-known to the NBU. The main effort in the short-term is therefore the mobilisation of external funding of the budget gap by international partners, which is currently estimated at USD 5 bn per month, preferably via grants than loans, which add to the debt stock. Beyond the short term, further fiscal measures on both the revenue and expenditure side might need to be taken to decrease the budget gap. These steps would allow the NBU to gradually reduce its emergency budget financing and reinstall independent (from fiscal objectives) decision making, focusing on inflation targeting.

Once the economy finds a new equilibrium, including its external trade, FX controls should be gradually relaxed, at least for current account transactions, while financial account transactions will probably need to stay in place for longer. The NBU's public announcement on 18 April highlights its commitment to a path of gradual resumption of the FX market (NBU, 2022b). The current transparent way of communication intends to support this view.

- **Increase in NPLs/deterioration of asset quality**

The amount of war-driven non-performing loans could realistically be evaluated only 3-6 months after a cessation of hostilities and a sustainable ceasefire; it is next to impossible to put a credible number to it now. The most recent statistics show that the liquidation of two Russian banks as response to the invasion helped to lower the reported share of NPL in the banking system by 3pp to 27.1%, while the ratio was at 41% in Dec-2020.

Figure 8: NPL ratio in bank portfolios



Source: NBU

When the war will be over, however, the banks will be forced to face a delayed shock. While the NBU currently refrains from sanctions for the incompliance with its regulations, macroprudential policies will still play an important role in the future. As a result, banks, facing losses from NPLs and capitalisation decline would have to deal with these challenges sooner rather than later, in a controlled manner and under a strict supervision.

Governmental intervention might further be needed when designing a compensation mechanism for assets destroyed by the Russian aggression, which could involve seized Russian assets. This might need much time, policy design, and complicated legal proceedings against Russia.

Policy responses:

Once the security situation stabilises, there will be a need for extensive, banking system-wide stress tests like the ones performed after 2014 to reveal the true situation. For this, international technical support (e.g., IMF, World Bank, EBRD) will be most welcome. However, the international support won't end at the technical level. In addition, financial support will most likely be needed in form of the injection of new capital. This will be another area where support can be delivered by IFIs, as private capital will most likely be hesitant due to the security situation. The concrete form of support (e.g. recapitalisation of individual banks versus setting up a centralised fund to deal with the expected surge in war-related NPLs) remains to be seen.

To improve banking supervision further and as part of Ukraine's possible path to future EU membership, policy makers should continue to smoothly adjust local supervision standards to EU standards.

- **New lending promotion**

Although the loan portfolio shrank in March, the decrease was small: loans in Hryvnia decreased only by 0.6%. The major decline in gross loans was attributed to the most flexible and fastest-growing Hryvnia retail segment, which is no surprise in times of war. The further growth of lending will be impeded by the huge security risks associated with Ukraine's geopolitical position. As Donetsk and Luhansk regions' example between 2015 and 2022 showed, there was extremely limited access to credit in those (controlled) territories, bordering potentially insecure spots, even in case there are no immediate war actions or civil unrest.

At the same time, the government will likely be promoting a boost to lending to support Ukrainian companies and ensure the credit access for them. This might conflict with the targets of financial stability via lending to risky borrowers. Here we sense the room for both the NBU prudential policies (e.g. on credit classification and provisions) and the partner countries´ step-in in providing special war-risks insurance programmes for assets as collaterals, for trade financial contracts as well as investment guarantees. The 5-7-9 subsidised loan programme, which was initially aimed at supporting SME in times of COVID, has continued through the war. Under this programme UAH 24 bn has been disbursed since 24 February, which is over 20% of the total disbursements of UAH 114 bn starting from February 2020.

Policy responses:

The revival of lending after the war must closely follow the structure of Ukraine's post-war economy. At the moment, the recovery of external trade is of paramount importance to re-establish Ukraine's access to international markets. The provision of trade finance, also from international partners, can contribute to this development.

Another issue consists of dealing with the overall security situation post-war, which will be difficult. Risk sharing models for commercial loans, incl. to SMEs, between commercial banks and IFIs/donors must be further developed, including via new instruments (e.g. guarantees).

The provision of new lending shall be allocated according to market principles, even though part of the costs may be (initially) paid from the public sector. However, this implies that there must be a continuation of the corporate governance reforms launched before the war, and no roll-back in this area.

Conclusion: After the war, several challenges for the sector and the regulator will emerge, connected with the exit strategies from the war-time policies like direct lending to the budget and the fixed exchange rate regime. The banks as well as international partners will have to find ways to deal with forthcoming NPL shocks and as a result, and possible new rounds of capitalisation.

References

GET (2020), “Monetary policy transmission in Ukraine”, Policy Briefing 09/2020, Link.

Gorodnichenko, Y. and Churiy, O. (2022), “Financial markets in the war and beyond”, VoxUkraine, Link.

IMF (2022), “Request for purchase under the rapid financing instrument and cancellation of stand-by arrangement – press release, staff report; and statement by the executive director for Ukraine”, Country Report 22/74, Link.

Ize, A. and Yeyati, L. (2006), “Financial De-dollarization: Is It for Real?”, Financial Dollarization: The Policy Agenda, pp. 38-63, Palgrave Macmillan.

KSE (2022), “Russia will pay / damaged.in.ua”, KSE Institute, Link.

NBU (2022a), “NBU Allows Banks to Sell FX Cash to People, Clarifies Rules for Loan Repayment by Banks to Nonresidents”, Announcement on 14 April, Link.

NBU (2022b), “NBU Commits to Return to Inflation Targeting with Floating Exchange Rate – Monetary Policy Guidelines”, Announcement on 18 April Link.

NBU (2022c), “Banking Sector Review”, May 2022 edition, Link.

Thornton, J. and Di Thomasso, C. (2021), “The effect of non-performing loans on credit expansion: Do capital and profitability matter? Evidence from European banks”, International Journal of Finance & Economics Vol. 26, Issue 3, pp. 4822-4839, Link.

Zholud, O. Lepushynskyi, V. and Nikolaychuk, S. (2019), “The effectiveness of monetary transmission mechanism in Ukraine since the transition to inflation targeting”, Visnyk of the National Bank of Ukraine, 2019, No. 247, pp. 19–37.