# Banking Sector Monitoring Ukraine

**Robert Kirchner, Vitaliy Kravchuk**

Berlin/Kyiv, July 2019

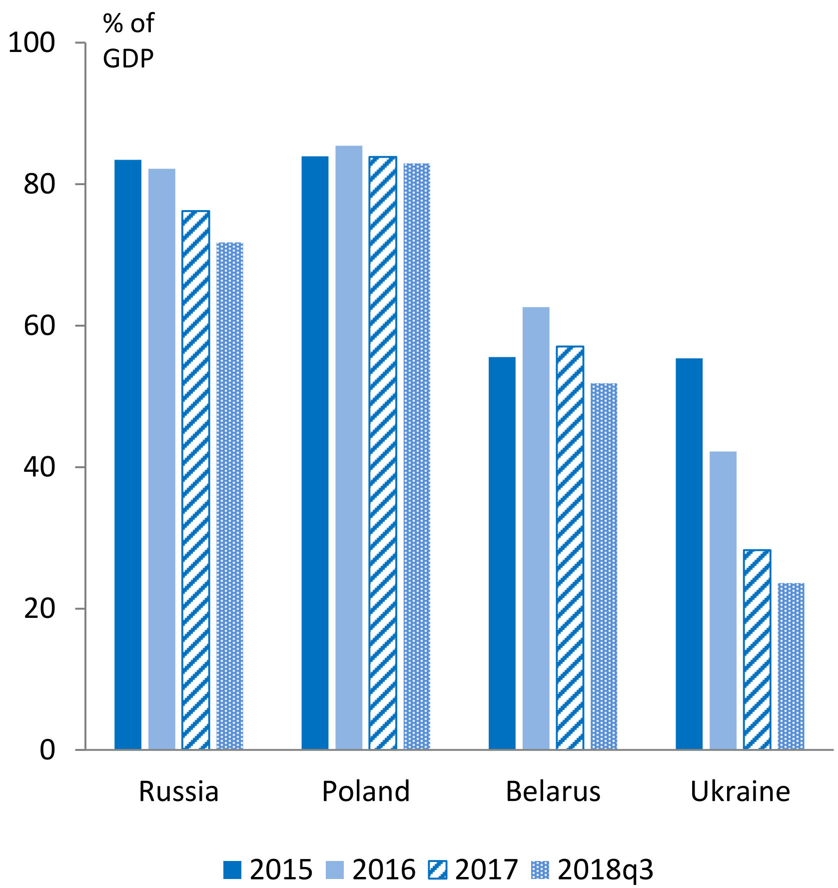
# Summary

- As the wave of exits from the banking sector calmed down, the **number of active banks stabilised** during 2018-19 to currently 76 (from 180 in early 2014)
- The **financial performance** of the overall sector improved significantly, with a first **net profit of UAH 21 bn** in 2018 after 4 years of hefty losses
- The **capital base has strengthened substantially**, **CAR has more than doubled** from its 2015 lows
- **Deposits are steadily growing in local currency**, and have stabilized in foreign currency
- **External deleveraging** still continuing, but signs of stabilisation
- **Lending is slowly recovering**, certain segments like UAH retail loans are booming
- **Corporate governance reform** in state-owned banks very positive
- However, **significant challenges** remain
  - Efforts to reduce **high level of NPLs** (52% of gross loans) have shown only limited success, in particular in state-owned banks
  - The **nationalisation of PrivatBank** at the end of 2016 is now under legal threat, creating significant uncertainty

# Content

# 1. Bank assets in a regional context

**Bank assets to GDP**

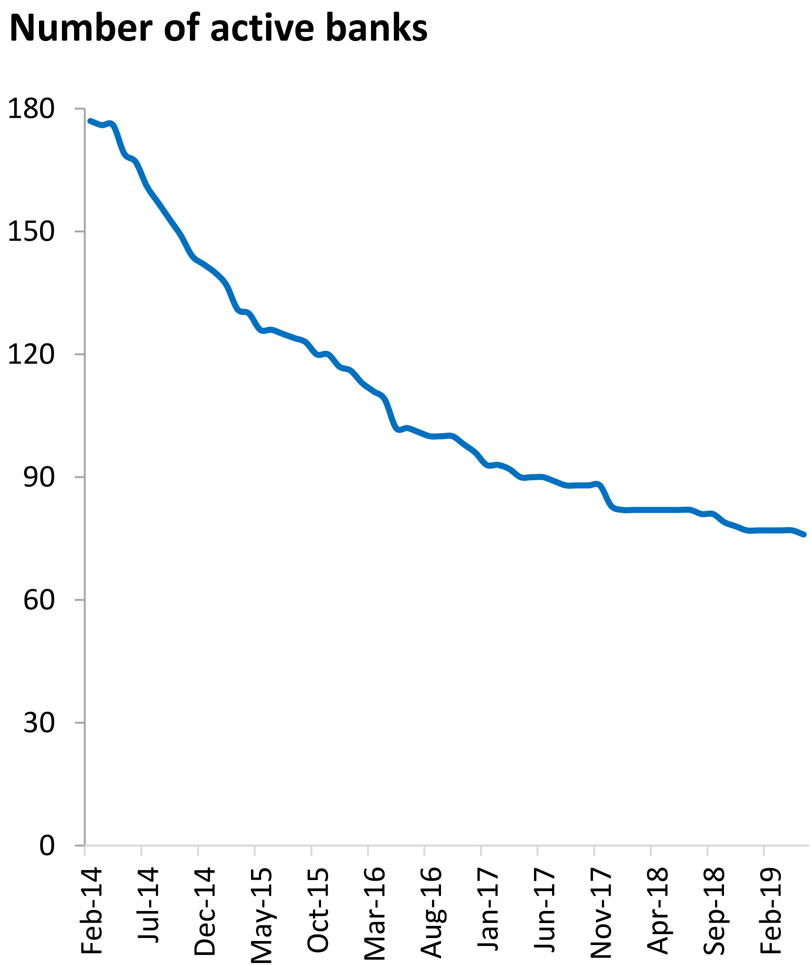



*Source: Own calculations based on IMF data*
*Note: Bank assets are net of provisions on NPLs*

- If measured by bank assets as % of GDP, the size of Ukraine's banking sector was close to that of Belarus, and lower than in Russia and Poland in 2015
- However, during 2015-2018, bank closures, proper provisioning of related party lending and deleveraging by surviving banks dramatically reduced bank assets:
  - Now several times lower than in all three neighbouring countries
  - Massive write-downs in PrivatBank play and important role

**⇒ Ukraine now lags far beyond Russia, Poland and Belarus in terms of banking sector size. This negative development is exacerbated by very limited alternative financing channels**

# 2. Number of banks



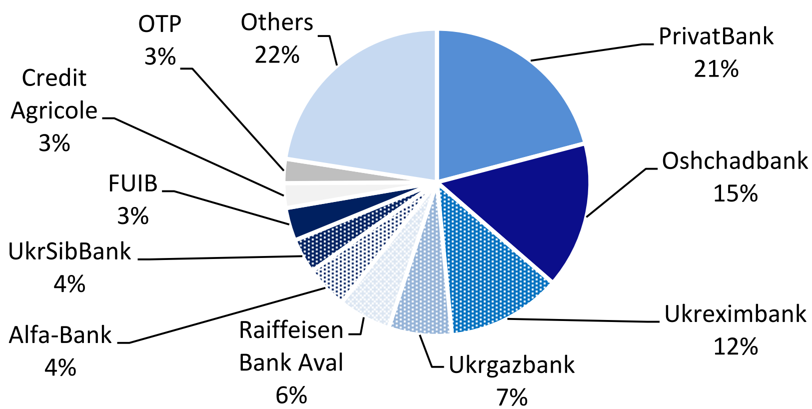

*Source: NBU, own adjustments*

- The number of banks in Ukraine has reduced dramatically during 2014-2016, as almost half of existing banks failed and were closed
- Consolidation of the banking sector continued in 2017 and 2018, as several small banks surrendered their banking licenses to become financial institutions
- However, the number of failed banks reduced to 8 in 2017. Aside from the VTB bank insolvency, no banks failed in 2018 and 2019
- The Deposit Guarantee Fund finished the liquidation of 13 banks in 2018 and 2019
- As of June 2019, 76 active banks remain in Ukraine, down from 180 in 2013

**⇒ Pace of bank sector consolidation came to a halt during 2018-19, with less than half of banks from 2013 still active**

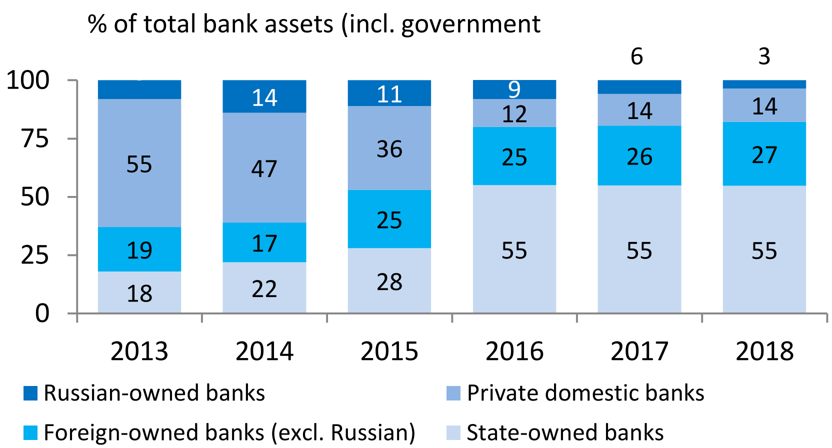
# 3. Market shares

**Market share of banking sector assets**




*Source: Own calculations based on NBU data from March 2019*

**Market shares by ownership**



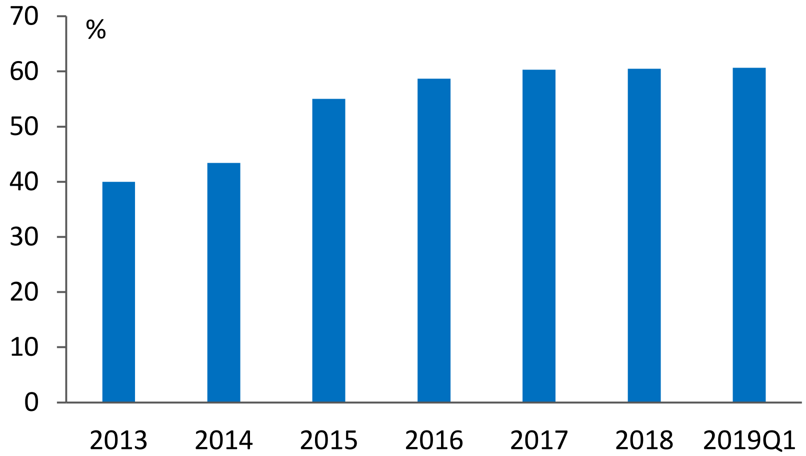

*Source: Own calculations based on NBU data, RZB*
*Note: Russian-owned banks exclude Alfa Group banks*

- State banks hold huge holdings of government bonds on their balance sheets (44% of their assets)
- Thus 55% share of four state banks in bank assets becomes significantly lower when adjusted for this risk factor (down to 40%)
- Non-state banks account for 60% of bank sector risk-adjusted assets
- Russian banks are leaving the Ukrainian market, while (non-Russian) foreign-owned banks are gradually gaining market share

**⇒ State-owned bank market share drops to 40% from 55%, if we look at risk-adjusted assets. Russian banks are leaving the Ukrainian market**

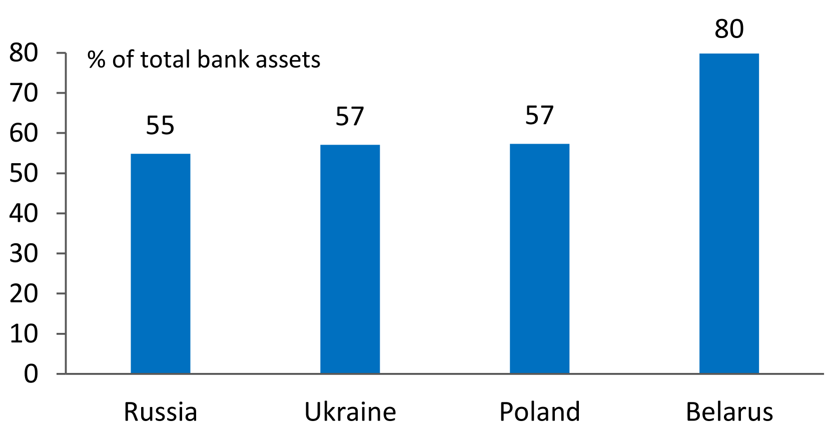
# 4. Concentration

**Asset share of Top-5 banks over time**




*Source: Own calculations based on NBU data*

**Asset share of Top-5 banks: Int. comparison (2016)**



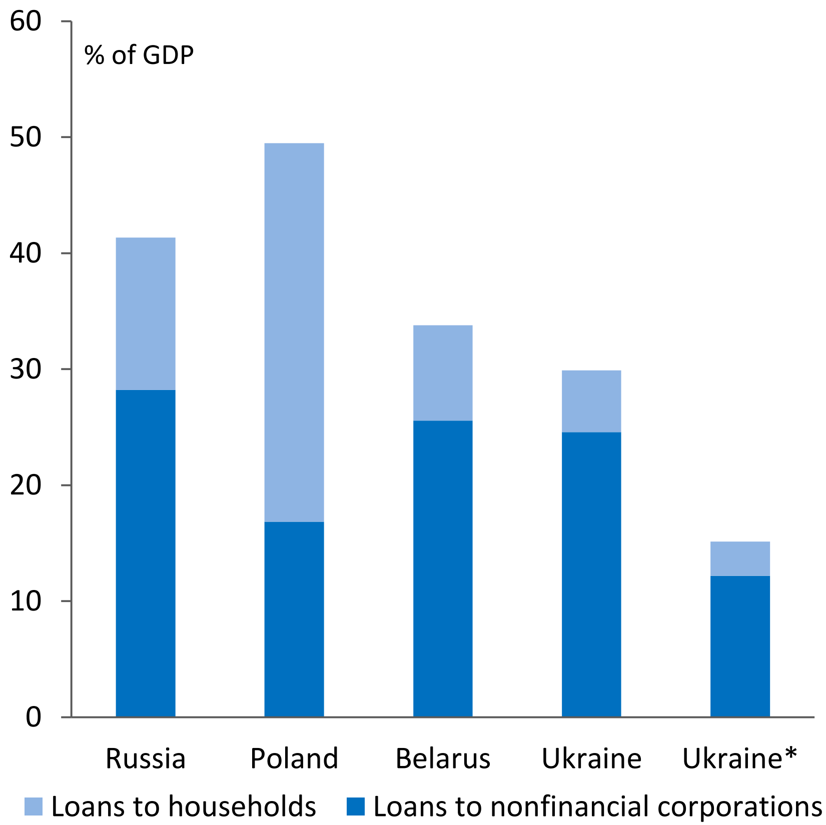

*Source: World Bank based on data from Bankscope, NBU*

- Market share of Top-5 banks stabilized in 2016-2019 at around 60% of bank sector assets
- As we noted before, a large share of state-owned banks assets are government bailout bonds
- Share of top-5 banks in risk-adjusted assets drops to 48%
- International comparison shows that bank sector concentration in Ukraine is similar to that of Poland and Russia

⇒ **Bank sector concentration in Ukraine is similar to that of its peers, with top-5 banks holding around 60% of assets over recent years.**

# 5. Lending to the real sector

**Loans to households and nonfinancial corporations**




*Source: own calculation based on IMF and NBU data*
*Data for 4 quarters ending in September 2018*
** Net loans, i.e. gross loans net of loan loss provisions*

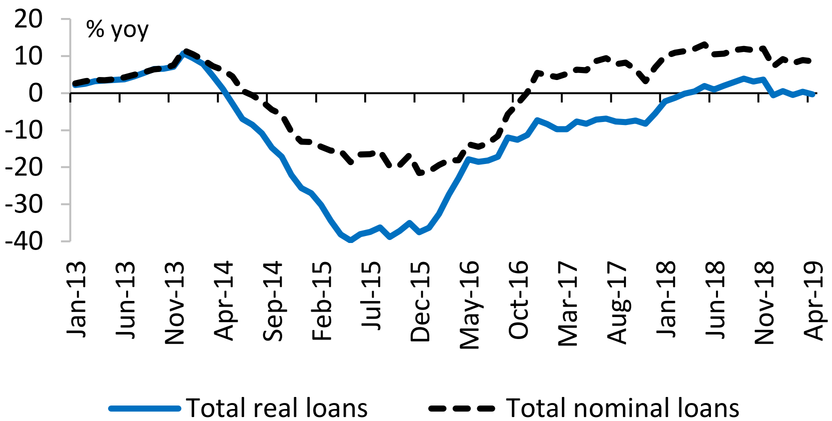
**Loans to real sector**

- Loan portfolio of Ukrainian banks in gross terms is lower than in peer countries
  - Corporate loans at 25% of GDP are higher than in Poland (17%) and slightly smaller than in Russia (28% of GDP) and Belarus (26% of GDP)
  - Relatively low volume of corporate loans in Poland reflects more diverse sources of funding for corporates
- However, over half of outstanding loans in Ukraine are non-performing – in large part legacy loans issued to related parties
- Thus, after accounting for these impaired loans, the gap between Ukraine and its peer countries becomes much larger

**⇒ Loan portfolio of Ukrainian banks after provisions is two-three times smaller than in Poland, Russia or Belarus**

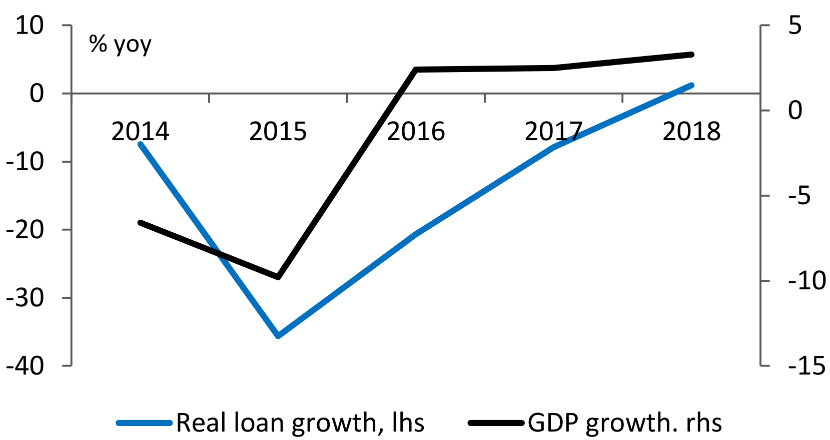
# 6. Loan growth and currency structure

**Loan growth**




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

**Loan growth and GDP**




*Source: own calculation based on NBU data*

**Loan growth**

- Sharp decline in loan book, both nominal and real, during 2014-2016
- Decline reflected bank failures and low demand
- Stabilization in 2017 and slight increase in 2018
  - Driven mostly by local currency lending, but FX loan book stabilized in 2018
  - Boom in UAH retail loans – 50% yoy growth in 2018, slowing to 30% growth in 2019
  - Gradual recovery in corporate funding
  - Dip in loan book in the end of 2018 due to VTB failure

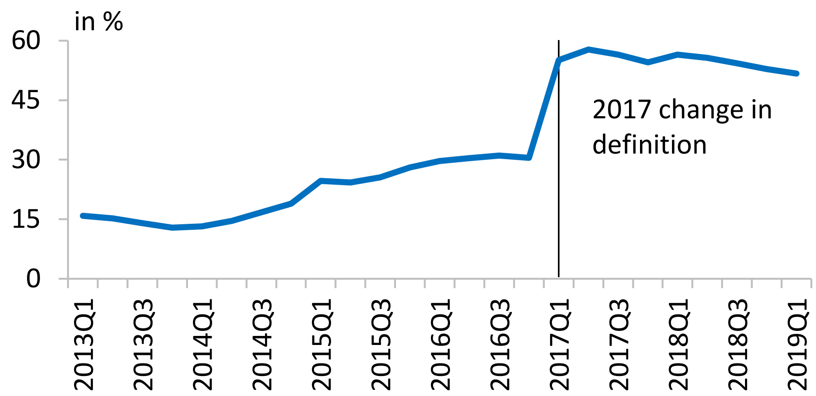
**Loan growth and the economy**

- Recovery in loan volumes followed return of economic growth

**⇒ Banks turned to high-interest consumer loans to boost interest margins**

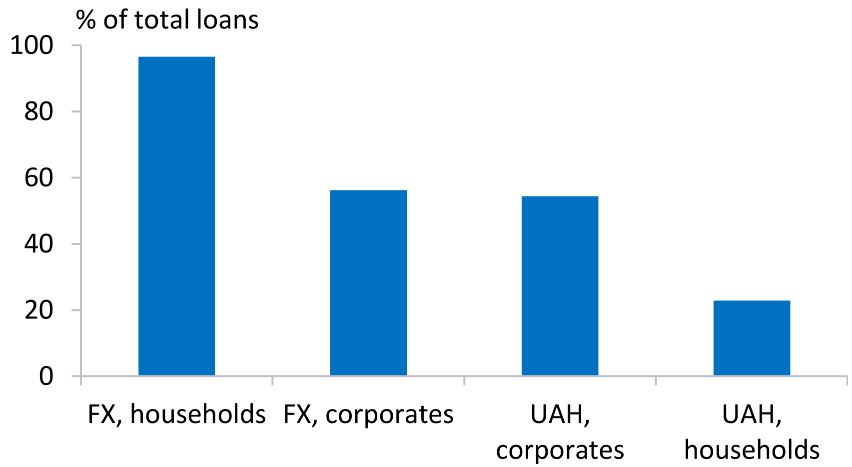
# 7. Non-performing loans (NPL)

**NPLs as share of gross loans**




*Source: NBU*

**NPLs by types of loans**



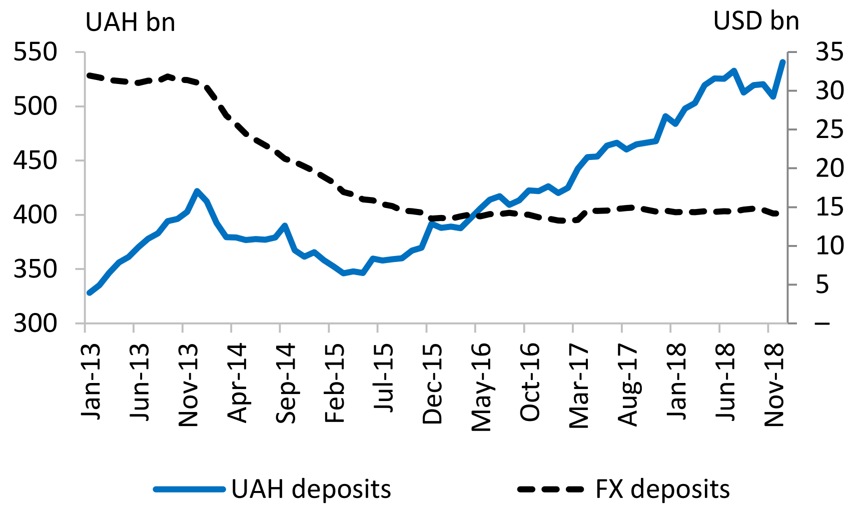

*Source: own calculations based on NBU, end-Mar 2019*

- Non-performing loans (NPLs) still exceed half of gross loans at 52.9% of the total
  - Gradual improvement over the last years, but remain over 50%
- There are also significant differences in NPLs among different types of loans
  - Corporate loans have a similar share of NPLs in both UAH and FX (around 54-56%)
    - Mostly due to state bank NPLs
  - Lowest share of NPLs in UAH retail loans, but still quite high. It is not clear where defaults are - in the legacy, or in newly issued loans
  - For UAH loans, NPL share of non-state banks is 17% with similar share for foreign-owned and Ukrainian banks
  - For FX loans, Ukrainian-owned private banks perform much better (27%) than other banks, likely due to lower exposure to legacy mortgages

⇒ **Little progress in cleaning the loan book of PrivatBank and other state banks**

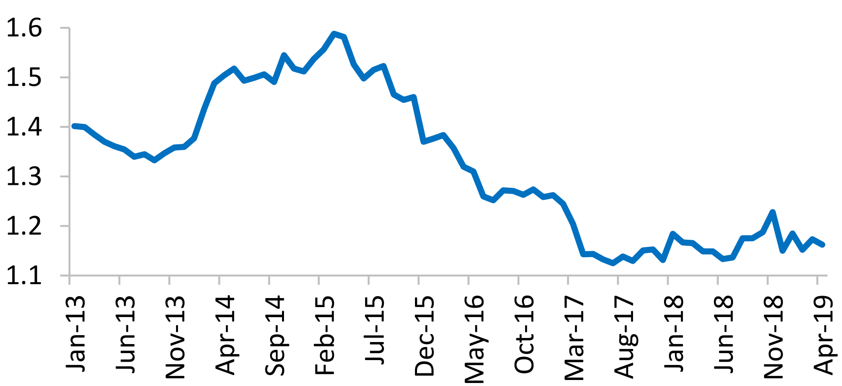
# 8. Deposits

**Bank deposits**




*Source: NBU*

**Loan to deposit ratio**



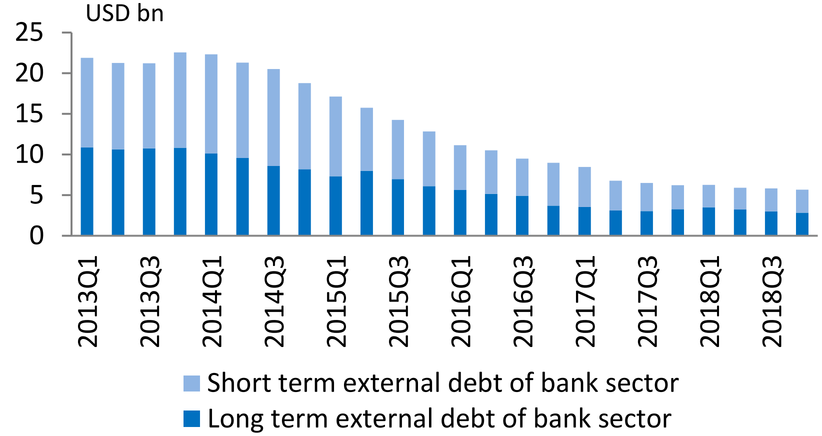

*Source: own calculations based on NBU data*

- Rising real interest rates, growing household and corporate incomes helped hryvnia deposits to grow steadily since 2015
  - Despite recent growth of household deposits in hryvnia, still less than 44% of pre-crisis level in real terms
  - Corporate hryvnia deposits recovered better, but only at 60% of pre-crisis level in real terms
- FX deposits stabilized in 2016 and remained in USD 14-15 bn range ever since. Dollarization of deposits remained at pre-crisis level as depreciation of hryvnia offset decrease in dollar deposits
- Loans are funded primarily by deposits with gross loan to deposit ratio below 1.2
  - Net loans are lower than 60% of deposits

**⇒ Even after several years of recovery, deposits remain far-below pre-crisis level in real terms**

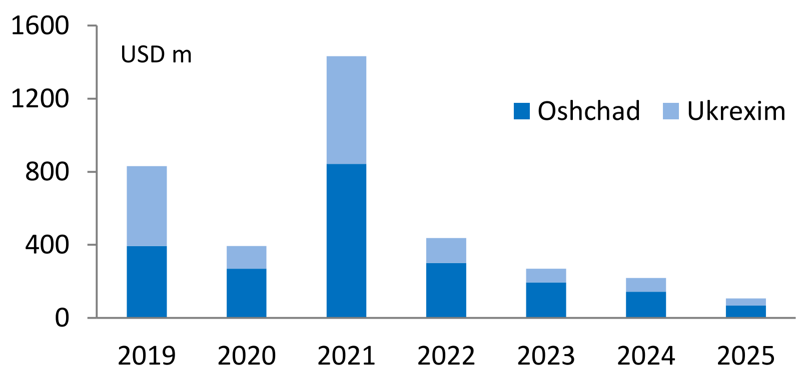
# 9. External debt

**External debt of the banking sector**




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

**Eurobond repayment schedule: Oshchadbank and Ukreximbank**



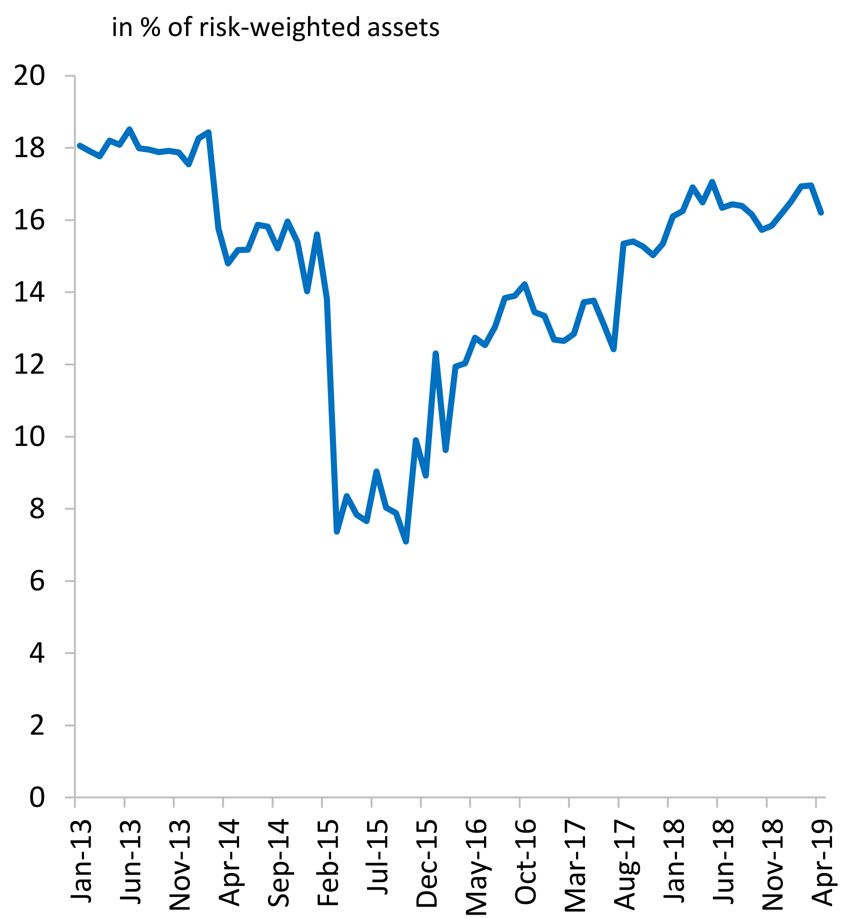

*Source: own calculations based on debt prospectuses*
*Note: only principal repayments*

- Previously, an important funding source apart from deposits
- No new bank Eurobonds in foreign currency since 2013
  - However, external Ukreximbank issue in Hryvnia in March 2018
- Very limited external borrowing. Thus, mostly gradual drawdown of pre-2013 existing debt
- BoP statistics shows positive debt inflows of the bank sector in 2018
  - For the first time since 2013
  - But still high levels of sovereign yields for Ukraine may limit debt inflows

**⇒ External debt is still falling but some signs of stabilization in 2018**

# 10. Capital adequacy

**Banking sector capital adequacy ratio**



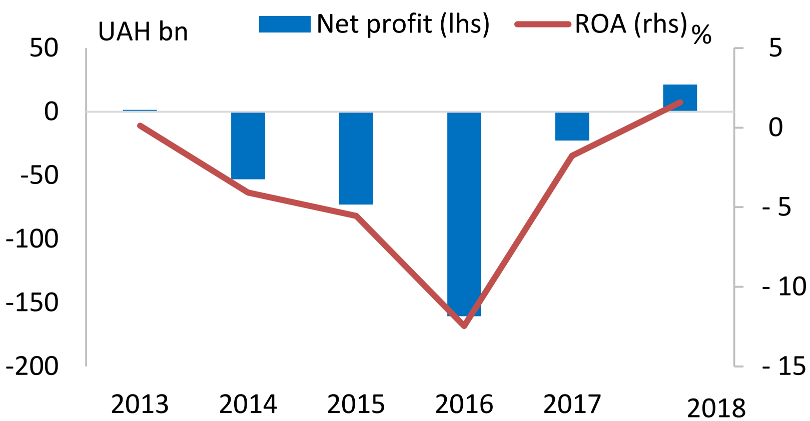

*Source: NBU*

- Severe drop in CAR in 2014-2015 reflected provisioning for problem loans
  - Including for problems that emerged before the crisis and related party lending
- Closure or recapitalization of problematic banks helped to restore CAR
  - High investment in government bonds limited state bank exposure to risk (through lower risk adjusted assets)
  - Total recapitalization of state-owned banks in 2014-2017 was UAH 226 bn incl. UAH 54 bn for Oshchadbank and UkrEximbank
  - CAR in top-10 banks from 12 to 20%
  - Return to profitability stopped capital drain

**⇒ Conservative investment policies helped to stabilize bank capitalization at adequate levels over the last years**

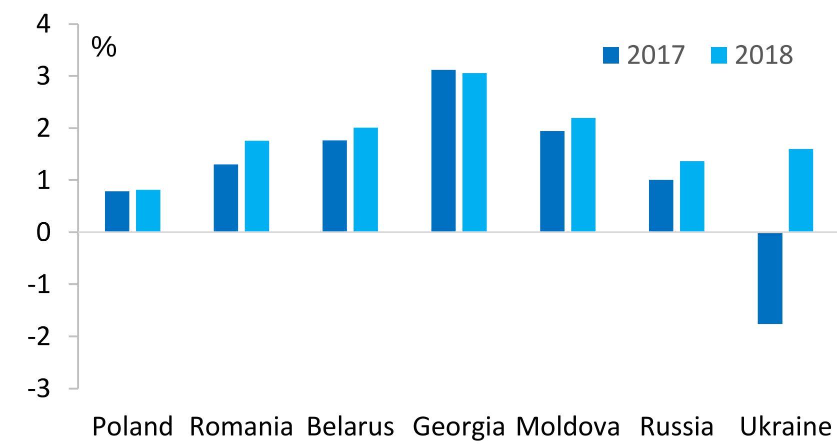
# 11. Return on assets

**Banking sector profit and return on assets**




*Source: IMF FSI*

**Banking sector return on assets (ROA)**




*Source: IMF FSI*

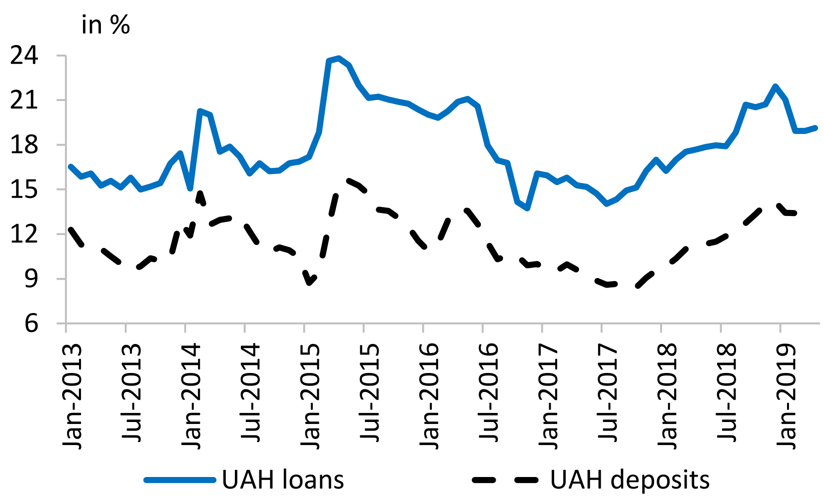
## Profitability

- After peak losses in 2016 due to massive write- down in PrivatBank, the banking sector pared losses in 2017 and returned to profitability in 2018
- Only 7 banks had losses over UAH 100 m in 2018, including three Russian-owned banks
- High interest rates on government bonds and consumer loans contributed to healthy profit margins
- Increase in loan loss reserves was limited in most banks
- After 4 year of severe losses, the ROA of Ukrainian banks is again comparable to those in neighbouring countries

⇒ **Banking system returned to profitability in 2018**

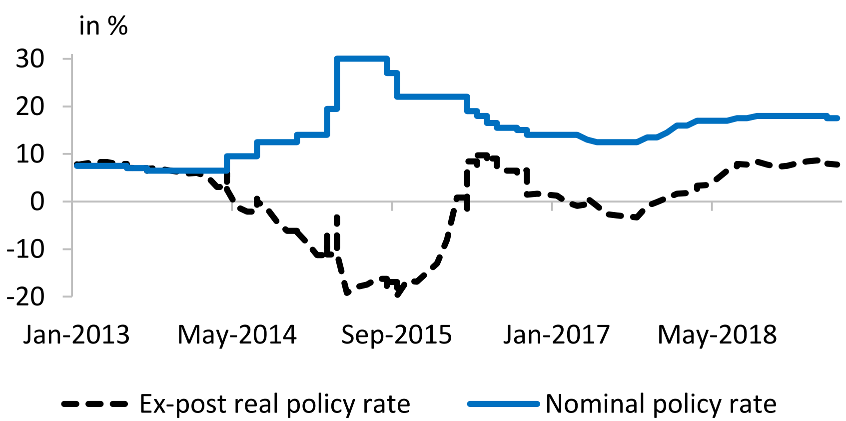
# 12. Interest rates

## Interest rates on loans and deposits




*Source: NBU*

## NBU key policy rate




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

## Loan and deposit rates

- Reduction in interest rates observable during 2015-2017 was reversed after the NBU increased its policy rate to combat inflation
- Higher average loan rate also reflects increase in high-cost consumer lending

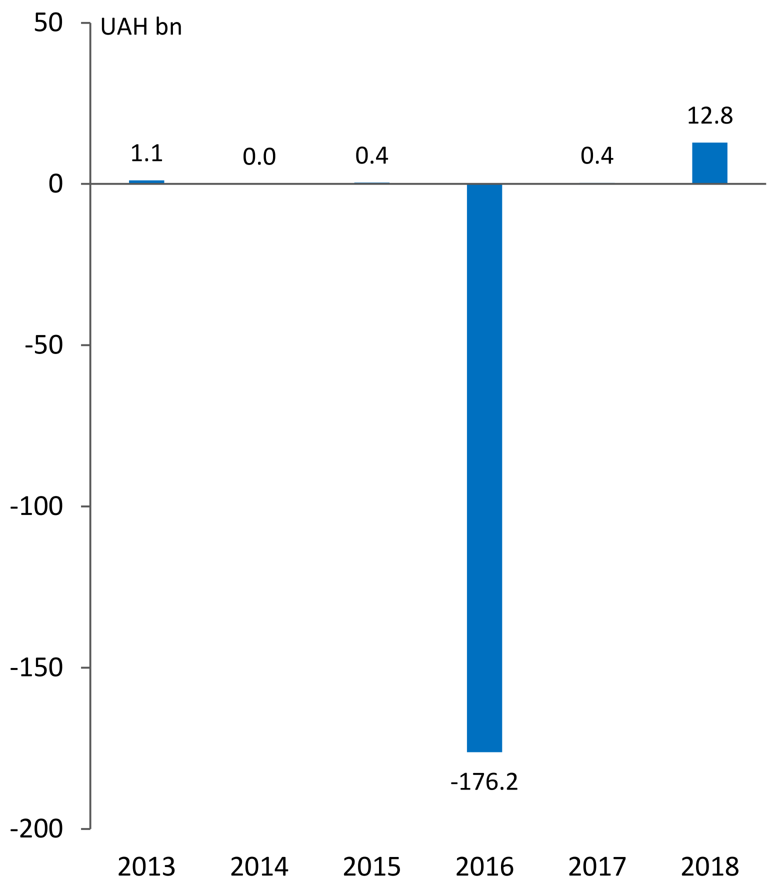
## Monetary policy rate

- After emergency hikes in 2015 to 30%, the NBU decreased interest rates in line with slowing inflation to a level of 12.5%
- Growing inflation pressure forced the NBU to increase the policy rate in 2017 and 2018 from 12.5% to 18% in September 2018
  - NBU decreased policy rate to 17.5% in April
- The high nominal policy rate , coupled with inflation returning to single digits, pushed up real interest rates

**⇒ NBU remains committed to tight monetary policy to bring inflation to its 5% target**

# a. PrivatBank – Recent Developments

**Profits and losses of PrivatBank**




*Source: PrivatBank annual reports*

## Operational turnaround …

- After nationalisation in late 2016, the state injected a total of UAH 171 bn into its capital
  - 95% of corporate loan book before nationalization linked to previous owners
  - In April 2019, 95% of corporate loans and 98% of legacy FX consumer loans were non-performing
  - 25% of NPLs for retail loans
- Still, the bank booked a net profit of UAH 12.8 bn in 2018 after restated UAH 0.4 bn profit in 2017
  - strong interest and commission income
  - 90% of net profit will be transferred to the owner

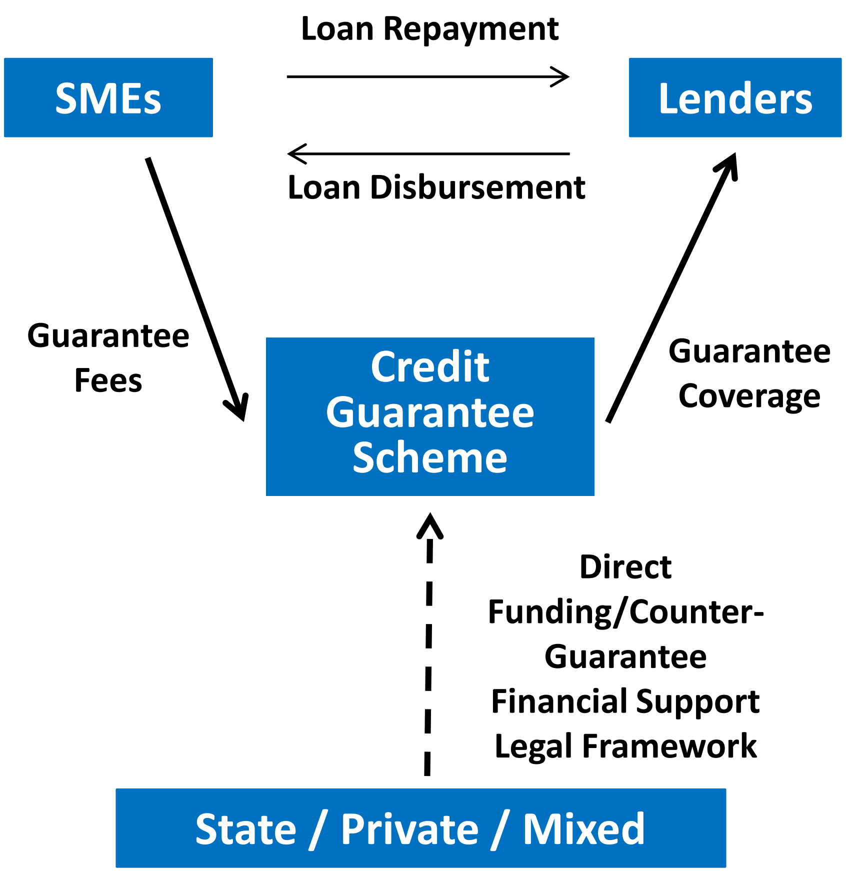
## … but increasing legal risks

- Recent decisions against the state by local courts have created significant uncertainty, also for the financial sector reform process
- Further developments will be closely watched by IFIs and international partners

**⇒ Continued legal uncertainty around the nationalisation of PrivatBank is clearly negative from a macro-financial perspective**

# b. SME Credit Guarantee Scheme

**The functioning of a Credit Guarantee Scheme**




*Source: PB/12/2016 by German Advisory Group*

**Access to Finance a key impediment for SME development**

- SME financing gap was estimated at more than EUR 9 bn by German Advisory Group (2016)
- Lack of collateral a particular problem for SMEs

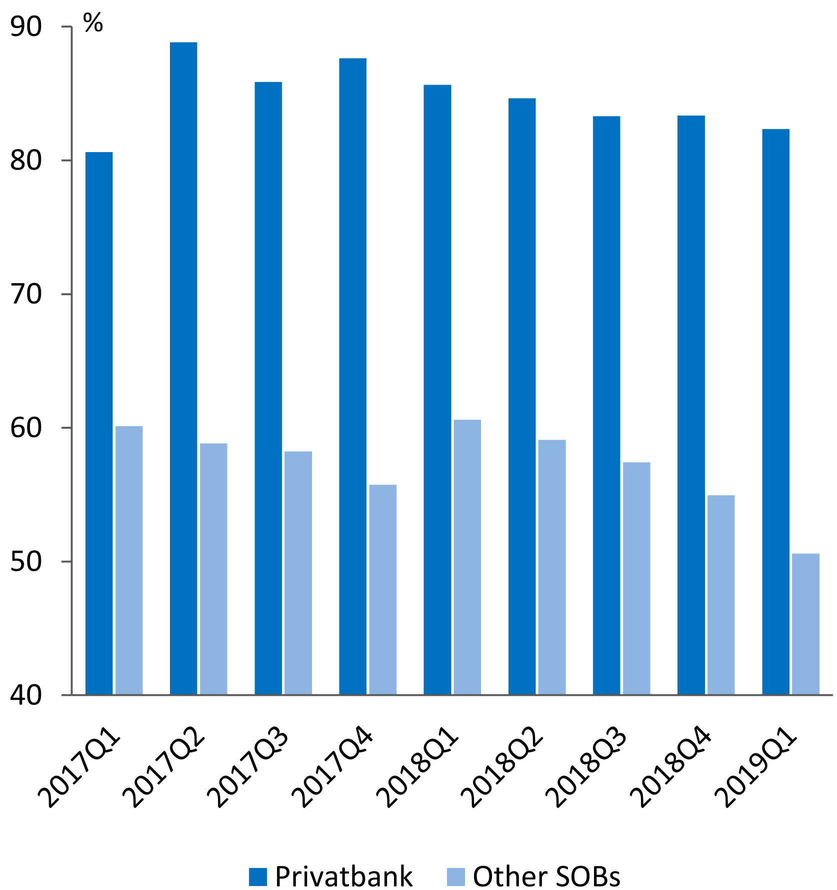
**Credit Guarantee Scheme (CGS)**

- Internationally widely used instrument to address lack of collateral
- In Ukraine missing so far, but plans to introduce the instrument
  - Possibly using existing institution "German-Ukrainian Fund (GUF)"
  - "Two-window" model: Combining credit lines and credit guarantees

**⇒ Establishment of CGS positive factor for SME development**

# c. Corporate Governance reform of State-owned banks

**NPLs in SOB's**




*Source: NBU*

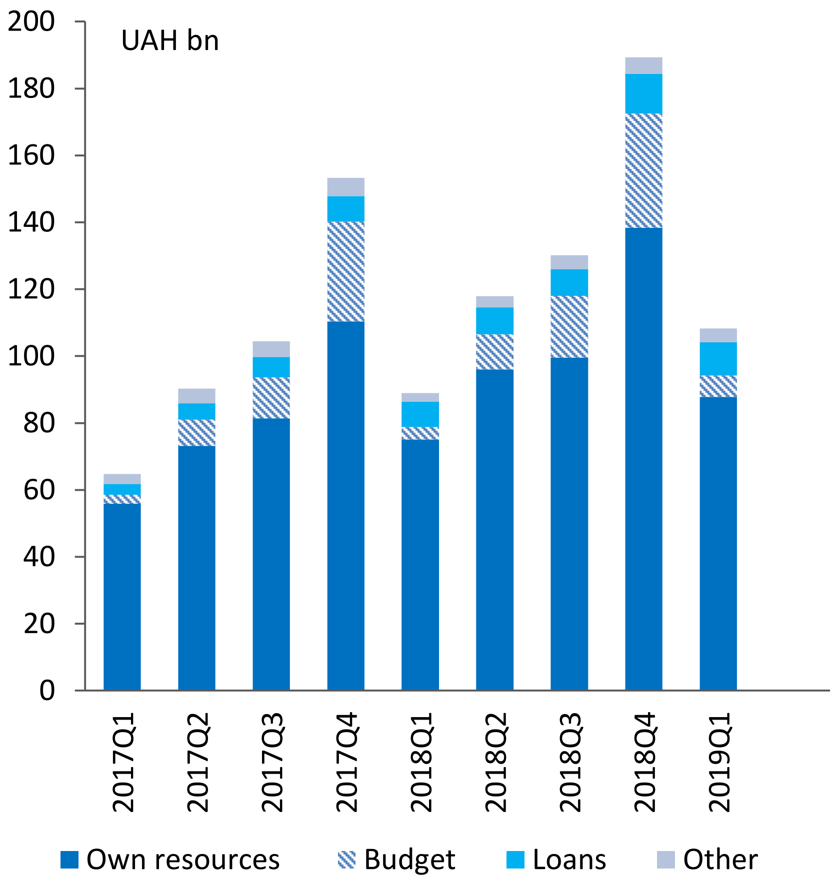
**One key priority in State-owned bank reform relates to an improved corporate governance**

- New law from July 2018 "Law On Improving the Functioning of the Financial Sector in Ukraine"
- In each supervisory board, independent (incl. foreign) members will form a 2/3 majority, shielding the bank from political interference
  - Non-independent members appointed by President, Government and Parliament
- Transparent selection procedures for boards of:
  - PrivatBank
  - Oschadbank
  - Ukreximbank
- Independent members appointed in June 2019

⇒ **Important milestone in the financial reform process**

# d. Sources of investment funding – The role of banks

**Breakdown of capital investment funding**




*Source: Ukrstat*

## Increasing capital investments are positive

- 18% yoy real growth in Q12019
  - Higher than Q42018 (11%) but lower than Q12018 (37%)
- Broad-based, across all sectors
  - Industry took the lead in Q12019 but also strong growth in services sectors

## How did the funding structure change?

- Traditionally, strong reliance on the own resources over 80%
- However, share of bank loans is gradually increasing, to 9.1%
  - Minimum Q12017: 5.0%

**⇒ Slowly increasing role of bank loans in capital investment finance, albeit from a very low base**

# Annex: Banking sector statistics

| Balance sheet data | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|
| Total assets (EUR m) | 115700 | 68462 | 46537 | 43189 | 40240 | 42874 |
| growth in % yoy | 8.2 | -40.8 | -32 | -7.2 | -6.8 | 6.5 |
| in % of GDP | 83.9 | 83 | 61.4 | 51.5 | 45.2 | 38.2 |
| Total loans (EUR m) | 72384 | 45423 | 26605 | 18953 | 16752 | 18559 |
| growth in % yoy | 9.8 | -37.2 | -41.4 | -28.8 | -11.6 | 10.8 |
| in % of GDP | 52.5 | 55.1 | 35.1 | 22.6 | 18.8 | 16.5 |
| Loans to legal entities (EUR m) | 59244 | 37842 | 22894 | 16341 | 14007 | 14964 |
| growth in % yoy | 11.3 | -36.1 | -39.5 | -28.6 | -14.3 | 6.8 |
| in % of GDP | 43 | 45.9 | 30.2 | 19.5 | 15.7 | 13.3 |
| Loans to households (EUR m) | 13140 | 7580 | 3711 | 2612 | 2745 | 3595 |
| growth in % yoy | 3.6 | -42.3 | -51 | -29.6 | 5.1 | 31.0 |
| in % of GDP | 9.5 | 9.2 | 4.9 | 3.1 | 3.1 | 3.2 |
| Loans in foreign currency (EUR m) | 25022 | 21059 | 13946 | 9151 | 7420 | 7637 |
| growth in % yoy | 2.2 | -15.8 | -33.8 | -34.4 | -18.9 | 2.9 |
| in % of GDP | 18.1 | 25.5 | 18.4 | 10.9 | 8.3 | 6.8 |
| Loans in foreign currency (% of total loans) | 34.6 | 46.4 | 52.4 | 48.3 | 44.3 | 41.1 |
| Total deposits (EUR m) | 63661 | 37343 | 28565 | 29824 | 27752 | 30303 |
| growth in % yoy | 12.2 | -41.3 | -23.5 | 4.4 | -6.9 | 9.2 |
| in % of GDP | 46.2 | 45.3 | 37.7 | 35.5 | 31.2 | 27 |
| Deposits from households (EUR m) | 40021 | 21980 | 14973 | 15058 | 14316 | 16033.0 |
| growth in % yoy | 14 | -45.1 | -31.9 | 0.6 | -4.9 | 12.0 |
| in % of GDP | 29 | 26.6 | 19.7 | 17.9 | 16.1 | 14.3 |
| Total loans (% of total deposits) | 113.7 | 121.6 | 93.1 | 63.5 | 60.4 | 61.2 |
| **Structural information** | | | | | | |
| Number of banks | 180 | 142 | 117 | 96 | 90 | 77 |
| Market share of state-owned banks (% of total assets) | 18 | 22 | 28 | 55 | 55 | 55 |
| Market share of foreign-owned banks (% of total assets) | 27 | 31 | 36 | 34 | 32 | 31 |
| Market share foreign-owned banks ex. Russian (% of total assets) | 19 | 17 | 25 | 25 | 26 | 27 |
| **Profitability and efficiency** | | | | | | |
| Return on Assets (RoA) | 0.1 | -4.1 | -5 | -12.6 | -1.9 | 1.7 |
| Capital adequacy (% of risk weighted assets) | 17.6 | 14 | 8.9 | 13.3 | 15.4 | 16.2 |
| Non-performing loans (% of total loans) | 12.9 | 19 | 28 | 30.5 | 54.5 | 52.9 |

*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