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

Key indicators:
1. Bank assets in a regional context
2. Number of banks
3. Market shares
4. Concentration
5. Lending to the real sector
6. Loan growth and currency structure
7. Non-performing loans (NPL)
8. Deposits
9. External debt
10. Capital
11. Interest rates

Special issues:
 a. PrivatBank – Recent Developments
 b. SME Credit Guarantee Scheme
 c. Corporate Governance reform of State-owned banks
 d. Sources of investment funding – The role of banks

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

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.

Source: Own calculations based on IMF data
Note: Bank assets are net of provisions on NPLs
2. Number of banks

- 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.

Source: NBU, own adjustments
3. Market shares

- 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

- 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

\[\Rightarrow\] 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 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

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
6. Loan growth and currency structure

**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 GDP**
- Recovery in loan volumes followed return of economic growth

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

---

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

*Note:* FX adjusted, gross loans
7. Non-performing loans (NPL)

- 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

Source: NBU

Source: own calculations based on NBU, end-Mar 2019
8. Deposits

- 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

- 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

- 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

Source: NBU
11. Return on assets

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

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

Source: NBU, own calculations based on NBU and Ukrstat data
a. PrivatBank – Recent Developments

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

Profits and losses of PrivatBank

- Profits: 1.1, 0.0, 0.4, 0.4, 12.8
- Losses: -176.2

Source: PrivatBank annual reports
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

Source: PB/12/2016 by German Advisory Group
c. Corporate Governance reform of State-owned banks

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

Source: NBU
d. Sources of investment funding – The role of banks

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

Source: Ukrstat
## Annex: Banking sector statistics

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets (EUR m)</td>
<td>115700</td>
<td>68462</td>
<td>46537</td>
<td>43189</td>
<td>40240</td>
<td>42874</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>8.2</td>
<td>-40.8</td>
<td>-32</td>
<td>-7.2</td>
<td>-6.8</td>
<td>6.5</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>83.9</td>
<td>83</td>
<td>61.4</td>
<td>51.5</td>
<td>45.2</td>
<td>38.2</td>
</tr>
<tr>
<td>Total loans (EUR m)</td>
<td>72384</td>
<td>45423</td>
<td>26605</td>
<td>18953</td>
<td>16752</td>
<td>18559</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>9.8</td>
<td>-37.2</td>
<td>-41.4</td>
<td>-28.8</td>
<td>-11.6</td>
<td>10.8</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>52.5</td>
<td>55.1</td>
<td>35.1</td>
<td>22.6</td>
<td>18.8</td>
<td>16.5</td>
</tr>
<tr>
<td>Loans to legal entities (EUR m)</td>
<td>59244</td>
<td>37842</td>
<td>22894</td>
<td>16341</td>
<td>14007</td>
<td>14964</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>11.3</td>
<td>-36.1</td>
<td>-39.5</td>
<td>-28.6</td>
<td>-14.3</td>
<td>6.8</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>43</td>
<td>45.9</td>
<td>30.2</td>
<td>19.5</td>
<td>15.7</td>
<td>13.3</td>
</tr>
<tr>
<td>Loans to households (EUR m)</td>
<td>13140</td>
<td>7580</td>
<td>3711</td>
<td>2612</td>
<td>2745</td>
<td>3595</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>3.6</td>
<td>-42.3</td>
<td>-51</td>
<td>-29.6</td>
<td>5.1</td>
<td>31.0</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>9.5</td>
<td>9.2</td>
<td>4.9</td>
<td>3.1</td>
<td>3.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Loans in foreign currency (EUR m)</td>
<td>25022</td>
<td>21059</td>
<td>13946</td>
<td>9151</td>
<td>7420</td>
<td>7637</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>2.2</td>
<td>-15.8</td>
<td>-33.8</td>
<td>-34.4</td>
<td>-18.9</td>
<td>2.9</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>18.1</td>
<td>25.5</td>
<td>18.4</td>
<td>10.9</td>
<td>8.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Loans in foreign currency (% of total loans)</td>
<td>34.6</td>
<td>46.4</td>
<td>52.4</td>
<td>48.3</td>
<td>44.3</td>
<td>41.1</td>
</tr>
<tr>
<td>Total deposits (EUR m)</td>
<td>63661</td>
<td>37343</td>
<td>28565</td>
<td>29824</td>
<td>27752</td>
<td>30303</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>12.2</td>
<td>-41.3</td>
<td>-23.5</td>
<td>4.4</td>
<td>-6.9</td>
<td>9.2</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>46.2</td>
<td>45.3</td>
<td>37.7</td>
<td>35.5</td>
<td>31.2</td>
<td>27</td>
</tr>
<tr>
<td>Deposits from households (EUR m)</td>
<td>40021</td>
<td>21980</td>
<td>14973</td>
<td>15058</td>
<td>14316</td>
<td>16033.0</td>
</tr>
<tr>
<td>growth in % yoy</td>
<td>14</td>
<td>-45.1</td>
<td>-31.9</td>
<td>0.6</td>
<td>-4.9</td>
<td>12.0</td>
</tr>
<tr>
<td>in % of GDP</td>
<td>29</td>
<td>26.6</td>
<td>19.7</td>
<td>17.9</td>
<td>16.1</td>
<td>14.3</td>
</tr>
<tr>
<td>Total loans (% of total deposits)</td>
<td>113.7</td>
<td>121.6</td>
<td>93.1</td>
<td>63.5</td>
<td>60.4</td>
<td>61.2</td>
</tr>
</tbody>
</table>

### 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
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