In cooperation with

INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

CENTRE FOR ECONOMIC STRATEGY

German Economic Team

NO 04 I SEP 2023

Policy Briefing UKRAINE

Banking Sector Monitor Ukraine

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Structure

Key indicators

1. Bank assets
2. Number of banks
3. Market shares
4. Concentration
5. Liquidity
6. Loan growth
7. Non-performing loans (NPLs)
8. Deposit growth
9. Debt
10. Capital adequacy ratio
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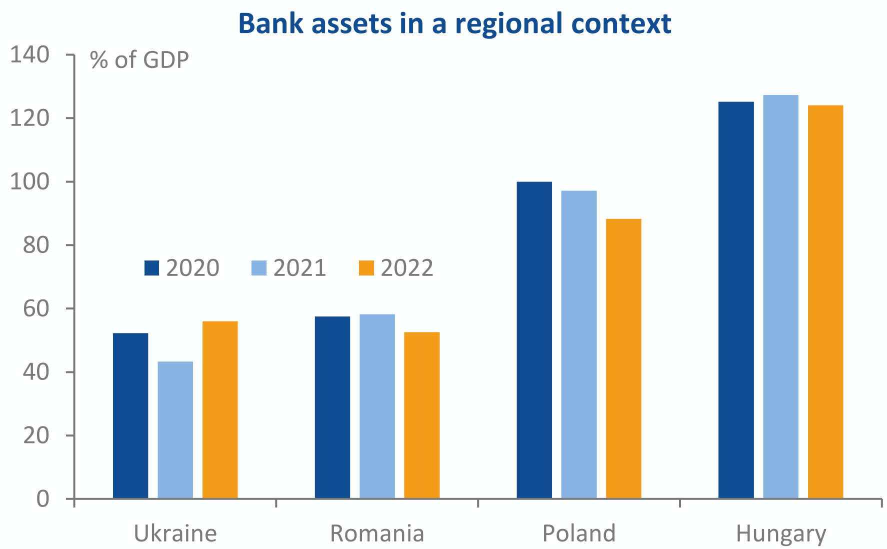
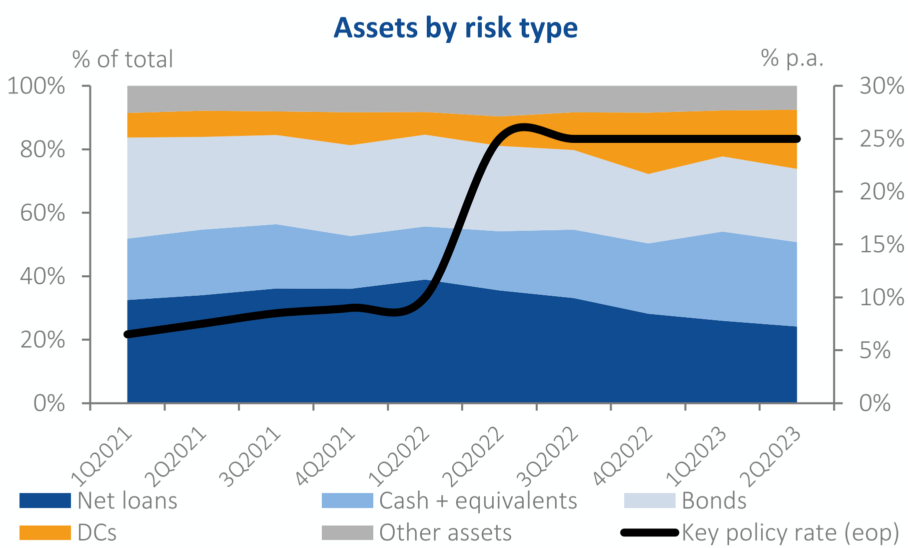
15. Loan subsidy programme ‘5-7-9’
16. Monetary policy regime change and capital controls
17. Banking supervision measures
18. Challenges for state-owned banks
19. Banks’ role in reconstruction

Annex: Banking Sector Statistics

1. Bank assets



Sources: respective national banks, Romania is 2Q2022

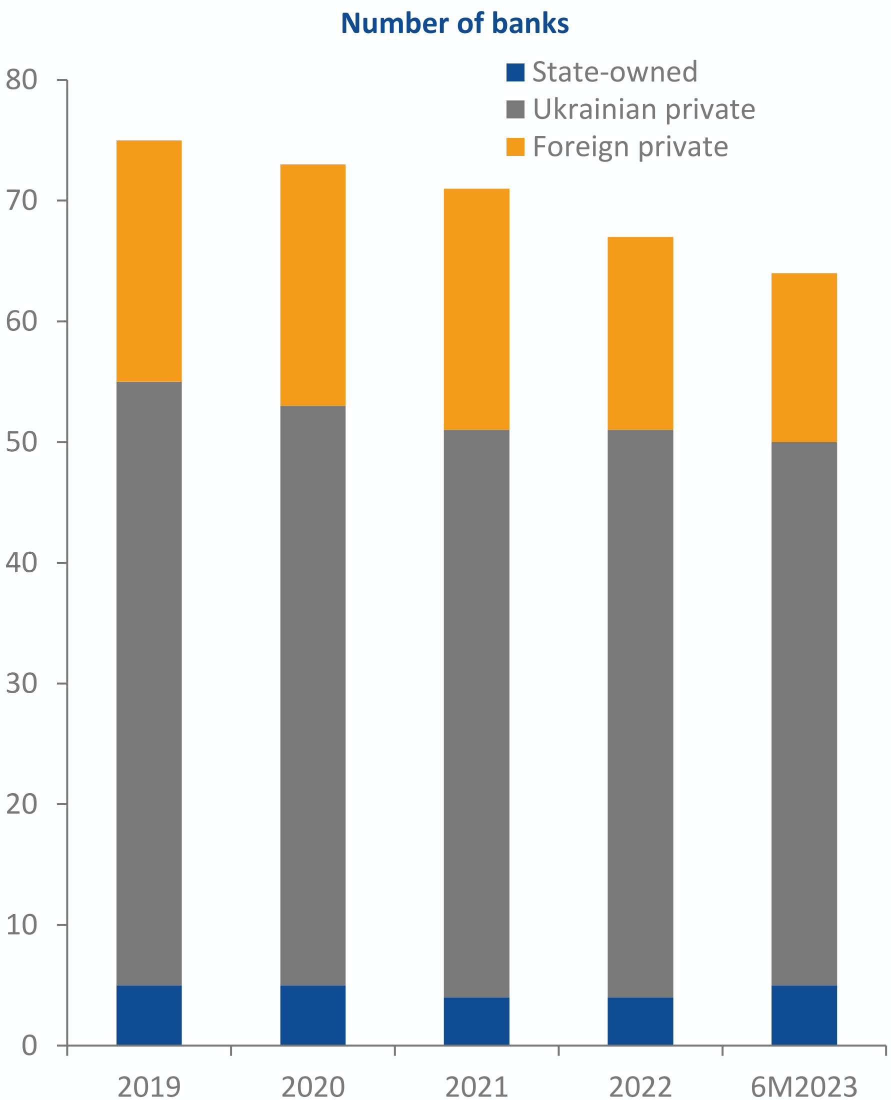


Source NBU

- Ukraine’ bank assets as % of GDP are rather low, meaning a low level of financial integration
- Bank assets to GDP ratio is on a similar level as in ROM but only half of POL or HUN
- In 2022, bank assets have slightly increased, while GDP has fallen → growing ratio
- In real terms (in UAH) bank assets have fallen: ca. 13% below Jan-21 level
- Loan supply declined, while cash and certificates of deposits (CDs) demand increased - banks prefer less risky assets

➢ **The banking sector continues to play a rather small role in Ukraine’s economy**

2. Number of banks

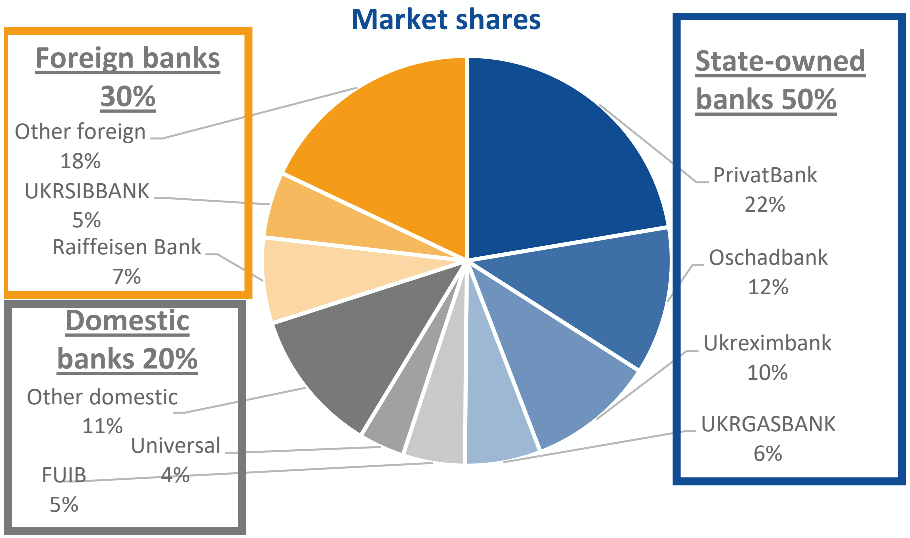


Source: NBU

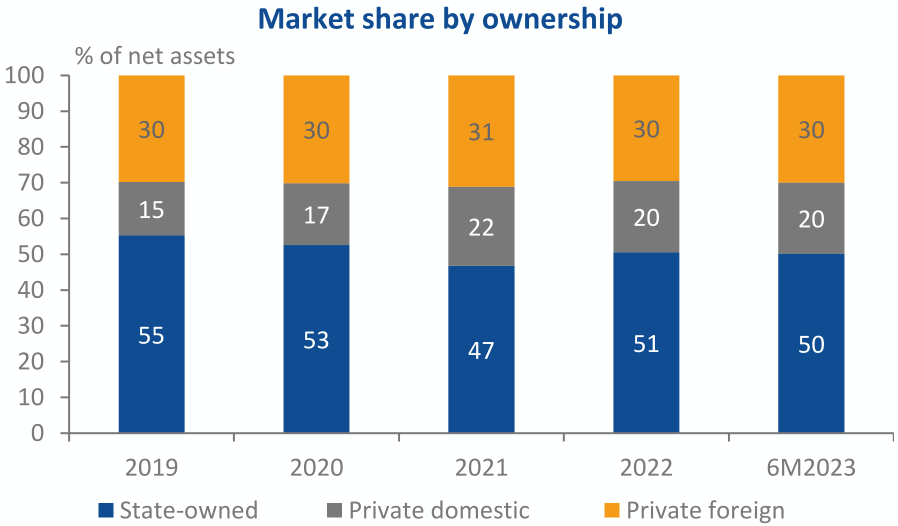
- » The number of banks has declined by 7 since 2021
- » Recently: liquidation of non-systemic CONCORD bank
- » SENSE, a systemically important bank (previously Alfa) was nationalised as main shareholder listed under sanctions
- » Currently, 1/5 of banks are considered to be systemically important → they undergo quality review and stress-tests
- » While these procedures have been postponed since the full-scale war, it is to be expected that the asset quality review (AQR) will be published by Mar-24 according to the IMF EFF

- ➢ **Systemically important banks require focused supervision**
- ➢ **AQR and stress-test to become vital**

3. Market shares



Source: NBU, net assets, 6M2023, SENSE nationalisation not yet visible in the data

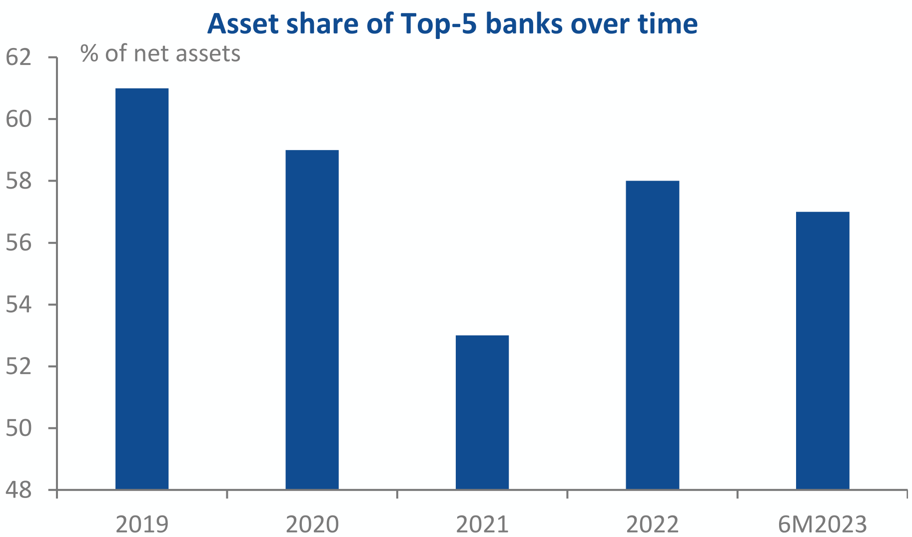


Source: NBU, net assets

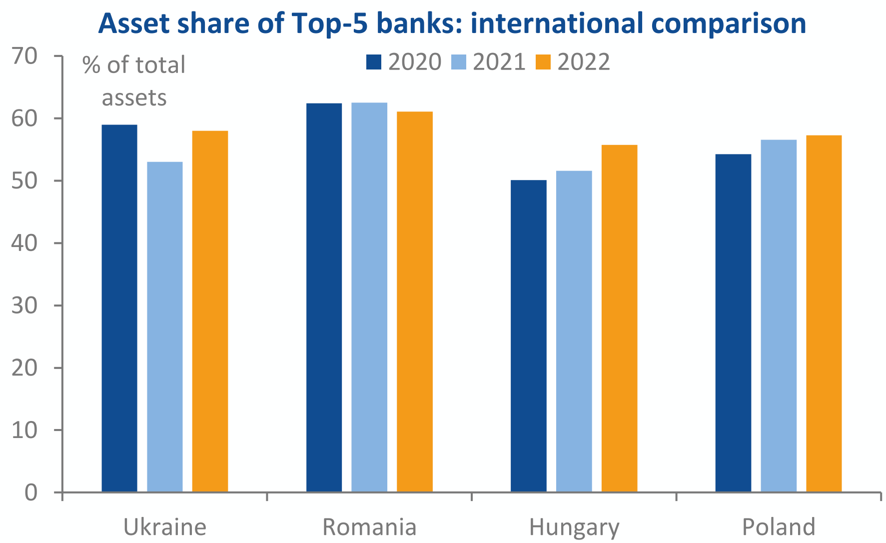
- State-owned banks (SOBs) dominate with 50% of net assets, even before nationalisation of SENSE is visible in the data only since Jul-23
- Market leader is Privatbank with 22% of net assets, while the second largest bank accounts for only 12%
- Ukrainian private banks play less significant role than foreign private ones after 2014/2015

- **On the one hand, quite fragmented sector**
- **On the other hand, competition is restricted as sector is dominated by state-owned banks**

4. Concentration



Source: NBU



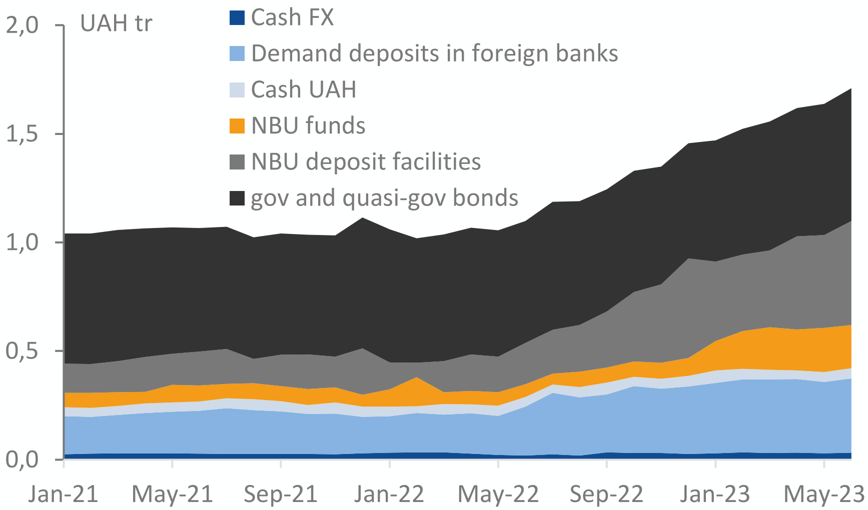
Sources: NBU, ECB

- Concentration of Top-5 has increased in 2022 compared to pre-war period, but slightly fell during 6M2023
- However, 4 of top-5 banks are state-owned → 50% of net assets owned by one owner
- Concentration is on a similar level to EU neighbours
- However, the share of state-owned banks is much lower in these countries

- **Share of Top-5 banks shows a rather fragmented sector**
- **However, high share of SOBs is a sign of concentration**

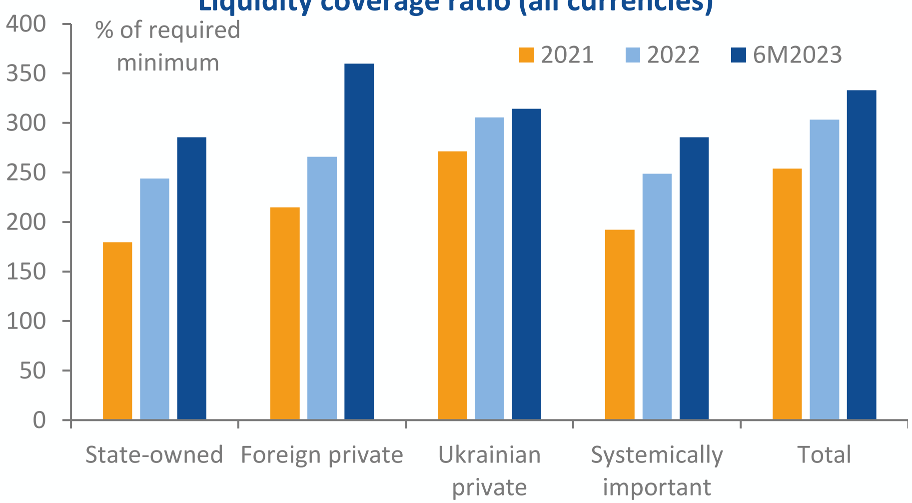
5. Liquidity

Broad liquidity



Source: NBU

Liquidity coverage ratio (all currencies)



Source: NBU, median bank

» The mandatory reserve requirement was hiked strongly since 1Q2023: Jun-23: 5.4 times pre-war level

» Banks are forced to set aside 10% to 20% of deposits (depending on type) into NBU funds and are allowed to cover 50% of reserves with state securities carrying market-based yields

» Nevertheless, LCR has grown strongly: to more than 330% of required minimum

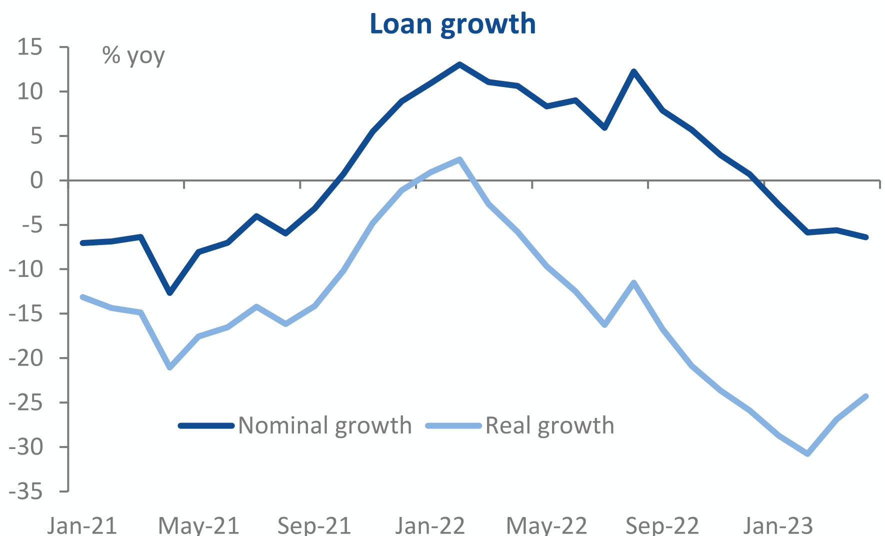
» Growth of deposit certificates due to salaries of military personnel with safe interest rates

» For banks, this policy is less risky than lending

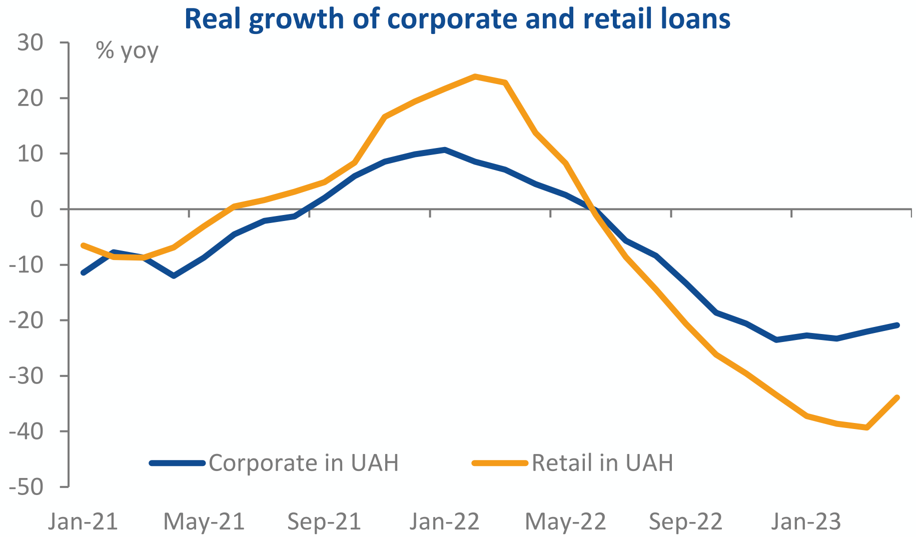
➢ **This buffer allows banks to repay debt and relaxes need for additional funding at times when access is restricted**

➢ **On the other hand, excess liquidity reveals lack of market-based lending to the private sector → problem for reconstruction**

6. Loan growth



Source: NBU

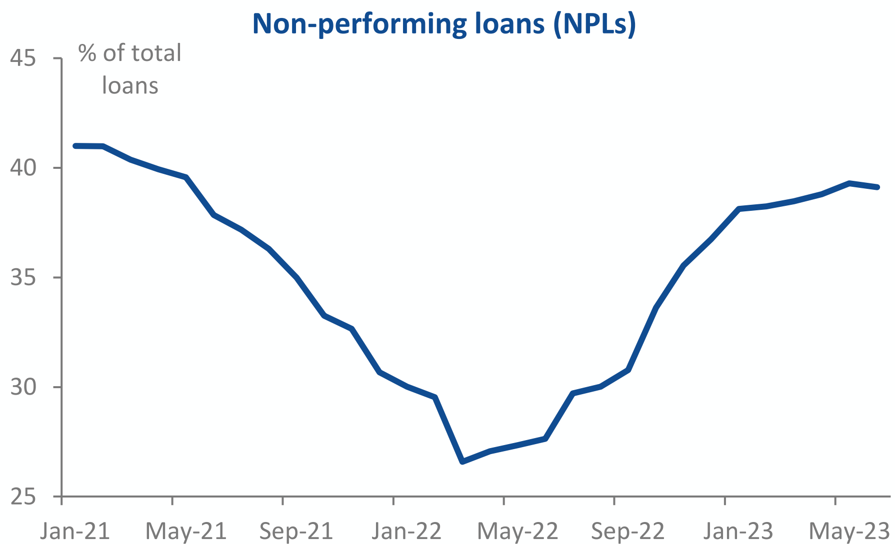


Source: NBU

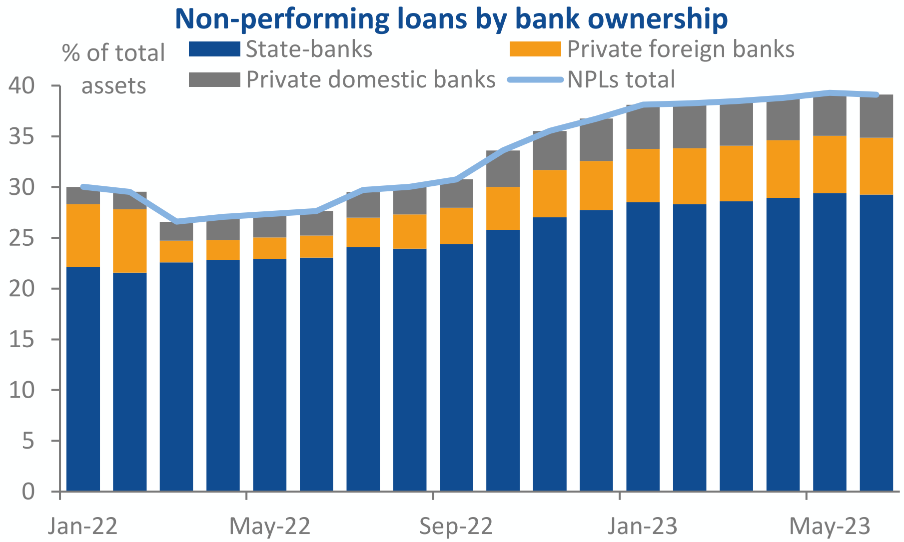
- Dynamics of loan growth is a good tracker of the overall economic situation
- Lending to the economy has strongly fallen since the full-scale war
- This decline would have been much higher without the state subsidy programme '5-7-9'
- UAH retail loans declined even further as they are not covered by the programme
  - Demand side: households restrain from borrowing due to real wage declines → private consumption fall
  - Supply side: banks charge high risk premia

➤ **Real loan growth deep in negative space**

7. Non-performing loans



Source: NBU

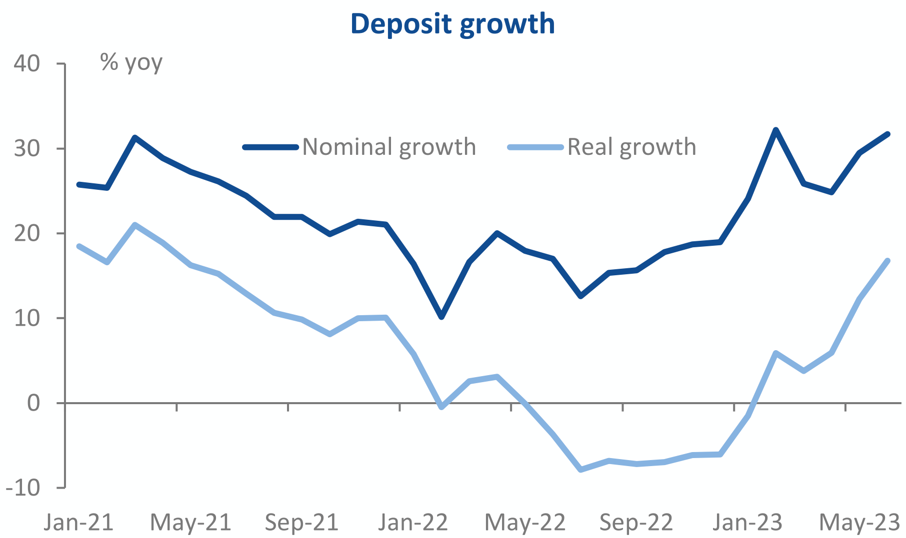


Source: NBU

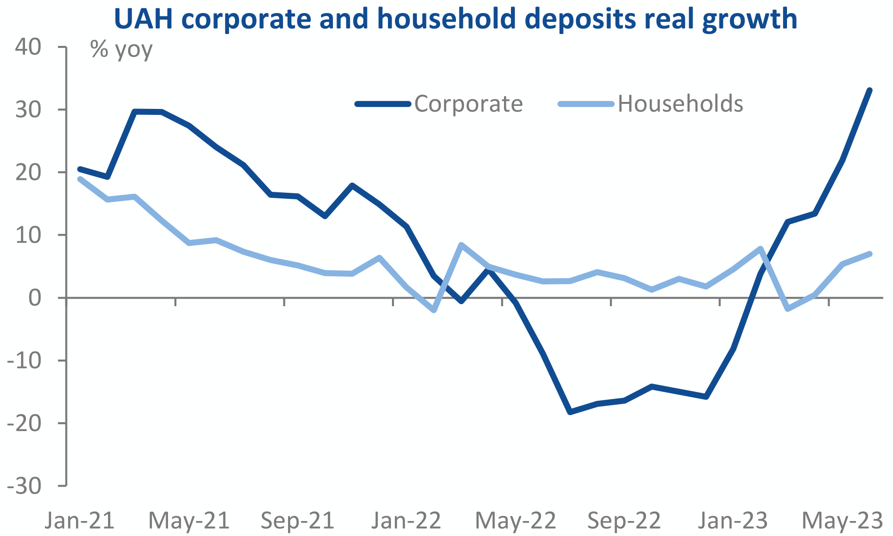
- NPLs keep rising, but remain below Jan-21 level
- The rise is driven by state banks and Ukrainian private domestic banks
- Ca. 14% of corporate loans that were performing at the beginning of the full-scale war now turned into NPLs
- But asset quality review and stress-test will reveal likely hidden risks of NPLs in the sector

- **Current statistics show a manageable increase of NPLs**
- **Comprehensive AQR and stress-tests are essential to understand hidden risks**

8. Deposit growth



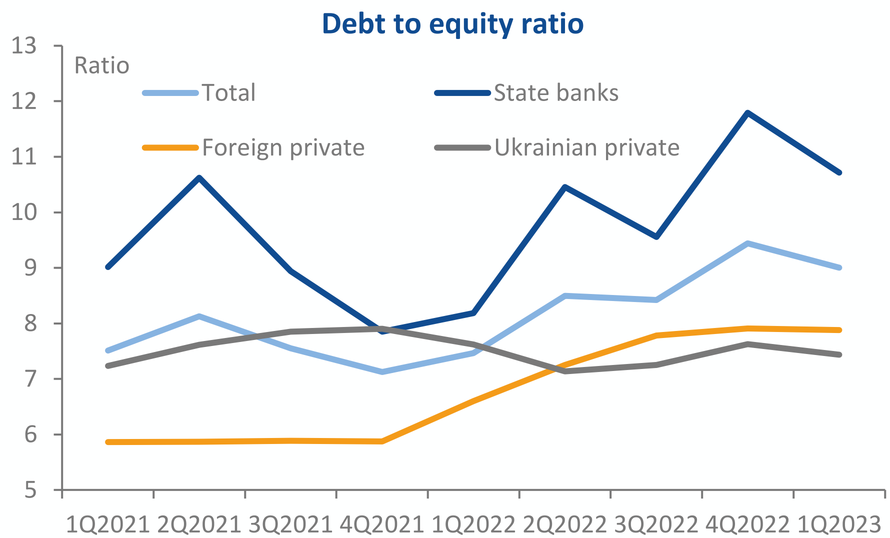
Source: NBU



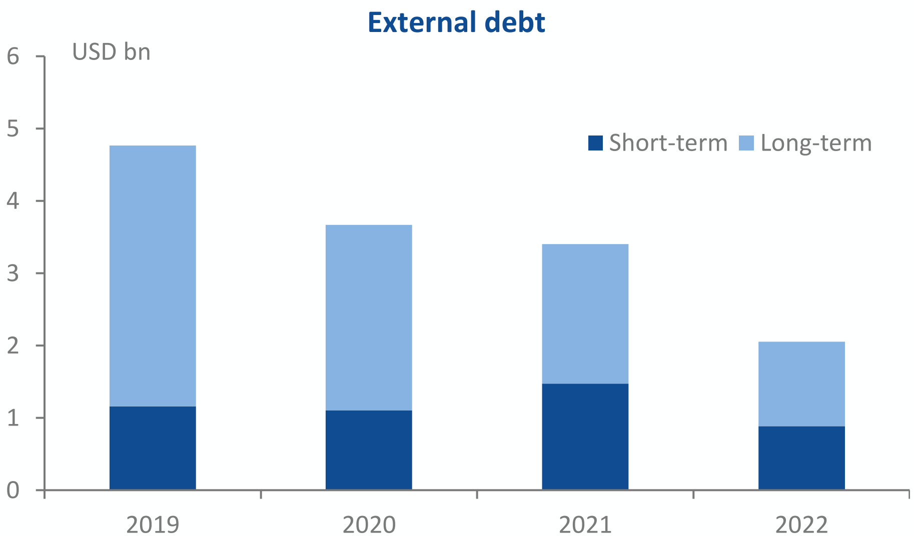
Source: NBU

- No bank-runs occurred
- Deposit growth was on a declining path
- However, it started to recover since the policy rate hike in Jun-23, now turned to positive growth, even in real terms
- Savings of households and corporates grow in real terms: depressed private consumption and corporates' investment as well as increased demand for deposit certificates
- Growth of deposits was main reason for the NBU to tighten reserve requirements:
  - Converting highly liquid assets into NBU funds
  - Using domestic gov bonds with market-based yields
- **Recovery of deposits is a sign of stability and public confidence in the sector**

9. Debt and external debt



Source: NBU

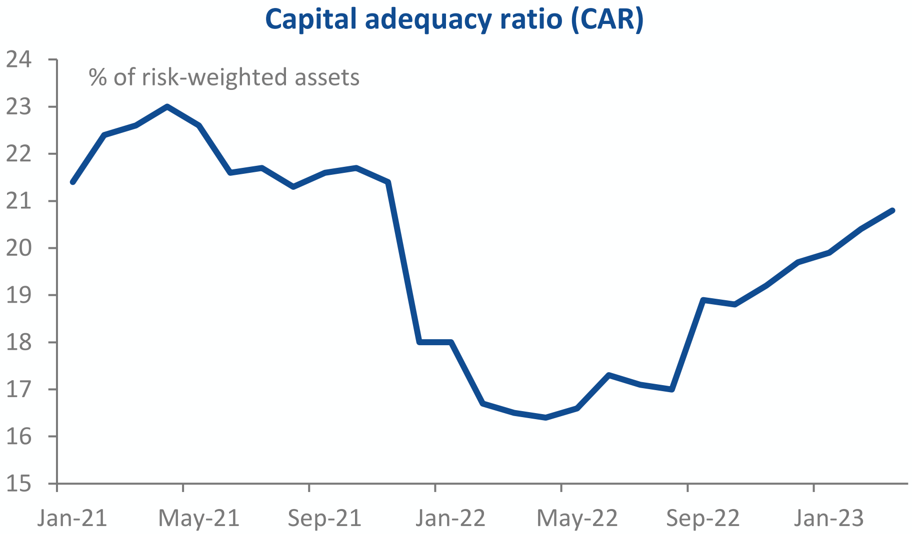


Sources: NBU

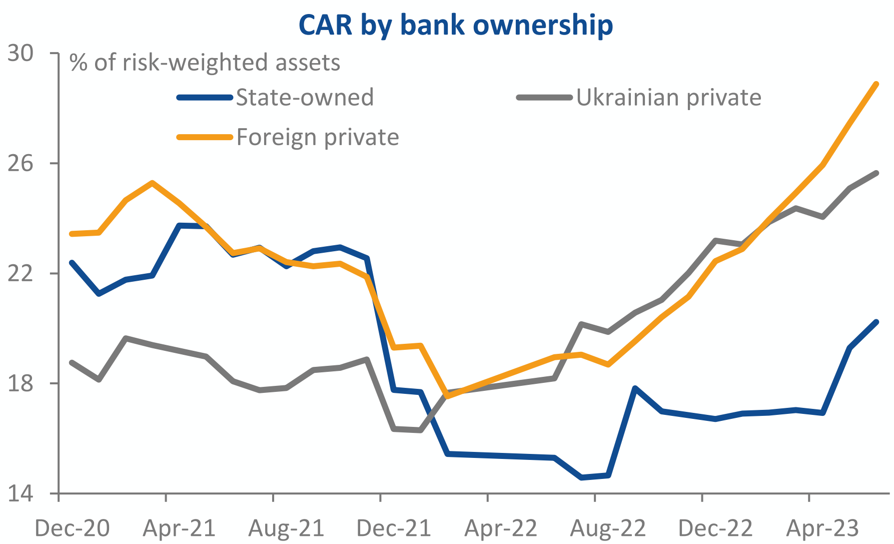
- » Debt has increased while equity not since Feb-22
- » Debt to equity ratio increased esp. in SOBs and foreign private banks
- » External debt has fallen, however
  - Banks have got only limited access to external financing since beginning of the full-scale war
  - Particularly, SOBs are subject to high-risk country rating, limiting access
  - Excess liquidity supported banks in repaying external debt

- ➢ Debt to equity ratio increased
- ➢ But external debt declined due to limited access to new external financing

10. Capital adequacy ratio



Source: NBU

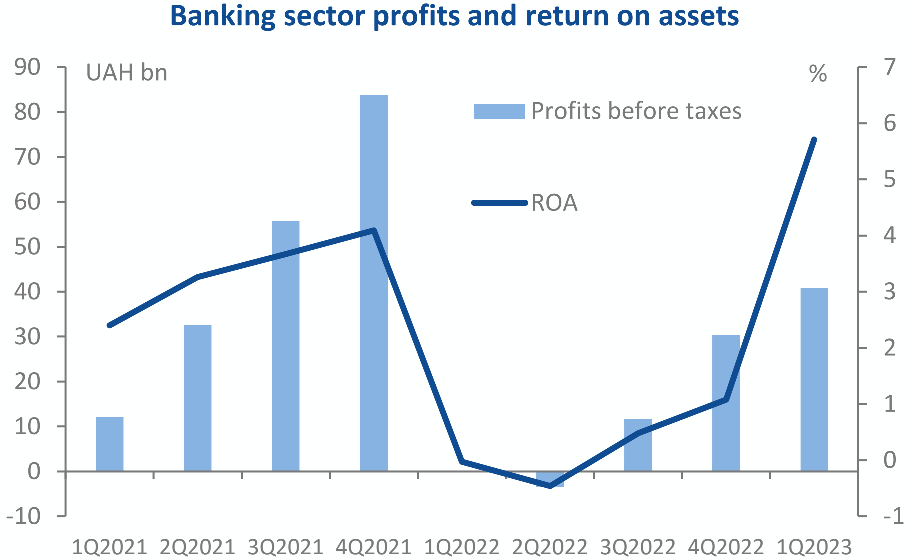


Source: NBU

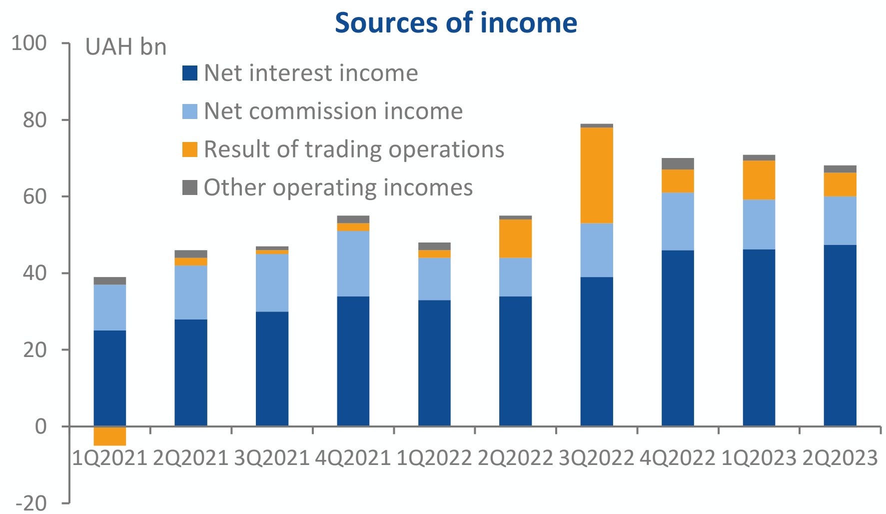
- » CAR recovered after a moderate decline in first two quarters 2022
- » Despite being on a lower level than pre-war, the ratio remains even higher than in the POL or HUN
- » Sector's profitability stemming from interest income (CDs) maintains the resilience buffer

- ➢ **CAR reveals a strong resilience buffer**
- ➢ **NBU's supervision policy plays a key role in the development of the resilience**

11. Profitability



Source: NBU, profits before taxation



Source: NBU

» Positive profits despite the war, but lower than in 2021

» Return on assets has recovered after being close to zero in 1H2022

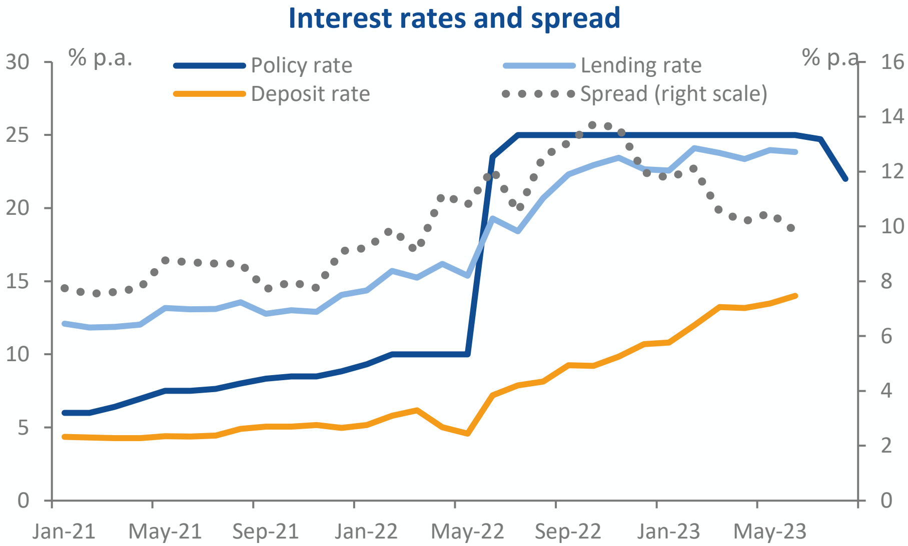
» Profitability driven by net interest income, particularly generated from deposit certificates, state bonds and margins from ‘5-7-9’

» Trading operations play only a minor role

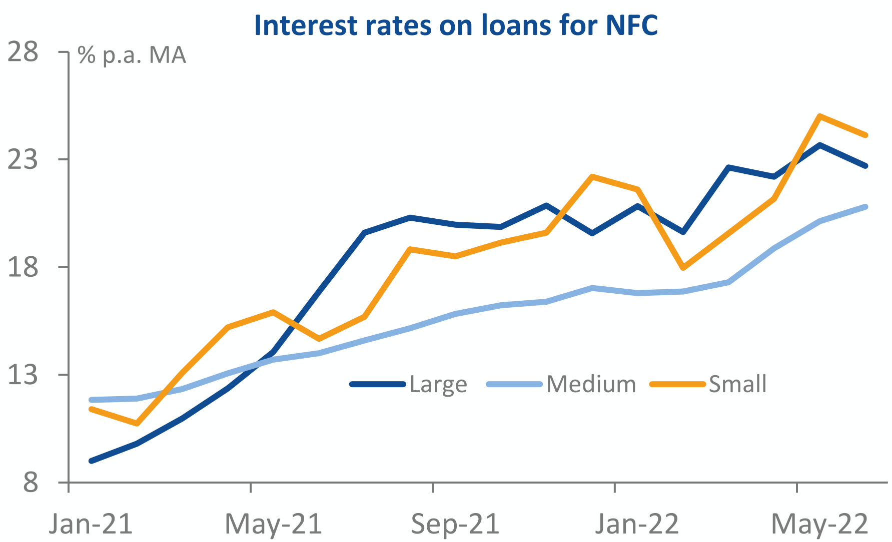
➢ Sector remains profitable and gains space to further increase resilience

➢ But: profitability is driven by state subsidised loans rather than private operations and CDs/state bonds during the war

12. Interest rates



Source: NBU, key policy rate monthly average

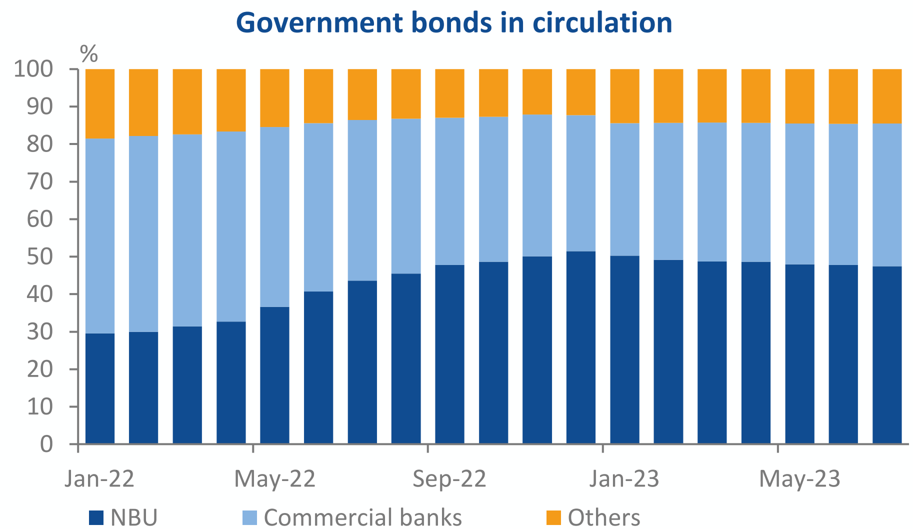


Source: NBU

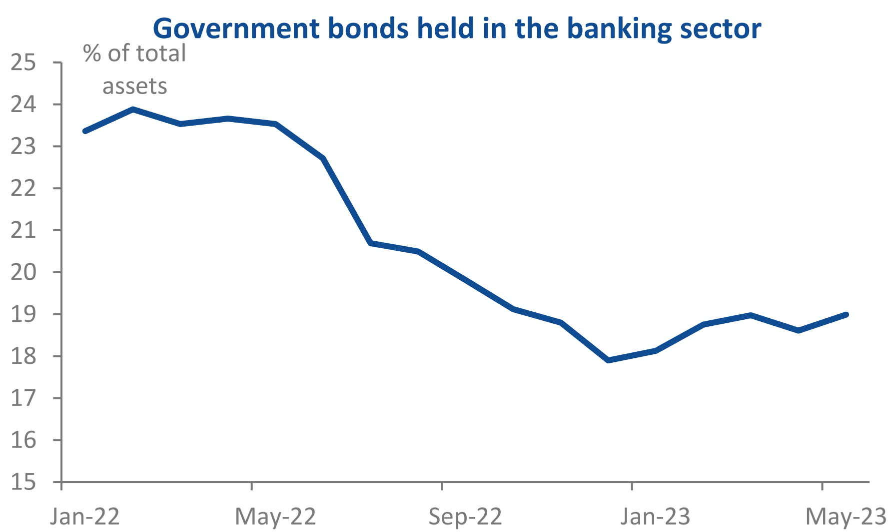
- » Policy rate hiked by 15pp in Jun-23, since then, deposit and lending rates are on a steady growth path
- » Easing cycle with first cut to 22% p.a started in Jul-23
- » Spread has been declining and reached pre-war level in Jun-23
- » Large NFC cannot borrow as part of 5-7-9 programme: rates are not subject to lending rate caps → higher interest rates than for medium-sized companies

- **Policy rate easing started**
- **Further cuts expected for this year key policy rate to fall below 20% p.a.**
- **Large NFC experience higher interest rates compared to medium-sized → market distortions**

13. Government bonds



Source: NBU



Source: NBU

» The NBU increased its share of government bonds from 30% in Feb-22 to 51% in Dec-22

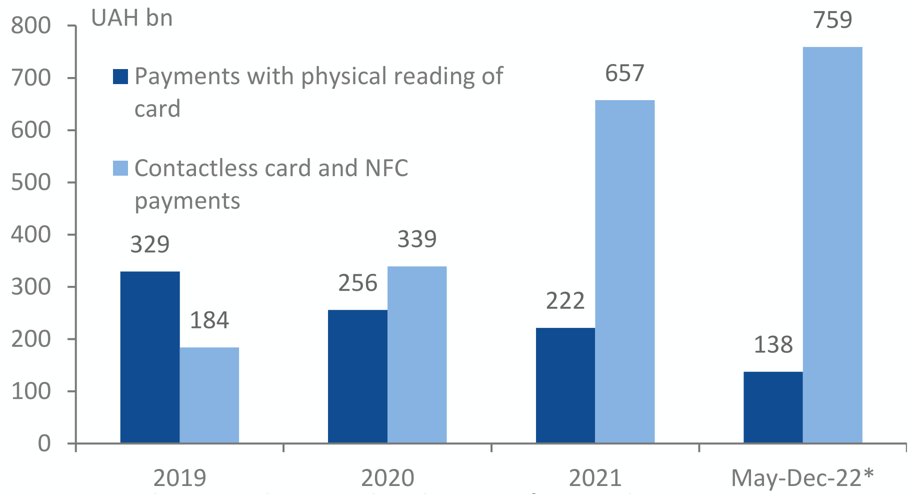
» The NBU stopped this policy in Jan-23, commercial banks stepped in gradually, they are allowed to cover 50% of reserves with state securities

» Government bonds are an important source for profits and can be accounted for in the reserve requirements → this increases demand

➢ **NBU's policy change supports banks' demand**

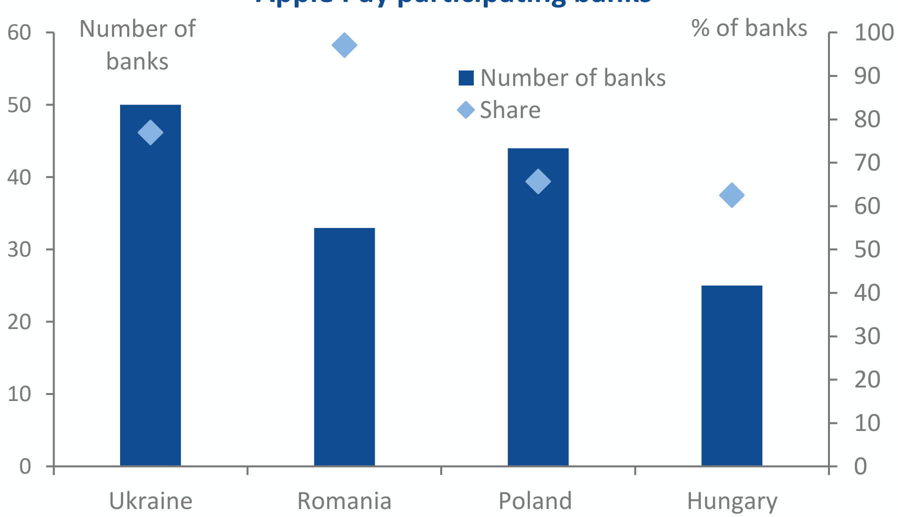
14. Digital transformation

Card and digital transactions in Ukraine



Source: NBU, between Feb-Apr-22, the submission of statistical reporting on transactions with payment cards was suspended.

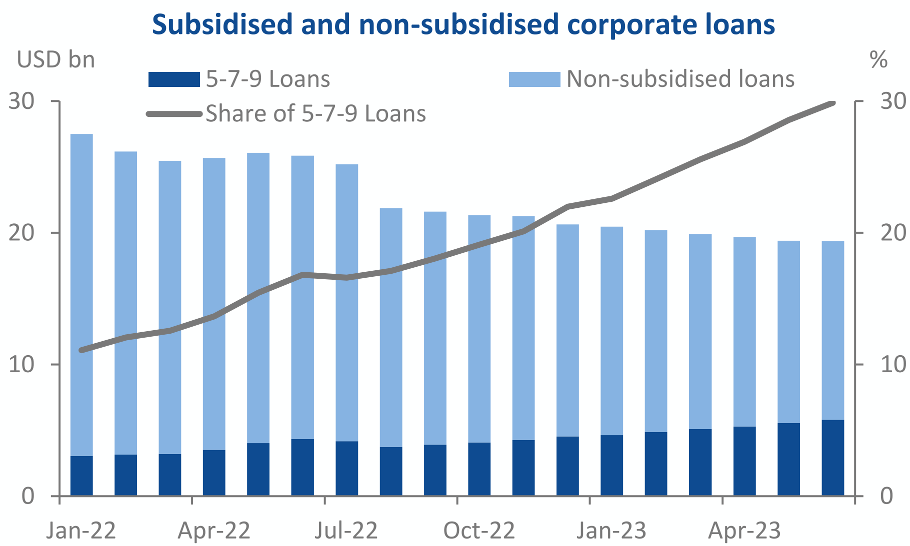
Apple Pay participating banks



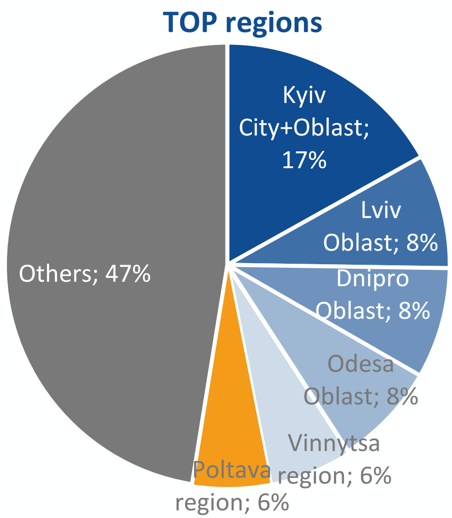
Sources: Apple, respective central banks, European Banking Federation

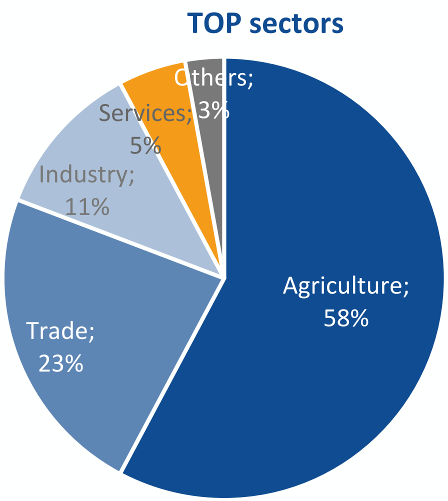
- Cashless transactions have become the most important payment method in Ukraine since 2020 (COVID), accounting for 69% of the amount of all card-based transactions in war-affected 2022.
- Despite Russia's attacks on the energy system in 2022, UKR payments system ran uninterruptedly.
- Payments with contactless cards and NFC increased by 53% in 2022 yoy, accounting for 85% of all cashless transactions (75% in 2021)
- The availability of Apple Pay technology in UKR is exceeding that in POL, HUN
- **Digital transactions are encouraged by UKR government as they improve transparency, lower costs and increase sector productivity, all crucial in wartimes**

15. Loan subsidy programme ‘5-7-9’



Sources: Business Development Fund, NBU, between Feb-22 to Jul-23, outstanding loans in UAH





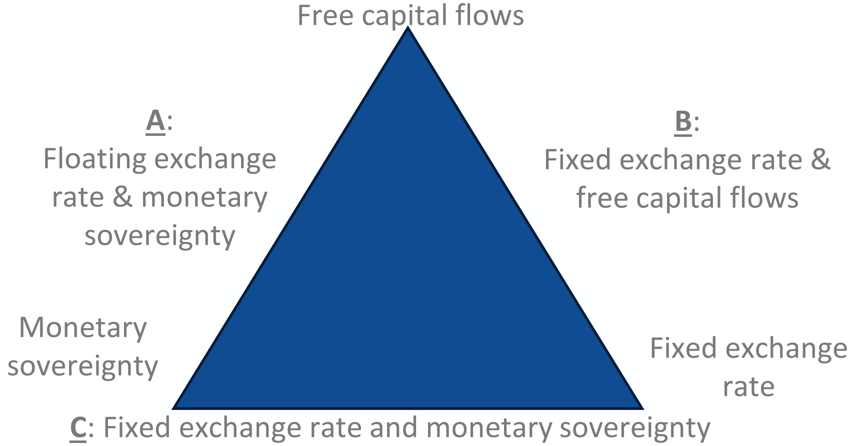
Sources: Business Development Fund, NBU, between Feb-22 to Jul-23

- High risk premia and increased lending rates are the main reasons behind a decline in market-based loan volume.
- 5-7-9 program aims to maintain loan access, volume: USD 3.5 bn since 24-Feb-22, currently constitutes 30% of all business loans.
- Main sectors: share of top sector agriculture (58%) further increased Regions: Kyiv city + region (17%),
- However, high policy rates increased fiscal burden, though subsidy capped at 3-month UIRD + margin (currently ca. 10-25% p.a): Fiscal costs at ca. UAH 10 bn (USD 0.3 bn) after 6M2023

- State support maintains access to loans
- Banks foresee the hryvnia portfolio growth to be primarily driven by state programs: threat of crowding out
- Managing fiscal burden is essential

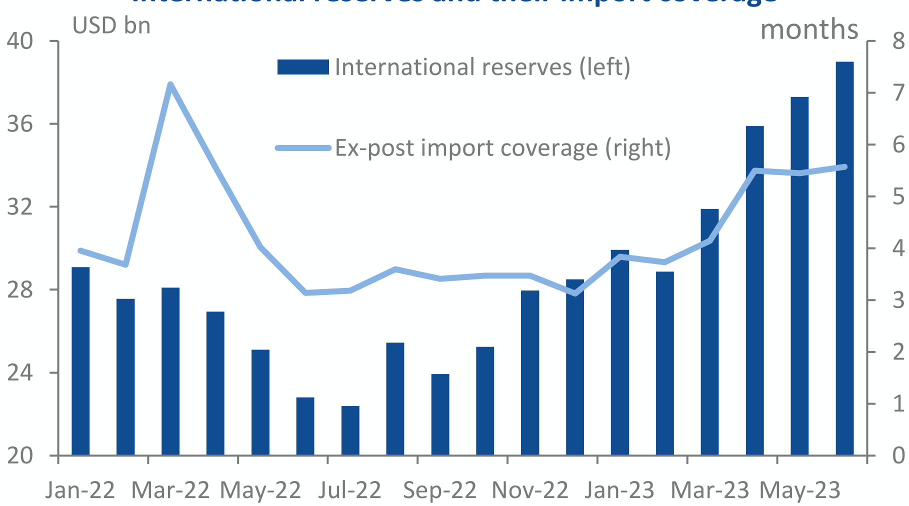
16. Monetary policy regime change and capital controls

International reserves and their import coverage



Sources: Obstfeld et al. (2005), Link, Shambaugh and Klein (2013), Link.

International reserves and their import coverage



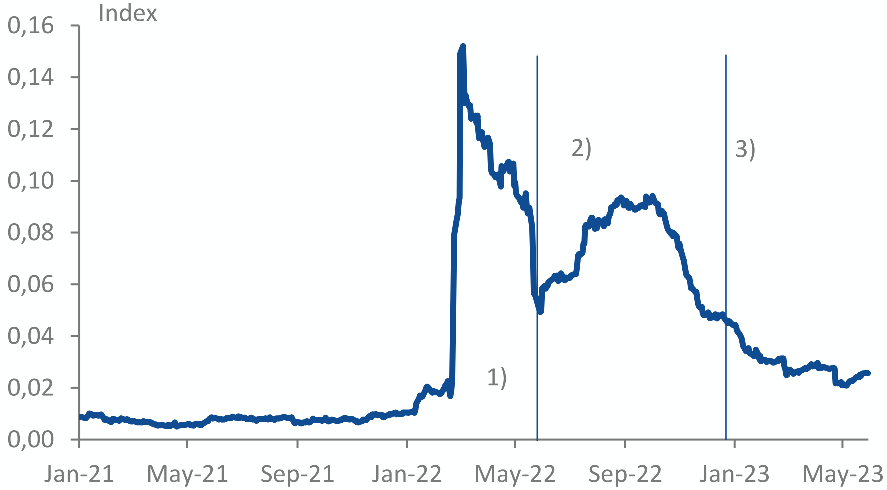
Source: NBU

- » Ukraine had to prioritise monetary budget financing over inflation stability and set exchange rate as main anchor: move A to C
- » New regime was successful in calming down markets: reserves reached all-time high, disinflation continues, spread between cash-market rate and official almost disappeared
- » NBU prepares markets to shift back C to A: capital controls slowly liberalized and new strategy agreed with the IMF announced
- » Though key policy cut recently, further liberalization steps will be followed keeping a tight regime

- ➢ Current macro-financial situation shows a window of opportunity to return to A and inflation targeting (IT)
- ➢ BUT only possible if inflation expectations are firmly anchored for the purposes of monetary policy, e.g. no sudden jump in capped energy tariffs

17. Banking supervision measures

Financial stress index: Bank subindex



Source: NBU

Regulatory measures

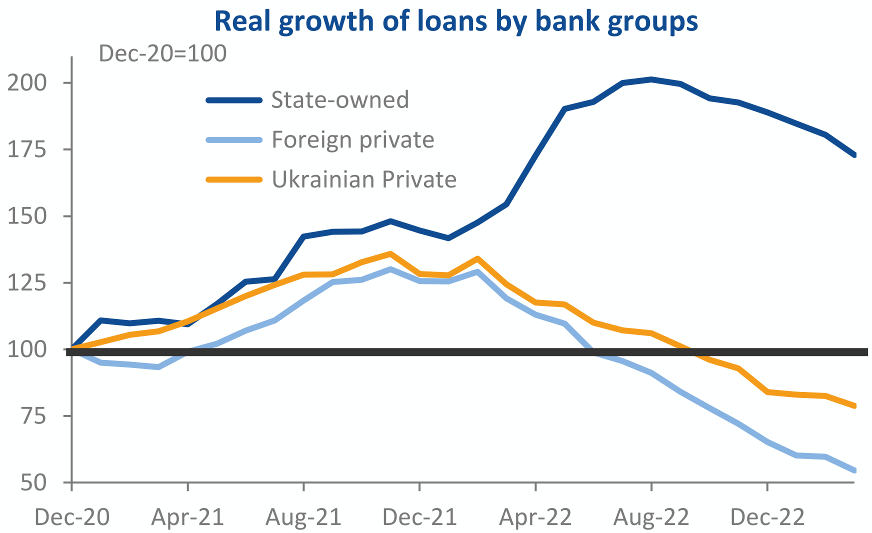
Period	Measures
1) Emergency	• Unsecured refinancing loans launched • Dividends payout forbidden • Suspended AQR, stress-test, actions for violating CAR, LCR etc. • Loan rate increase were forbidden for customers • Key policy rate (KPR) decisions suspended, exchange rate fixed at pre-war, capital controls
2) Adjustment	• UAH/USD depreciated, policy rate hike • Cancel additional fees for ATM withdrawals • Simplified cash withdrawal, currency exchange, money transfer at cash desks
3) Recovery	• Changes to liquidity requirements • Liberalisation of capital controls + KPR cut • Allowance to cover 50% of reserves with state securities Resilience assessment announced for 2023 • Nationalisation of SENSE

Source: NBU

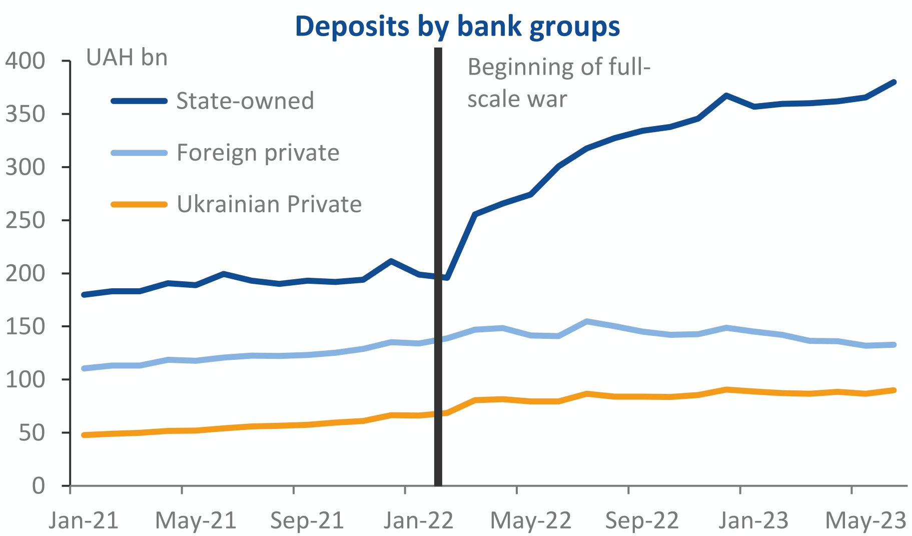
- » Supervision measures were decisive at the beginning of the full-scale war to reduce financial stress
- » Experience from 2014/2015 (max. 0.138), COVID (0.03) and past reforms but stress level was less profound
- » Then, they supported adjustment to the situation and during energy blackouts and now in the period of recovery
- » Measures aim at large availability of liquidity, simplified access to cash for customers and FX stability
- » Recovery of loan growth was not tackled: vital for investment recovery

- ➢ **Professional response ensures stable banking sector based on key past reforms**
- ➢ **Loan growth resumption is key**
- ➢ **Stress-test and AQR important for 2023**

18. Challenges for state-owned banks



Source: NBU

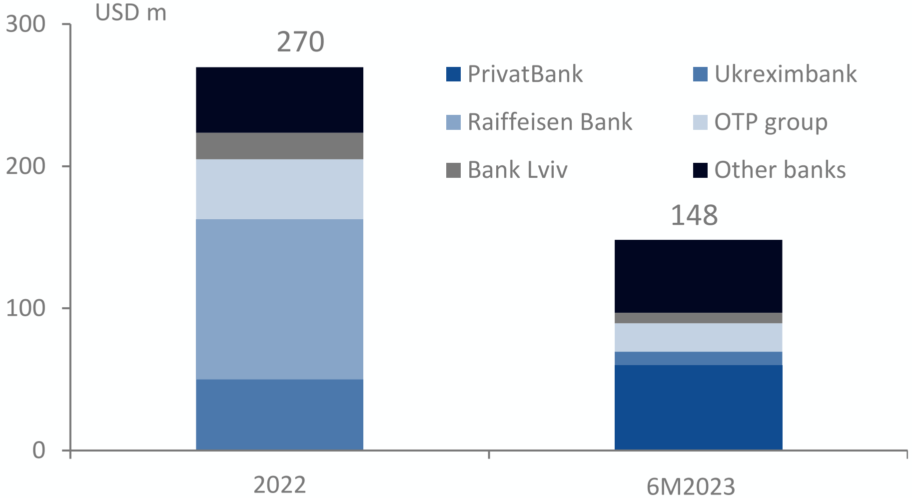


Source: NBU

- » State ownership plays an extraordinary role during the full-scale war
  - \+ Rescue of systemically important bank activities (SENSE) during the war
  - \+ Streamline state priorities during the war (e.g. loans for (re-)construction, agri-food sector, 5-7-9, state-owned companies)
  - \- Reduce competition
  - \- Possible political influence
- » SOBs have higher NPLs, debt-to-equity, lower CAR and LCR than private banks in Ukraine, while having increasing share of deposits (63% in Jun-23)
- » Strengthening independent supervisory board vital: stressed in the IMF EFF
- » Roadmap for privatisation after comprehensive AQR in 2024
- ➢ **The role of SOBs has increased since war**
- ➢ **However, many challenges remain**

19. Banks’ role in reconstruction

Loans and guarantees from IFIs to the banking sector



Sources: EBRD, DfC, USAID, MIGA

Financial sector development strategy

Initiative	Measures	Responsibility
Development of financial institutions	• Updated regulation and supervision • Improvement of corporate governance • Resolving bad asset problems • Information disclosure efficiency based on IFRS	NBU, *National Security and Stock Market Commission (NSSMC)* , *Deposit Guarantee Fund (DGF)*
Development of SOBs	• Reduction of the state’s share • Ensuring the financial resilience, including by conducting AQRs	Ministry of Finance (MoF), NBU
Recovery of failed Institutions	• Implementation of EU laws on rehabilitation and resolution of financial institution	NBU, DGF, MoF, NSSMC, Ministry of Justice
Guarantee system	• Implementation of EU laws	DGF, NSSMC

Source: NBU

- Worldwide, banks usually play a powerful role in financing the economy and green recovery. However, this is not the case in Ukraine yet:
  - New lending is driven by state subsidies rather than private operations
  - Assets are heavily dominated by risk-free investments (NBU certificates and government bonds) rather than lending
- There’s a lack of international funding support during the war
- The policies to address these shortcomings might include:
  - Enlarging banks’ participation in investment guarantee and export credit insurance schemes, thus reducing risk premia and making loans affordable
  - Promote participation of banks in IFI programmes

➢ **The NBU‘s financial sector development strategy aims at preparing the sector for its reconstruction role, which is lacking so far**

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.*

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