Banking Sector Monitoring Ukraine

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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
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7. Non-performing loans (NPL)
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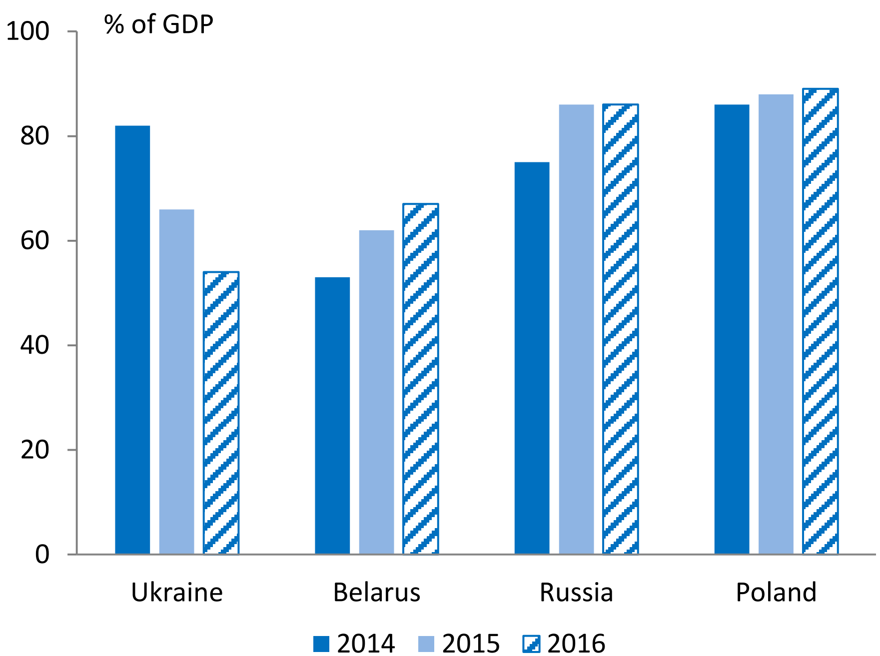
Special issues:

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

Bank assets to GDP



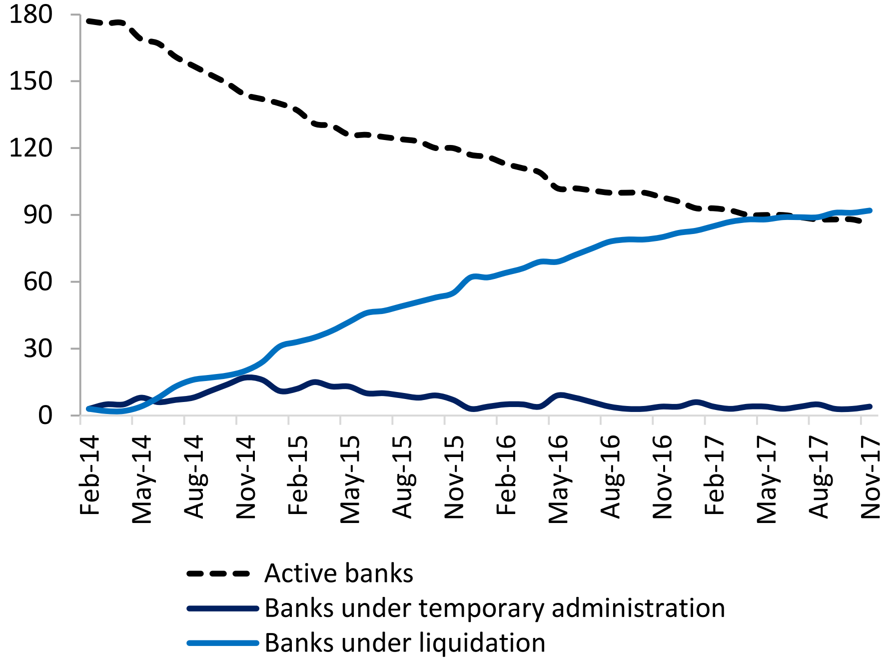
Source: Own calculations based on IMF data
Note: Bank assets are gross assets net of provisions

- 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

Number of banks



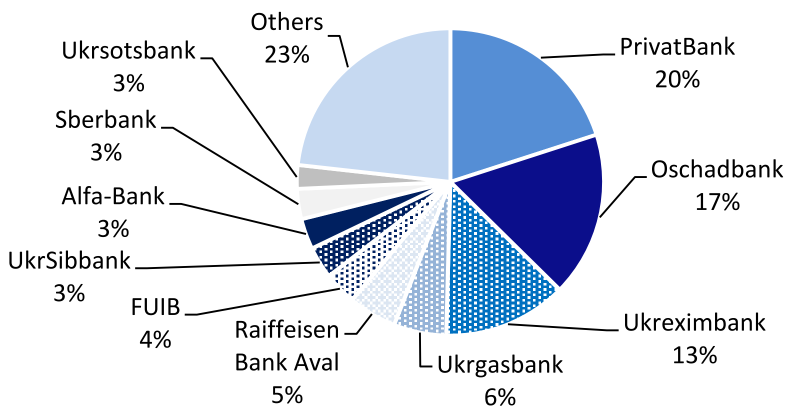
Source: Own calculations based on NBU data

- 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

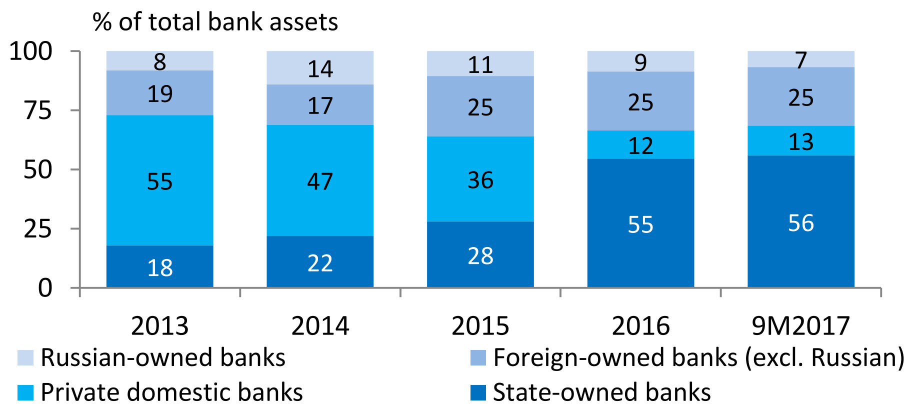
3. Market shares

Market share of total banking sector assets



Source: Own calculations based on NBU data from September 2017

Market share by type of ownership



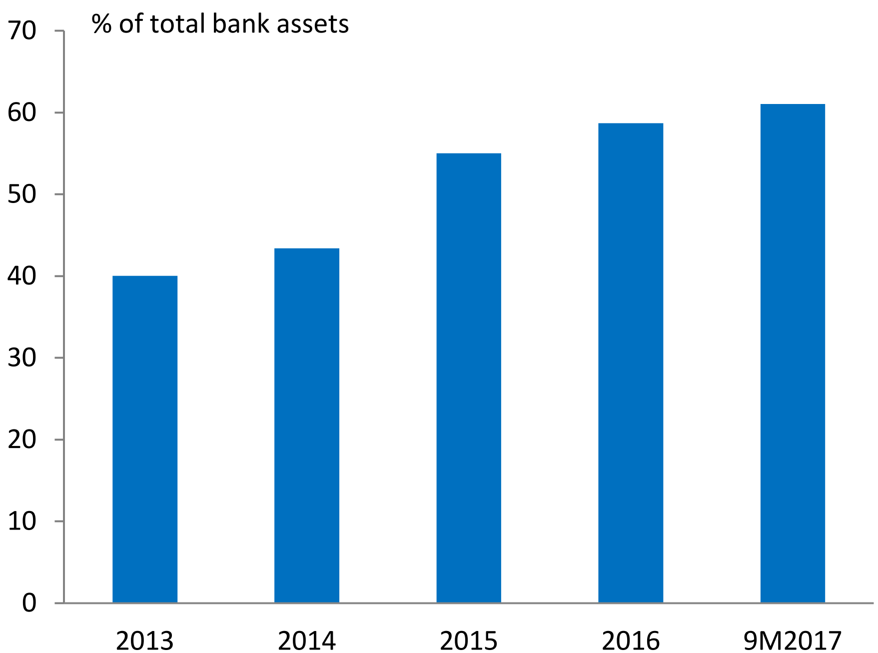
Source: Own calculations based on NBU data, RZB
Note: Russian-owned banks exclude Alfa Group banks

- 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%

4. Concentration

Assets share of Top-5 banks



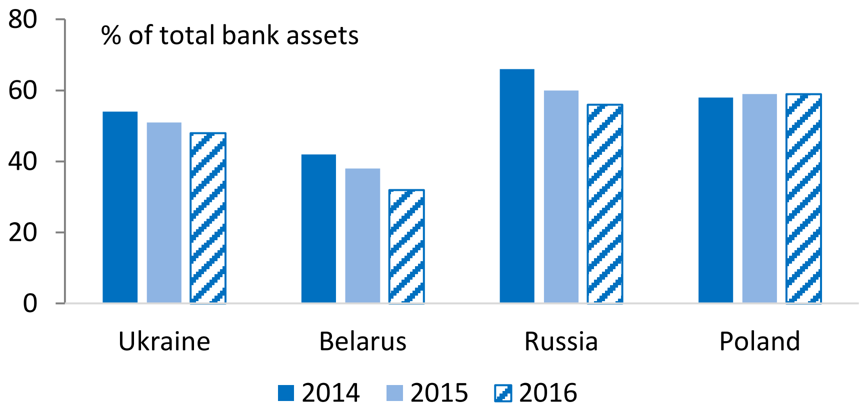
Source: Own calculations based on NBU data

- 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**

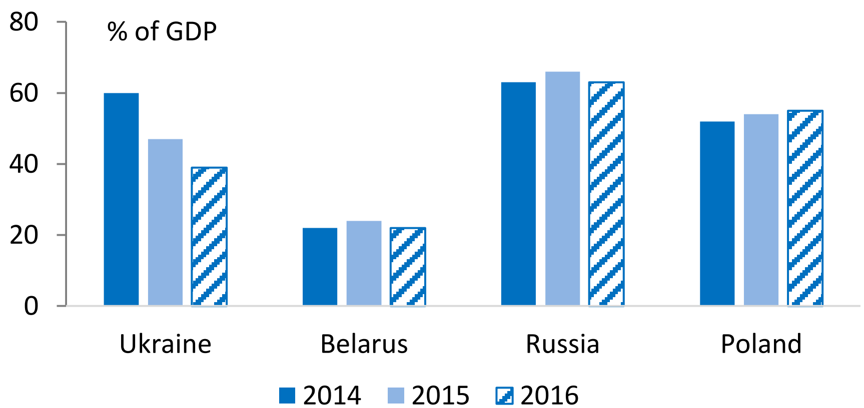
5. Lending to the real sector

Credit to private sector



Source: Own calculation based on IMF data
Note: 2016 data for Russia is an estimate as data are reported only until Oct 2016; credit to private sector net of provisions

Credit to private sector



Source: Own calculation based on IMF data

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

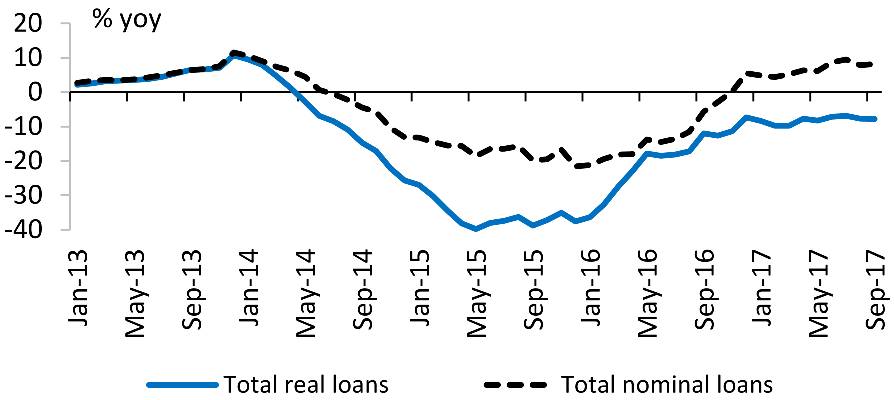
Private sector credit to GDP

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

⇒ Reduction in claims on private (real) sector by about a third

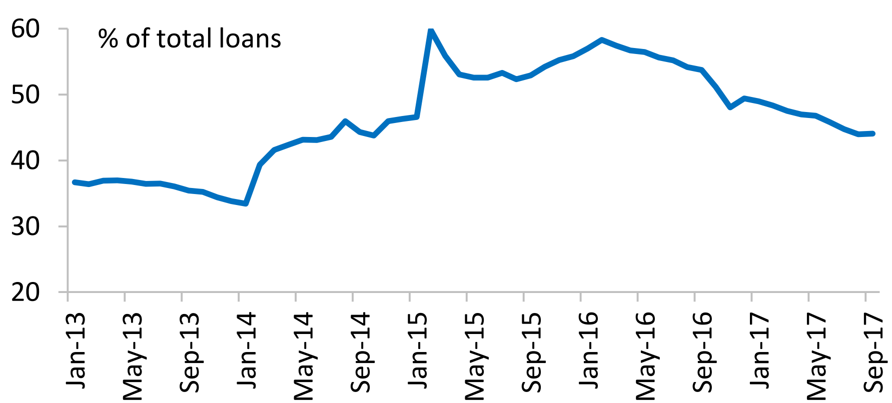
6. Loan growth and currency structure

Loan growth



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

Share of foreign currency loans



Source: Own calculation based on NBU data

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

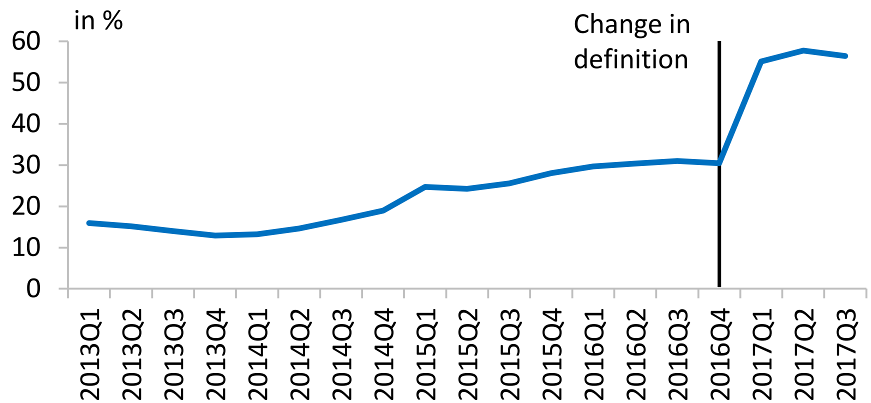
Currency structure

- 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

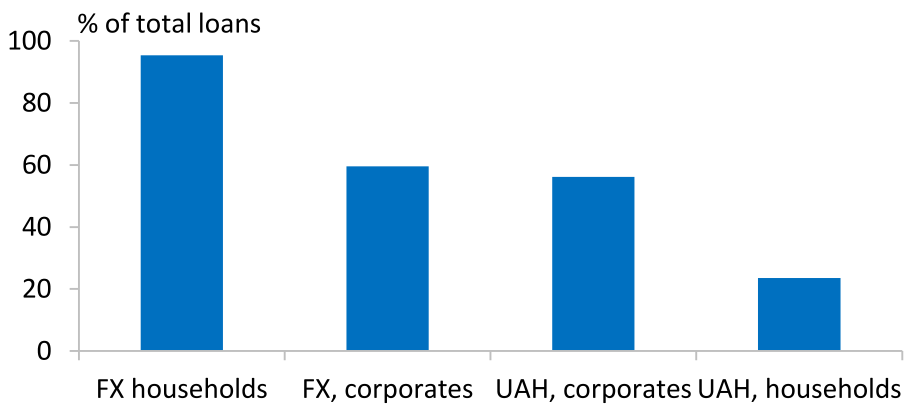
7. Non-performing loans (NPL)

NPLs as share of gross loans



Source: NBU

NPLs by types of loans



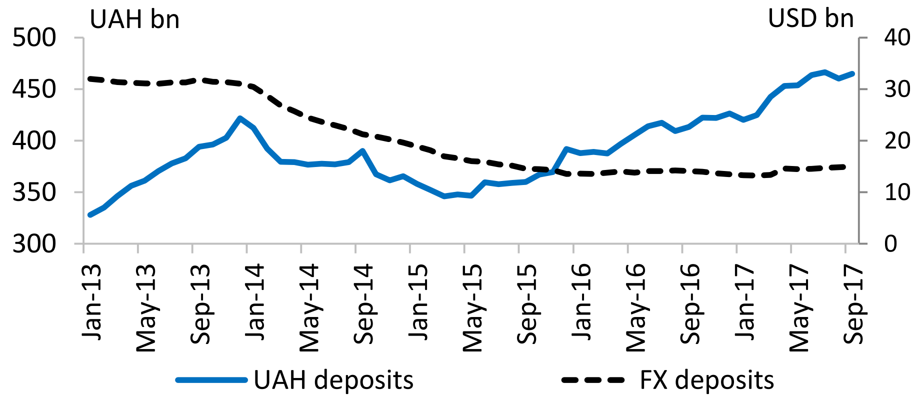
Source: Own calculations based on NBU, end-Sep 2017

- 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**

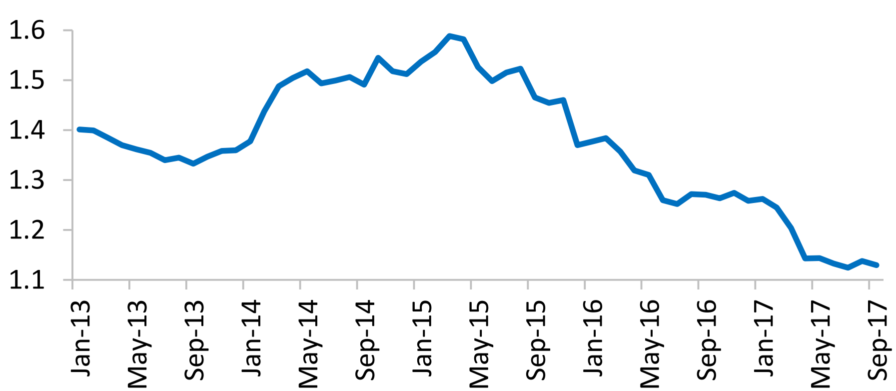
8. Deposits

Bank deposits



Source: NBU

Loan to deposit ratio



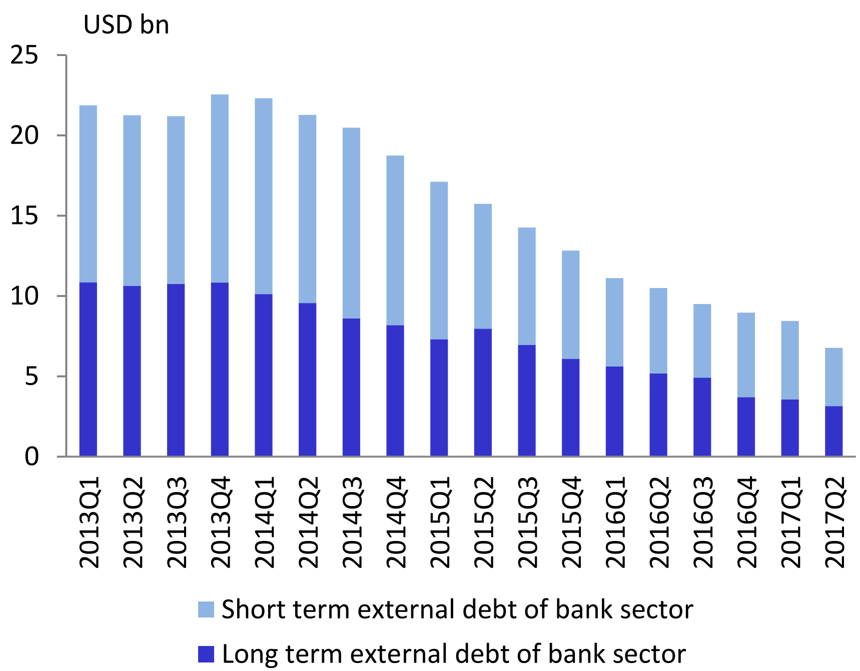
Source: Own calculations based on NBU data

- 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

External debt of the banking sector



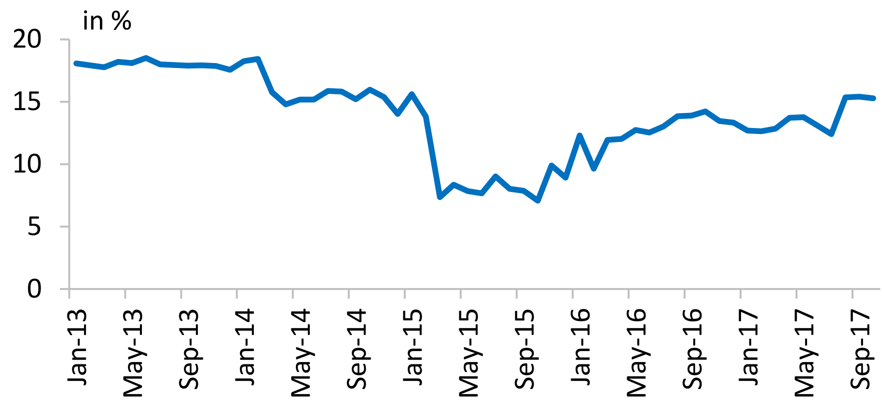
Source: NBU
Note: short-term/long-term debt at remaining maturity

- Previously, an important funding source apart from deposits
- Massive external deleveraging during the crisis: Down from USD 22.5 bn (Q42013) to USD 6.8 bn (Q22017) 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

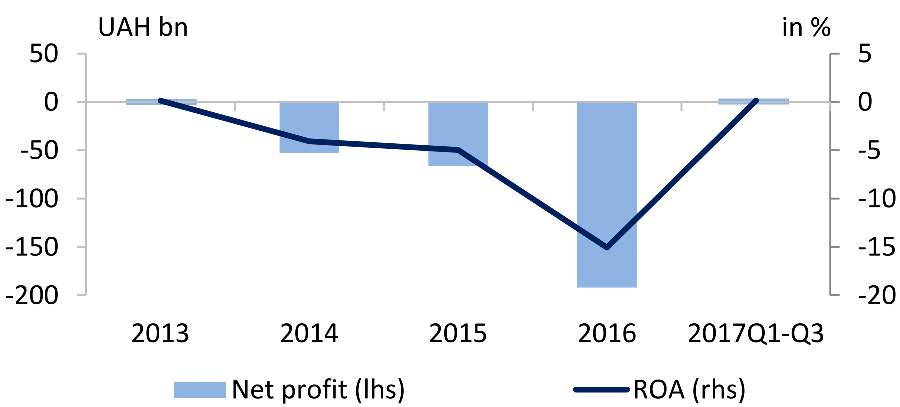
10. Capital

Banking sector capital adequacy ratio



Source: NBU

Banking sector profit



Source: NBU, own calculations based on NBU data

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

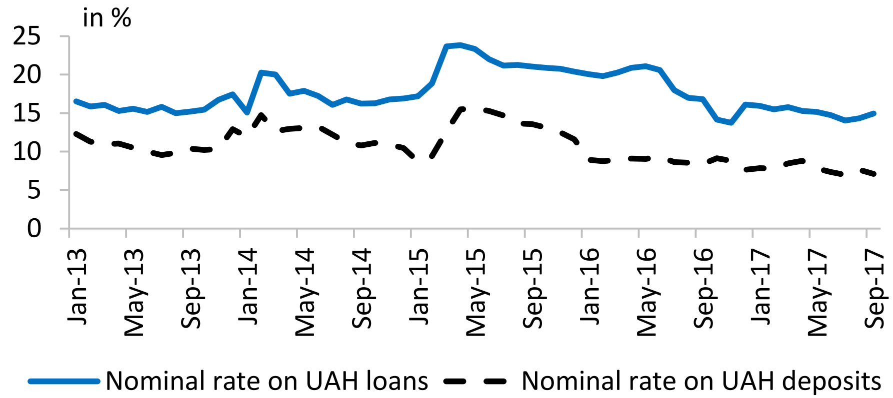
Profitability

- 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

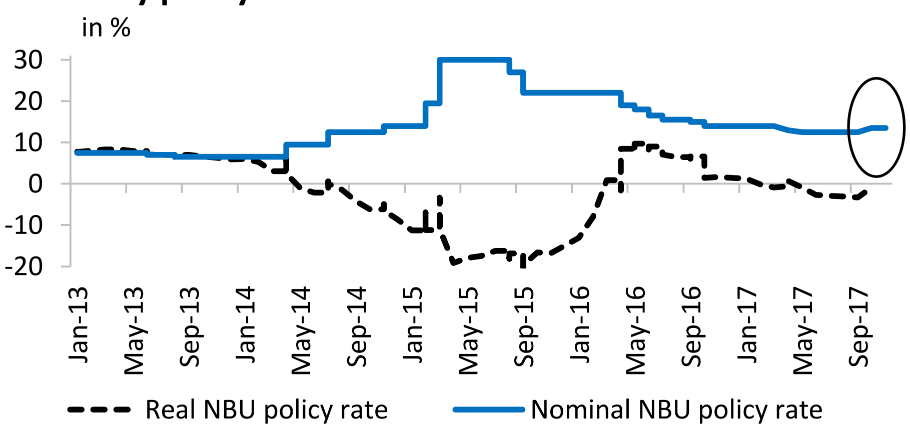
11. Interest rates

Interest rates on loans and deposits



Source: NBU

NBU key policy rate



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

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

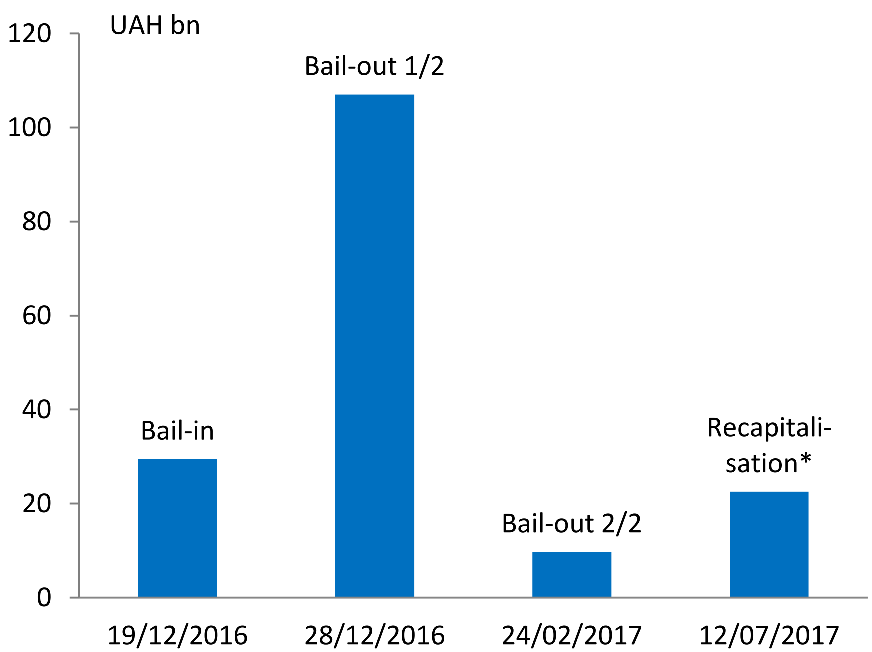
Monetary policy rate

- 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 capital injections



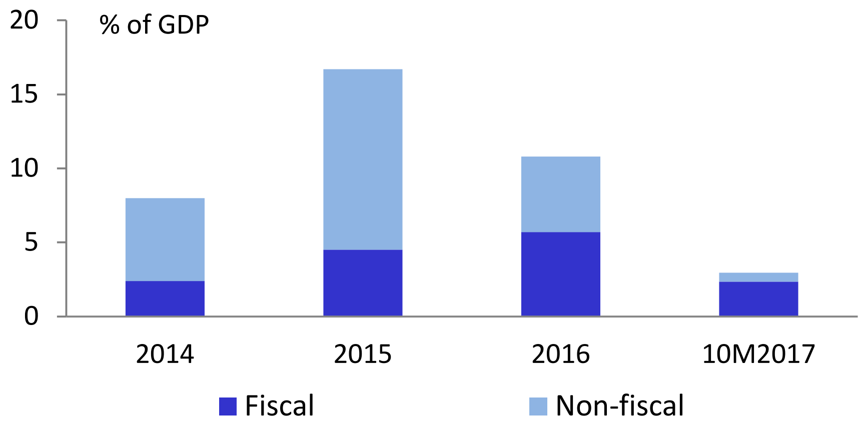
Source: Own calculations
*Note: * The government approved a total amount of UAH 38.5 bn, of which only UAH 22.5 bn was injected*

- 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

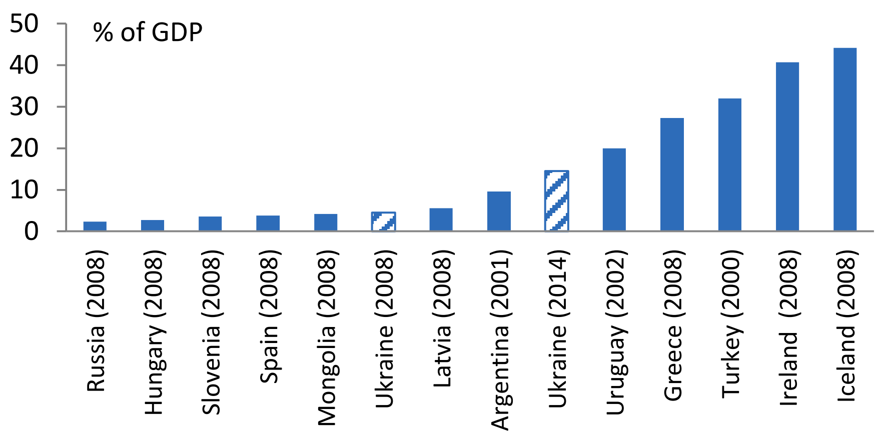
b. Losses due to the Banking Sector Crisis

Losses due to the Banking Sector Crisis



Source: Own calculations based on NBU and DGF data

Fiscal costs of crises



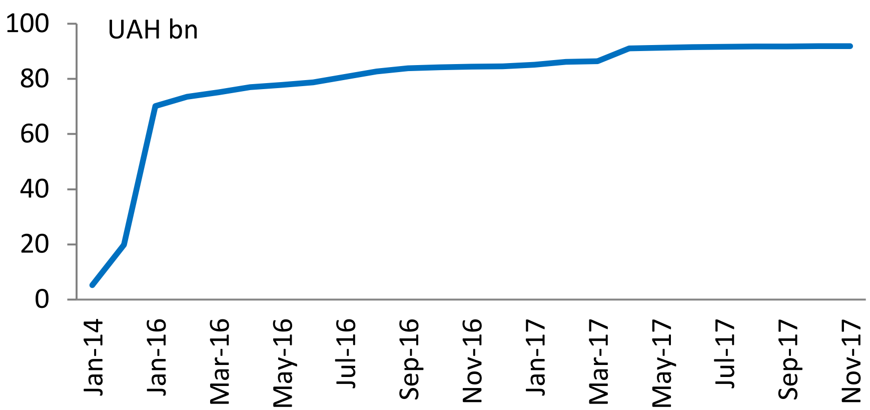
Source: Laeven and Valencia (2013), own calculations based on NBU and DGF

- 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

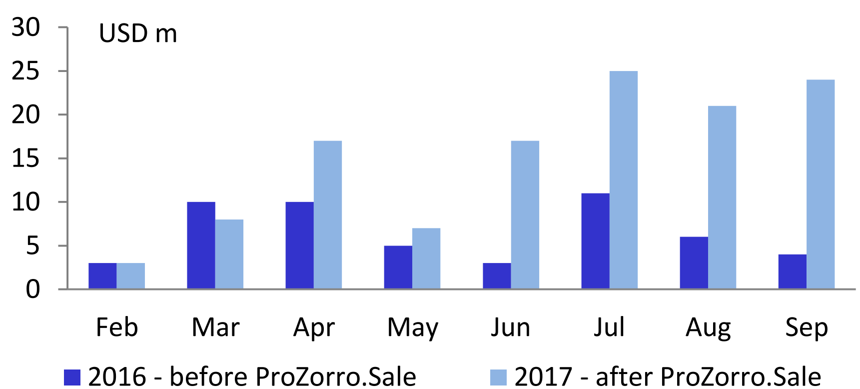
c. Deposit Guarantee Fund

Cumulative pay-out of guaranteed deposits from DGF



Source: DGF

DGF monthly asset sales



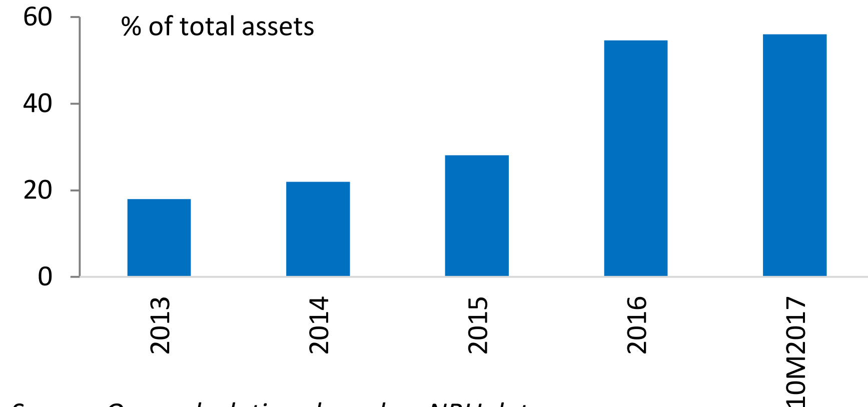
Source: ProZorro.Sale

- 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**

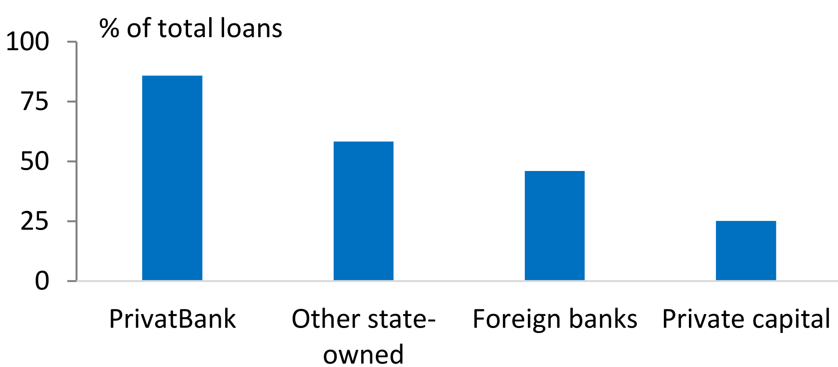
d. Reform of State-owned banks

Market share of state-owned banks



Source: Own calculations based on NBU data

NPLs by type of ownership of bank



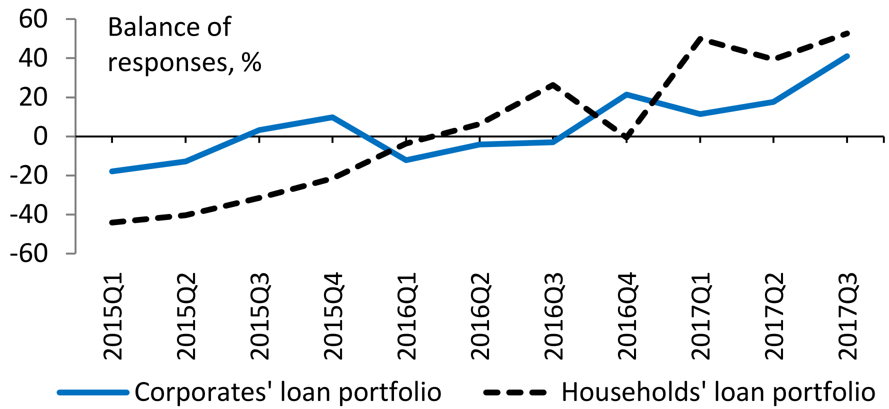
Source: NBU

- 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

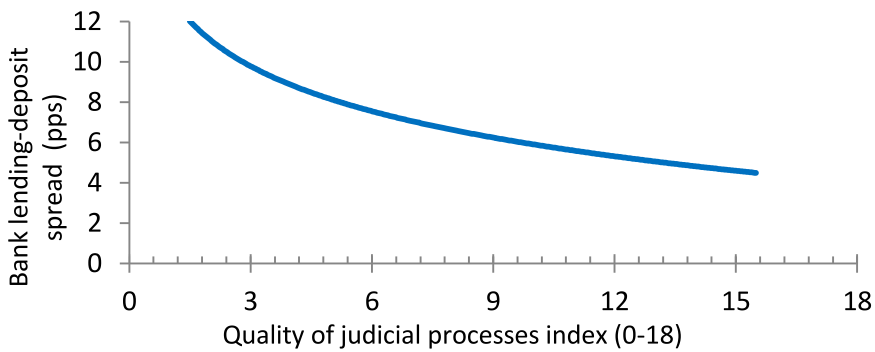
e. How to restart lending

Lending expectations for the next 12 months



Source: NBU Lending survey, latest edition
Note: A positive balance indicates lending growth

Interest rate spread and quality of judicial process



Source: Own calculations based on World Bank data
Note: The relationship shown is based on a non-linear regression. Bank interest spread is the difference between average lending rate and 3m deposit rate. A higher score of the index indicates a higher quality of the judicial process

- 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	2013	2014	2015	2016	2017Q2
Total assets (EUR m)	115700	68462	46537	44063	41531
growth in % yoy	8,2	-40,8	-32,0	-5,3	-9,0
in % of GDP	83,9	83,0	61,4	51,5	46,8
Total loans (EUR m)	72384	45423	26605	19337	17241
growth in % yoy	9,8	-37,2	-41,4	-27,3	-28,7
in % of GDP	52,5	55,1	35,1	22,6	19,4
Loans to legal entities (EUR m)	59244	37842	22894	16672	14511
growth in % yoy	11,3	-36,1	-39,5	-27,2	-30,7
in % of GDP	43,0	45,9	30,2	19,5	16,4
Loans to households (EUR m)	13140	7580	3711	2665	2730
growth in % yoy	3,6	-42,3	-51,0	-28,2	-15,5
in % of GDP	9,5	9,2	4,9	3,1	3,1
Loans in foreign currency (EUR m)	25022	21059	13946	9336	7792
growth in % yoy	2,2	-15,8	-33,8	-33,1	-36,6
in % of GDP	18,1	25,5	18,4	10,9	8,8
Loans in foreign currency (% of total loans)	34,6	46,4	52,4	48,3	45,2
Total deposits (EUR m)	63661	37343	28565	30428	29510
growth in % yoy	12,2	-41,3	-23,5	6,5	0,9
in % of GDP	46,2	45,3	37,7	35,6	33,3
Deposits from households (EUR m)	40021	21980	14973	15363	14840
growth in % yoy	14,0	-45,1	-31,9	2,6	0,3
in % of GDP	29,0	26,6	19,7	18,0	16,8
Total loans (% of total deposits)	113,7	121,6	93,1	63,6	58,4
Structural information					
Number of banks	180	142	117	96	90
Market share of state-owned banks (% of total assets)	18,0	22,0	28,0	55,0	56,0
Market share of foreign-owned banks (% of total assets)	27,0	31,0	36,0	34,0	32,0
Market share foreign-owned banks ex. Russian (% of total assets)	19,0	17,0	25,0	25,0	25,0
Profitability and efficiency					
Return on Assets (RoA)	0,1	-4,1	-5,0	-15,0	0,1
Capital adequacy (% of risk weighted assets)	17,6	14,0	8,9	13,3	13,1
Non-performing loans (% of total loans)	12,9	19,0	28,0	30,5	57,7

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

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