BANKING SECTOR REVIEW

Issue 1
October 2016

Banking sector was in good liquidity position throughout the first 8 months of 2016 primarily due to continuous inflow of retail and corporate deposits. Lifting of limitations on daily withdrawals from households' hryvnia deposits and significant increase in limits on daily withdrawals from FX deposits had no negative impact on deposits dynamics. Bank lending had been restrained by weak solvency of households, high leverage of corporations and still strict lending conditions offered by most banks. Excess liquidity was mainly channeled into government bonds. Banks' financial results improved notably due to lower provisioning; banks are reporting profits since May 2016. However, operating profits before provisions slipped compared to the previous year as net interest incomes became lower. Recapitalization of the largest banks, based on results of the first wave of diagnostic study of 2015, led to capital adequacy improvement over last months.

Sector structure. Since the beginning of 2016, the concentration in the sector has increased moderately because of reduction in number of solvent banks. The share of state-owned banks in total banking assets increased since the beginning of the year by 2.7 percentage points to 32.2% while the shares of other groups diminished. In terms of deposits growth, the increase of share of state-owned banks was less pronounced: by 0.8 percentage points (to 23.5%). In eight months of 2016, 15 banks were withdrawn from the market, 4 of them due to opaque ownership and 2 (the largest among liquidated) because of failure to complete re-capitalization program. Additionally, shareholders in other two banks decided to liquidate their institutions. Top-20 banks made up 90% of the banking assets as of 01/09/2016.

Assets. Lending remained subdued because of persistent high credit risks, weak solvency of borrowers and still strict lending conditions. The UAH 6 billion increase in corporate loan portfolio (mostly occurred in July and August) was offset by shrinking retail lending. Banks channeled liquidity primarily into government securities: the portfolio of domestic government bonds went up by UAH 68.8 billion. Banks have also divested significantly from the NBU's certificates of deposit (minus UAH 56 billion since the start of 2016). Government and quasi-public securities, interbank loans and correspondent accounts with NBU combined in total to 25% of banking assets.

The rate of NPLs reported by banks increased to 30.6% as of 1 September. The gap in recognized NPLs between banks of groups I and II (around 13% of portfolio) and banks with foreign capital (38% of portfolio) remains significant. This means that some of the banks with Ukrainian capital postpone recognition of NPLs and making adequate loan loss provisions. Continued diagnostic study of banks and new rules on credit risk assessment (in line with regulation #351 of 30/06/2016), which are to come into force in early 2017 will facilitate banks to recognize and report the real quality of their assets.

Funding. Liquidity in the sector improved through the reporting period. That allowed banks to repay in eight months UAH 22 billion that they had received from the NBU. Deposits at banks have been recovering further: retail deposits* have increased by 4.8% in hryvnia and by 1.9% in FX. Lifting limitations on withdrawals from retail hryvnia deposits and raising limits for daily withdrawals from retail FX deposits did not affect deposit dynamics. The share of corporate and retail deposits and accounts in banks' liabilities went up in eight months from 64% to 69.8%.

Interest rates. Commercial interest rates in banking sector went further down as a response to the key rate cuts by the NBU (from 22% at the beginning of 2016 to 15% since 16 September). Since the beginning of the year the interest rate on 12-month retail deposit** dropped by 2.7 percentage points to 18.6% per annum in hryvnia and by 2 percentage points to 6.2% per annum in US dollars. The reason behind falling FX deposit rates is low banks' demand for FX funding. The FX deposit rates are at historical lows now. The difference between deposit rates in hryvnia and FX is still sizable, over 10 percentage points. Decreasing deposit rates allowed banks to ease somewhat price conditions on corporate lending. That facilitated a moderate growth of corporate loan portfolio.

Financial results and capital. In Q1, banks showed low operating efficiency: the CIR (cost to income ratio) was 79% because of losses due to FX revaluation. In Q2 and Q3, the operating efficiency improved due to profits from trading operations and cheaper funding. The CIR returned to 2015 average (52%). New loan loss provisions were much lower in 2016 compared with last year, which allowed banks to report better financial results. Since May 2016, banking system reported net profits in three months out of four.

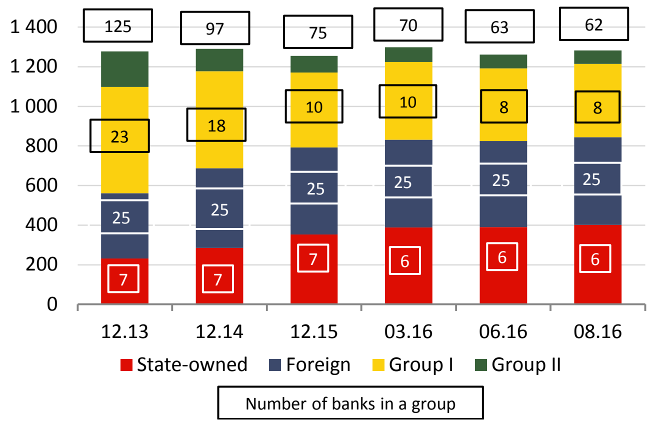
Outlook. Over the coming quarters, the deposit rates are to go further down as a result of the NBU policy of gradual key rate cuts and improved banking sector liquidity. We expect faster deposit base recovery on the back of better trustworthiness of the banking sector. FX deposits inflow is going to remain weak. Recovery of bank lending in all segments (except for state-owned corporations) will be slow because of high credit risks. However, the NBU expects both price and non-price lending conditions to soften. During Q4 2016, an active phase of recapitalization of next top-20 banks takes place: those that lack capital have to take appropriate measures in order to comply with positive Tier1 Capital requirement by the end of November.

** at banks that were solvent at the end of August 2016*
*** according to Ukrainian Index of Retail Deposit rates*

Sector structure

15 banks were withdrawn from the market since the beginning of the year, 4 of them because of opaque ownership. Shareholders of two other banks took decided to liquidate their institutions. The balance sheet indicators were mostly affected by withdrawal of four banks, which accounted for 2.3% of assets as of the end of 2015.

*Banking sector net assets, bln. UAH**



* Banks divided into groups according to [classification as of 01/01/16]

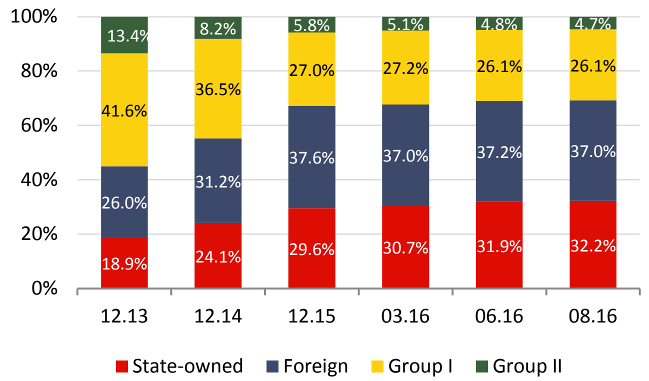
Number of banks

	2014	2015	I.16	II.16	III.2016*
Solvent	**147**	**117**	**111**	**102**	**100**
- change	(-33)	(-30)	(-6)	(-9)	(-2)
State-owned	**7**	**7**	**6**	**6**	**5**
- change	(0)	(0)	(-1)	(0)	(-1)
Foreign	**25**	**25**	**25**	**25**	**25**
- change	(0)	(0)	(0)	(0)	(0)
Group I	**18**	**10**	**10**	**8**	**8**
- change	(-5)	(-8)	(0)	(-2)	(0)
Group II	**97**	**75**	**70**	**63**	**62**
- change	(-28)	(-22)	(-5)	(-7)	(-1)
Insolvent	**16**	**3**	**5**	**8**	**4**
- change	(16)	(-13)	(2)	(3)	(-4)
Under liquidation	**21**	**64**	**68**	**74**	**80**
- change	(19)	(43)	(4)	(6)	(6)

* Changes are reported for July-August 2016, numbers – as of the end-August.

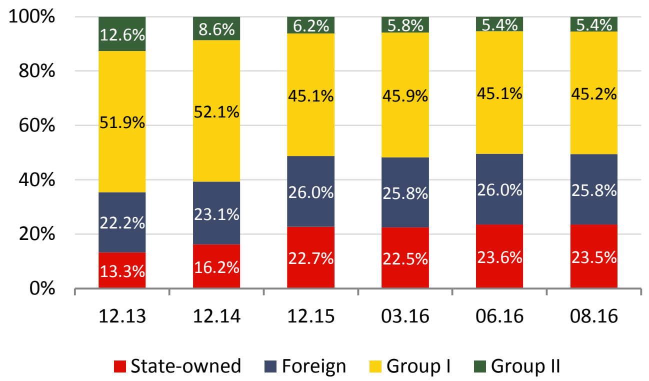
State-owned banks were the only group, which increased its share in total assets since the beginning of 2016 (+2.7 pps).

Total assets by groups of banks



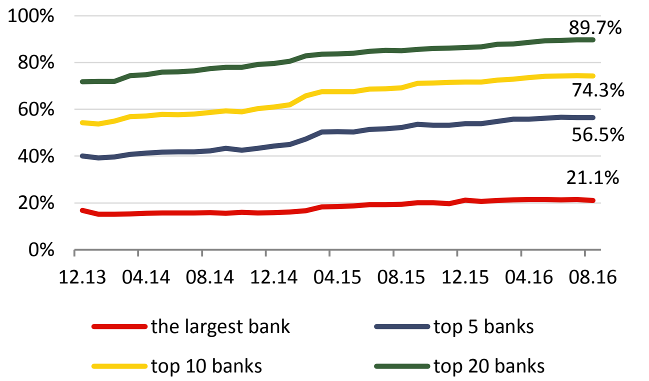
The retail deposits segment saw the increase in share of state-owned banks (+0.8 pps since the start of 2016) and banks of group II (+0.1 pps).

Retail deposits by groups of banks



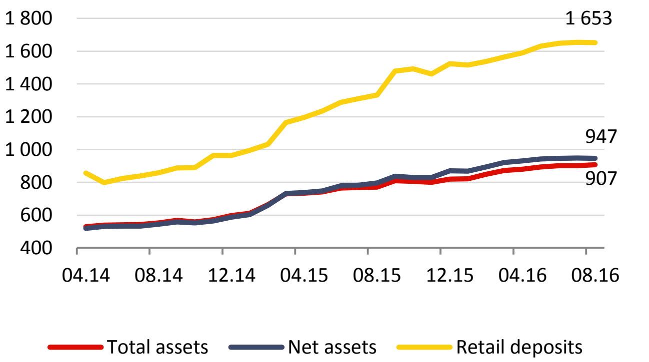
The share of total assets of top-20 banks increased by 3.3 pps to 89.7%.

Share of 1, 5, 10 and 20 largest banks in the sector assets



Deposits are much more concentrated comparing to other indicators (HHI Index*=1653).

*Concentration rate in banking sector, HHI**

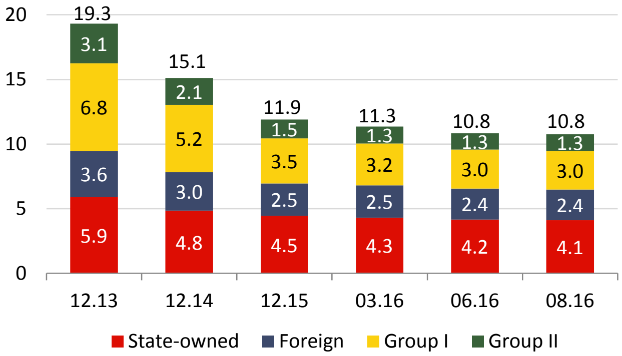


* *Herfindahl–Hirschman Index (HHI) — concentration indicator for banking market. It is calculated as a sum of square shares of individual banks in total. It varies in the range between 0 and 10 000 (up to 1000 –concentration on the market is low).*

Banking infrastructure

Withdrawal of 'Khreschatyk' bank led to significant cut of number of branches (to 10.8 thousand).

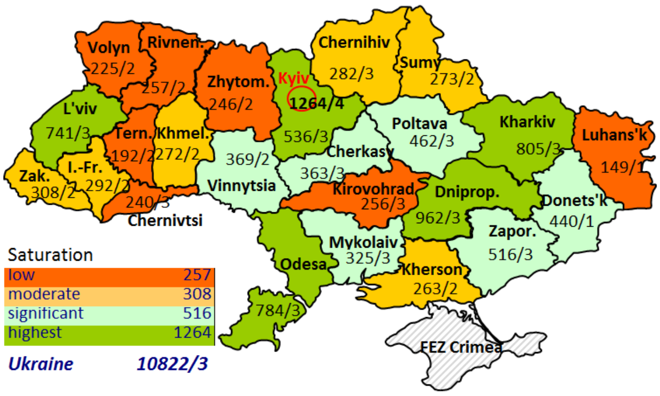
*Number of structural units of banks, thousands**



* branches and head-offices

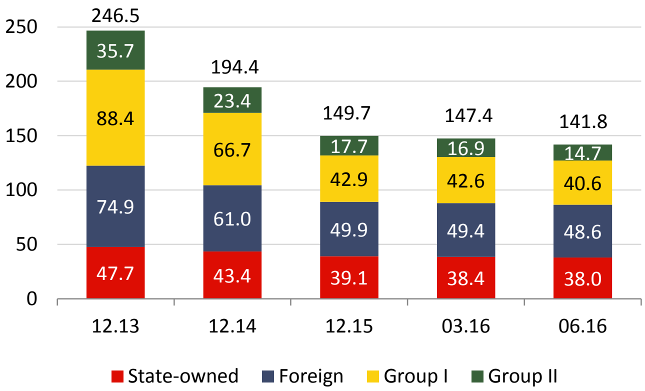
Kyiv and major cities are most saturated with banking services.

Number of operating bank branches across regions as of 01/07/16, units/units per 10 000 of inhabitants

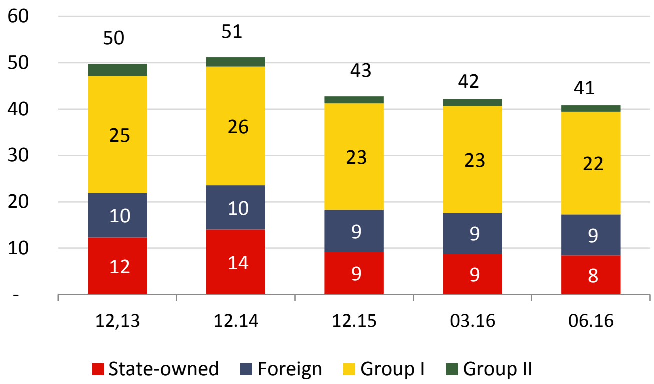


Number of bank employees dropped by 8 thousand since the start of 2016 to 142 thousand employees. Banks of group I have an impressive exposure to retail.

Headcount of bank employees, thousands

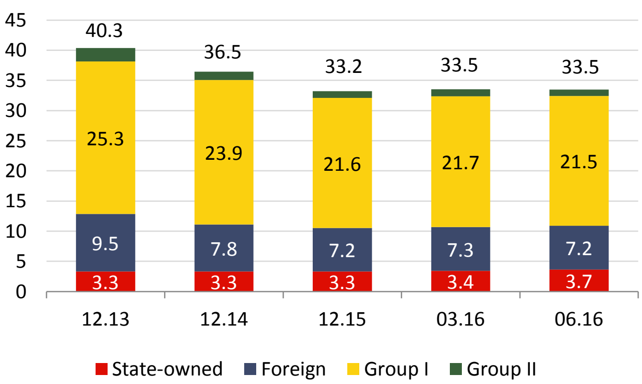


Number of clients – bank card holders, millions

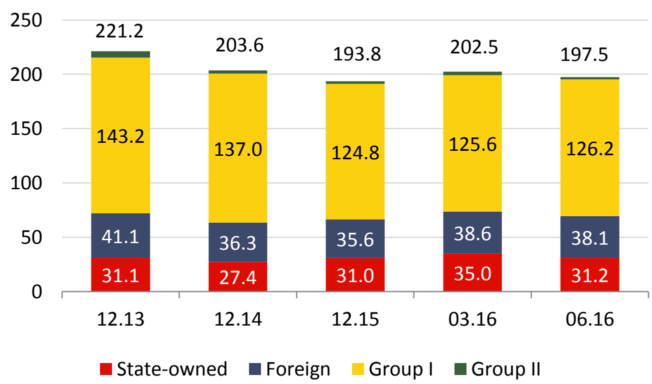


The development of payment infrastructure by solvent banks compensated for withdrawal of insolvent banks from the market, in particular through sale of technical networks. Number of ATMs remained at 33 thousand level, number of POSs increased to 189 thousand.

Number of ATMs, thousands



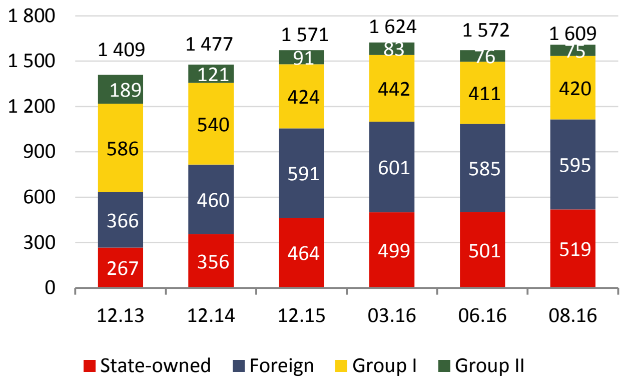
Number of banks' POSs, thousands



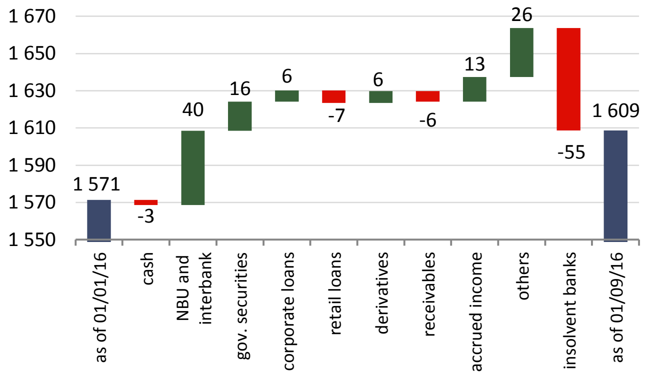
Assets

With virtually nil lending solvent banks extended government and NBU securities portfolio by UAH 16 billion, interbank operations by UAH 18 billion and funds at the NBU by UAH 22 billion.

Total assets by groups, bln. UAH



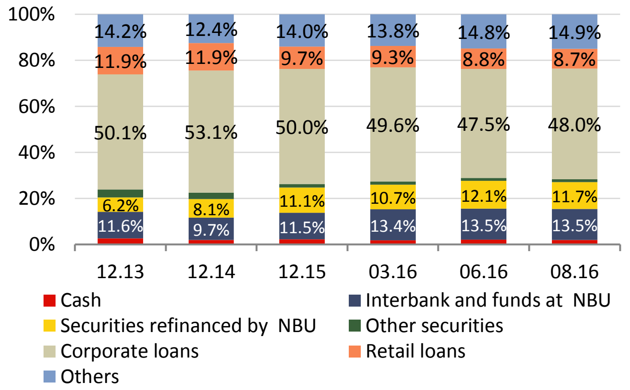
Change of total assets by components, bln. UAH



Government securities include NBU's certificates of deposit

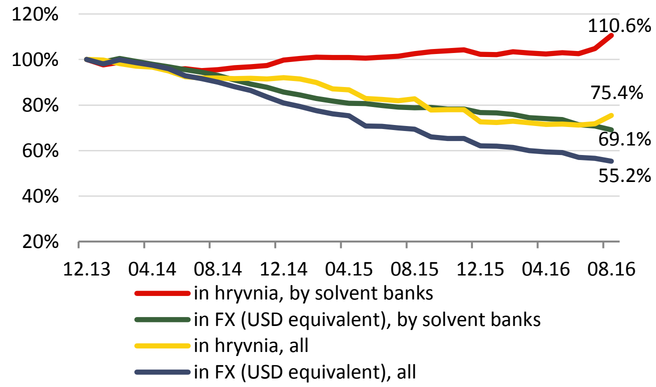
Share of state bonds and NBU securities, correspondent accounts at the NBU and interbank in total assets have increased by 2.6 pps since the start of the year.

Total sector assets by components



Virtually all loan growth took place in Q3 – 7.8% (for banks solvent as of August).

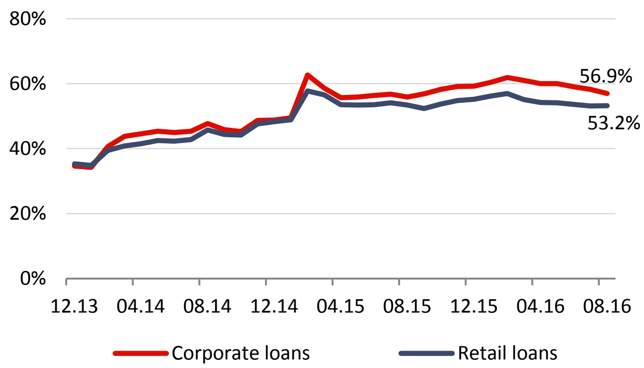
*Corporate and retail loans, 2013=100%**



** by solvent banks as of 01/09/16, accrued interest included*

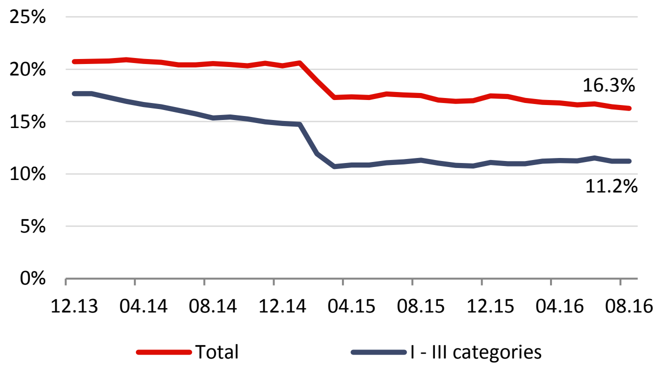
Loan dollarization dropped by 2 percentage points since the start of the year.

*Share of FX loans**



Share of retail loans in performing loans (I – III quality categories) is just 11%.

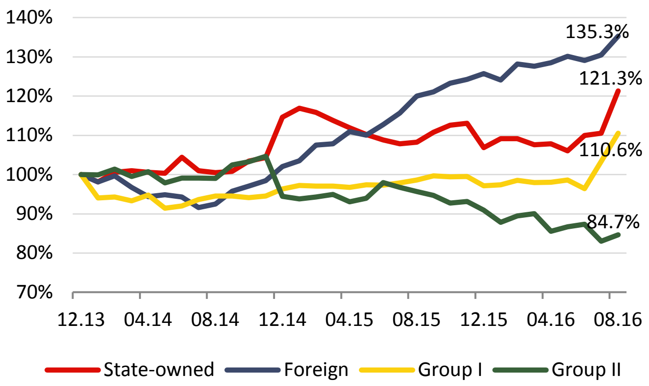
*Share of retail loans**



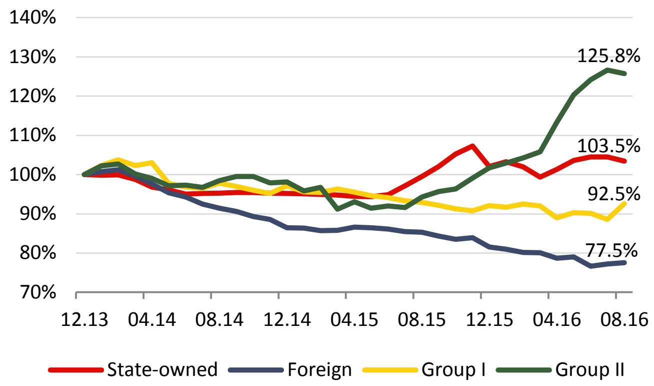
* *For solvent banks as of reporting date, accrued interest included.*

All banks except for group II contributed to 9% increase in hryvnia corporate lending in Q3.The leaders are Group I banks (+15% in July-August). Retail lending picked up only at group II banks.

*Corporate lending in hryvnia, 2013=100%**



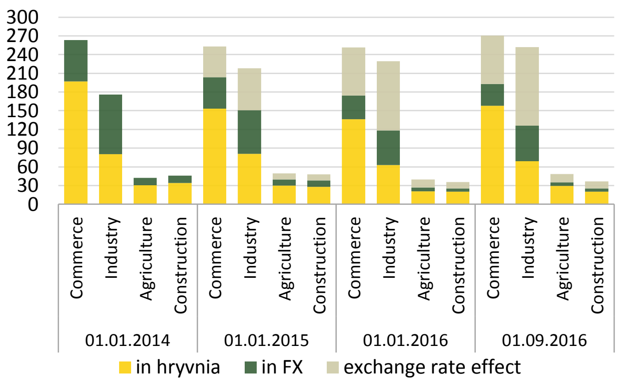
*Retail loans in hryvnia, 2013=100%**



** For solvent banks as of 01/09/16, accrued interest included.*

Withdrawal of banks from the market led to decrease in loan portfolio by economic sectors.

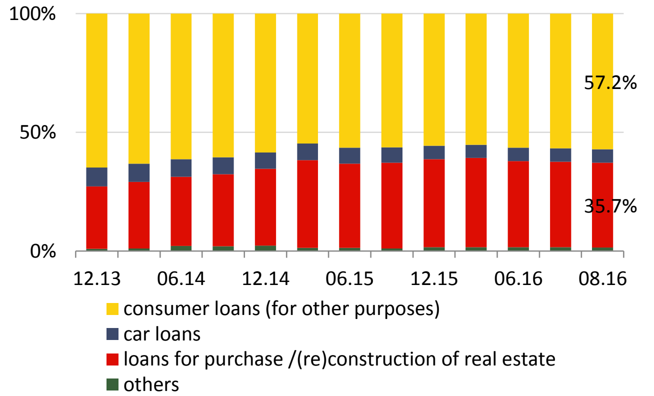
Lending to sectors of economy, bln. UAH



Exchange rate effect calculated at fixed rate at the beginning of 2014.

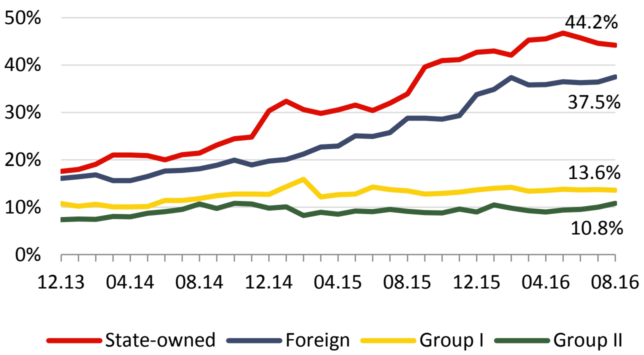
Share of consumer loans in total retail loans increase by 1.5 percentage point to 57.2%.

Retail loans by type



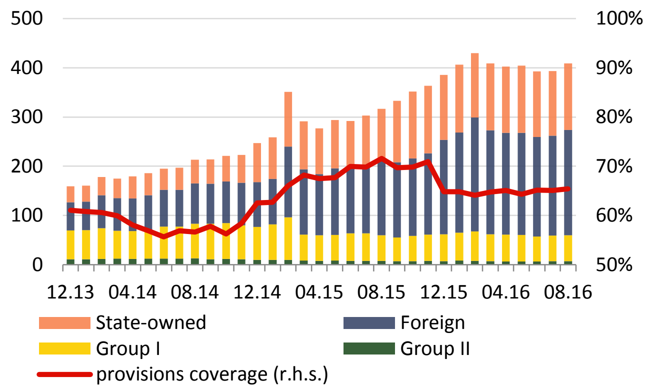
Share of NPLs goes further up (over 30% of portfolio).

Share of impaired loans in bank portfolios



Banks that passed diagnostic study, mostly state-owned and foreign, adequately assess quality of assets.

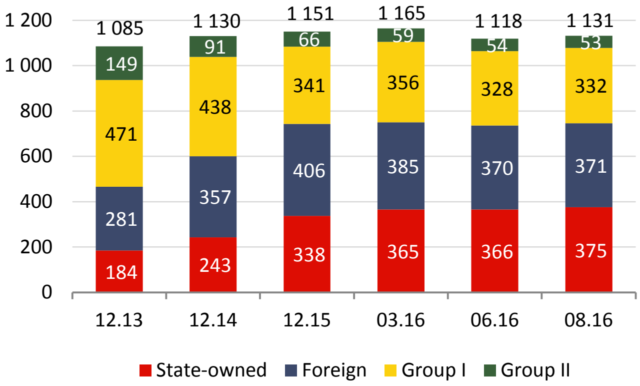
Impaired loans, bln. UAH, and impaired loans coverage by LLP, % (r.h.s.)



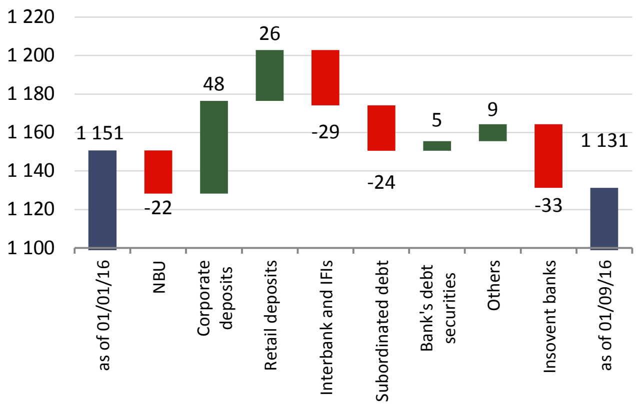
Funding

The key drivers behind shrinking liabilities were the repayment of loans to NBU and conversion of subordinated debt and interbank into capital. The UAH 48 billion increase in corporate deposits was the main source of banks' funding in 2016.

Liabilities by groups of banks, bln. UAH

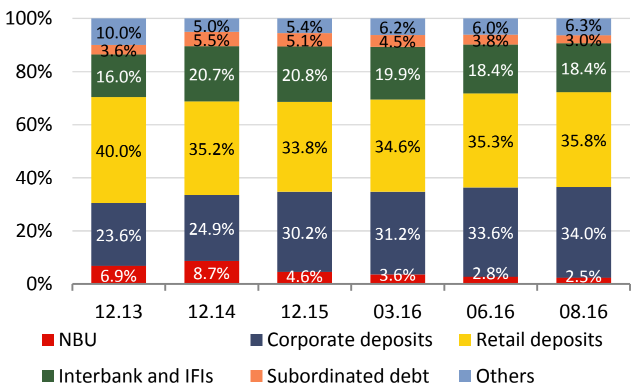


Change in liabilities, bln. UAH



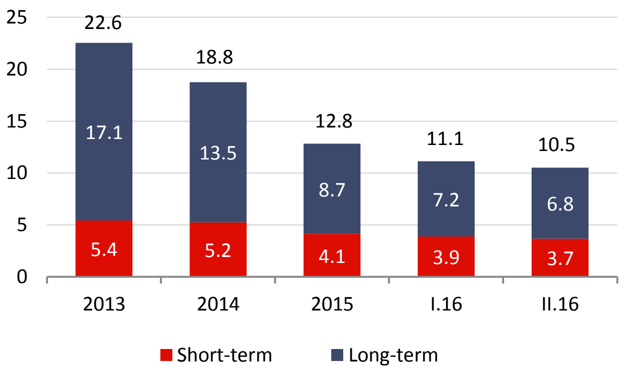
Adequate liquidity rates help to limit demand for interbank and NBU loans.

Liabilities by items



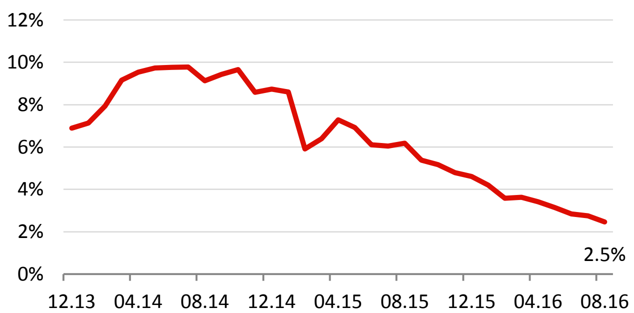
Repayment of previously raised loans and their conversion into capital led to decrease in external debt of the sector by USD 2.3 billion in eight months of 2016.

Gross external debt of banks, bln. USD



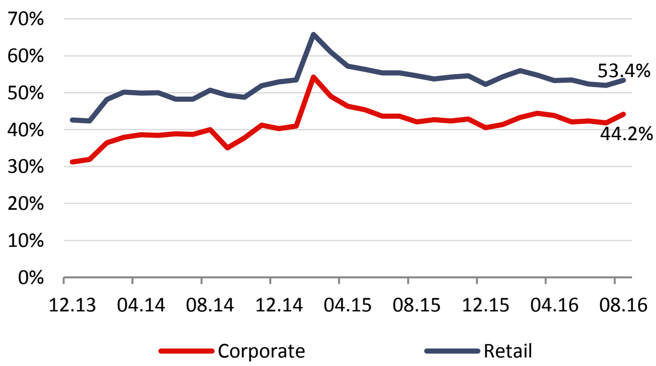
The share of NBU loans fell to lowest level since 2008 – to 2.3% of liabilities.

Share of NBU funds in banks' liabilities



The deposit outflow was offset by exchange rate effect.

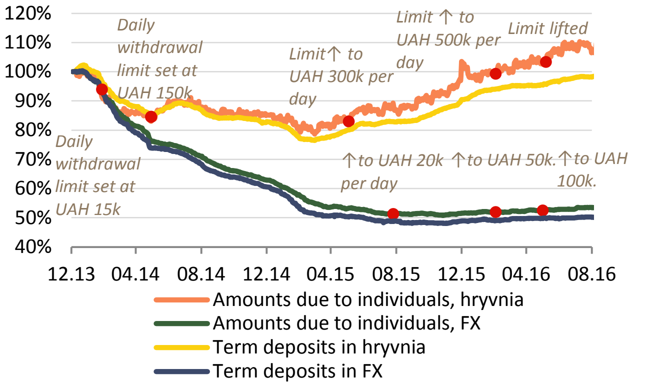
*Share of FX deposits**



** accrued interest included*

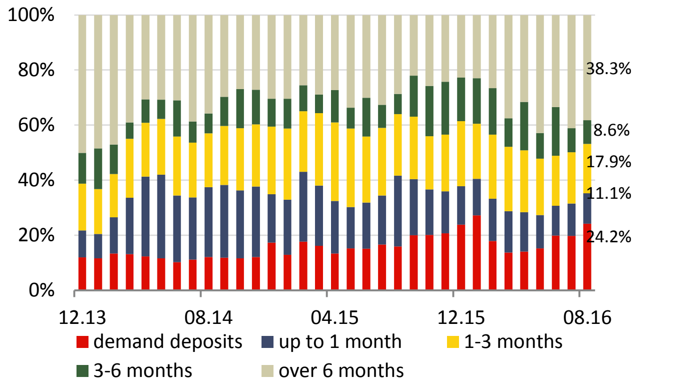
The build-up of retail hryvnia deposits continued: they rose 4.8% since the start of the year. FX accounts due to individuals increased by 3.7% because of certificates of deposits.

*Accounts due to individuals including deposit certificates, 2013=100%**



Share of new 6m+ retail deposits rose to 38.8% in August compared to 22.7% in December 2015. However, number of new retail deposit deals contracted the last month.

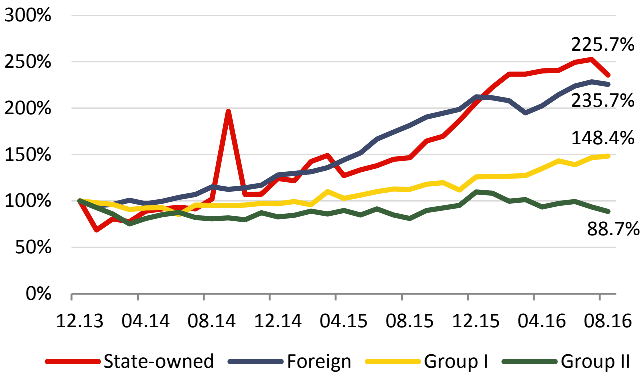
*New retail deposits by maturity**



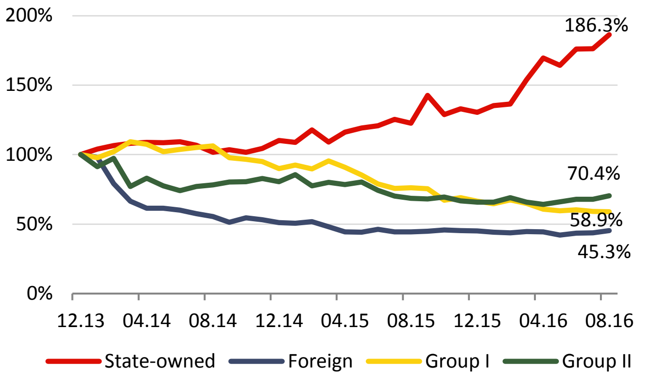
** For solvent banks as of 01/09/16, including accrued interest.*

State-owned banks were the major safe haven for corporations. The deposits at these banks on average doubled during the crisis: +125.7% in hryvnia and +86.3% in FX.

*Corporate deposits in hryvnia by groups of banks, 2013 = 100%**



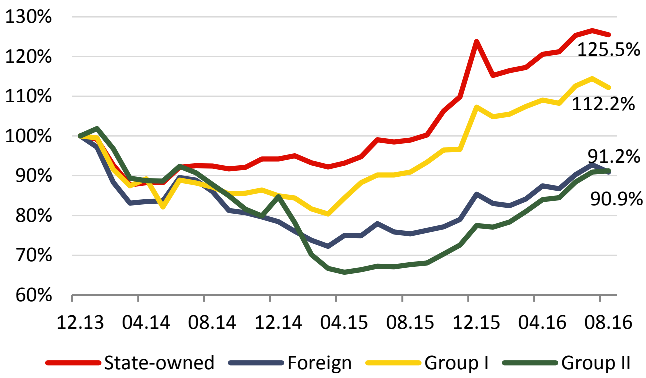
*Corporate deposits in FX (USD equivalent) by groups of banks, 2013 = 100%**



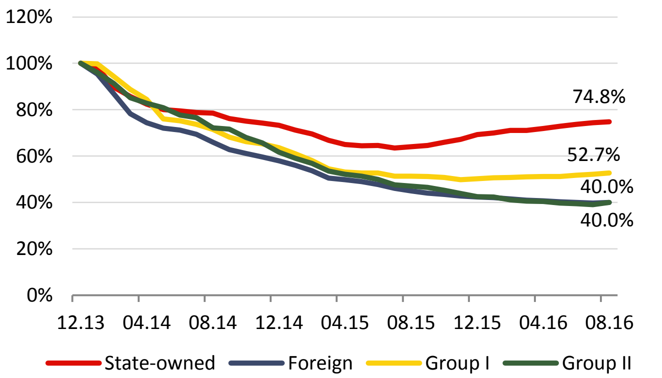
** For solvent banks as of 01/09/16, including accrued interest.*

State-owned and the largest domestic banks were the most active in attracting retail hryvnia deposits (+25.5%; +12.2% against 2013). These groups of banks also reported an increase in FX deposits since the second half of 2015.

*Retail deposits in hryvnia by groups of banks, 2013 = 100%**



*Retail deposits in FX (USD equivalent) by groups of banks, 2013 = 100%**

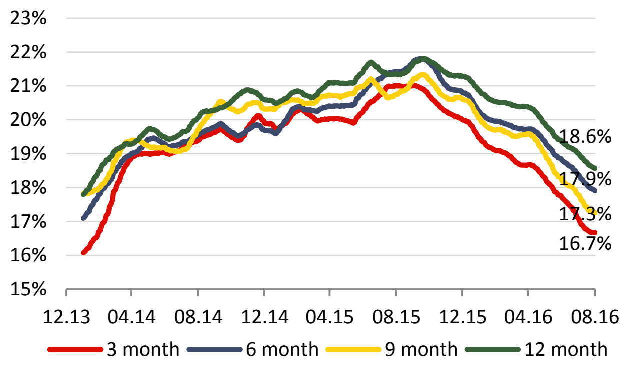


** For solvent banks as of 01/09/16, including accrued interest*

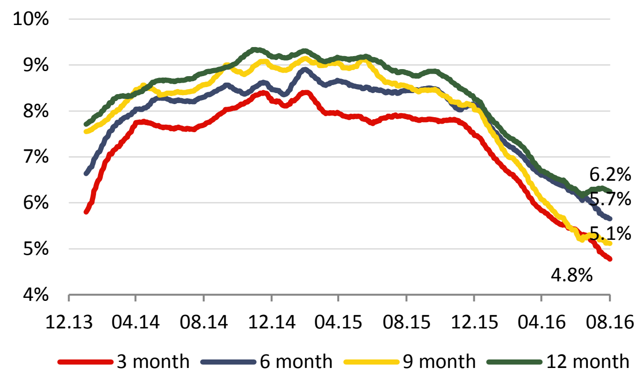
Interest rates

Interest rates on 12-month retail deposits decreased since the beginning of 2016 by over 2.3 percentage points in hryvnia and by 1.7% in US dollars.

*Ukrainian Index of Retail Deposit in hryvnia, % p.a.**



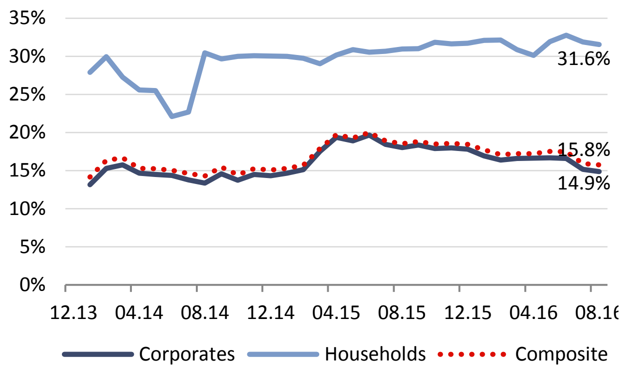
*Ukrainian Index of Retail Deposit in FX, % p.a.***



** based on data from Thomson Reuters, 20-day average rate.*

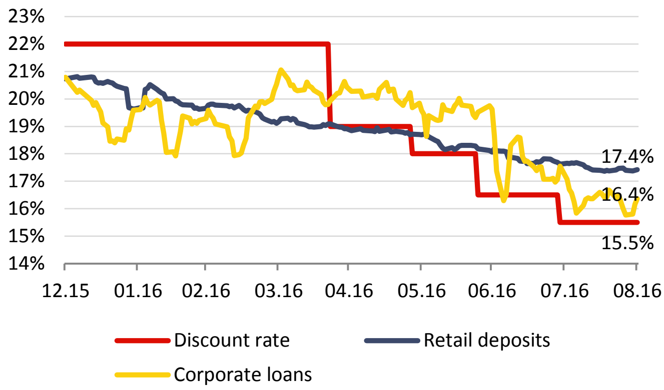
Price conditions for corporate lending softened somewhat to 14.9% in September.

Interest rates on new loans by borrowers, % p.a.



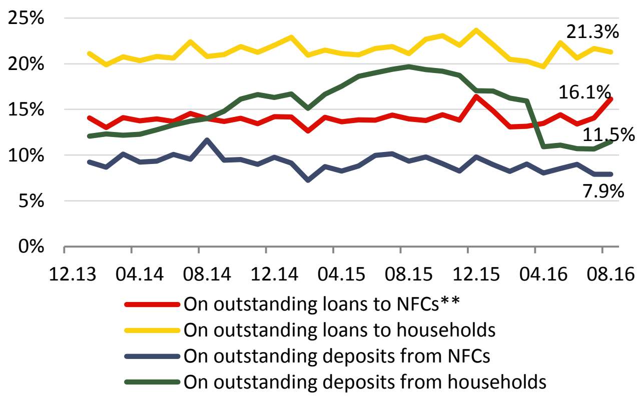
Rates on key banking operations dropped by 3 – 4 percentage points since the start of 2016.

Discount rate, price of loans and deposits in hryvnia, % p.a.



In Q2, the cost of retail deposits finally became lower than interest rates on corporate loans. Before that, retail deposit rates were higher than corporate loan rates for 1.5 years, which undermined banks' profitability.

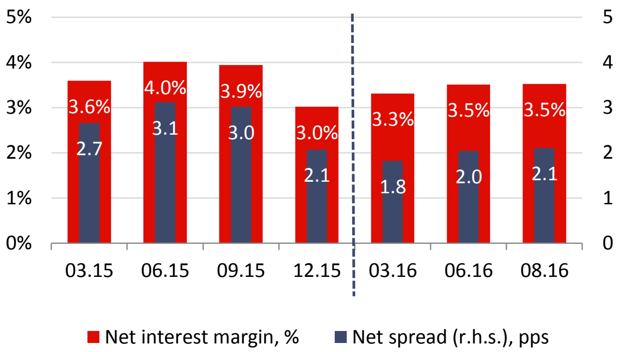
*Interest rates on loan and deposit portfolios, % p.a.**



** Insolvent banks included; ** non-financial corporations.*

Return on credit operations per unit of deposit gradually improves (net spread – 2.1 percentage points).

*Efficiency of interest operations**

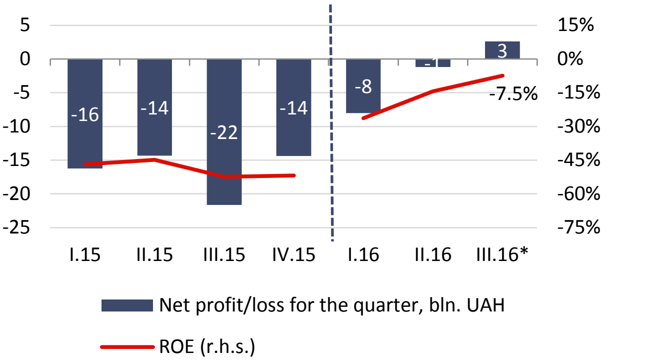


** In respective month, insolvent banks included.*

Financial results and capital

In May 2016, the banking sector recorded profit for the first time since April 2015. Cumulative net income of solvent banks reached UAH 4.9 billion in May-August.

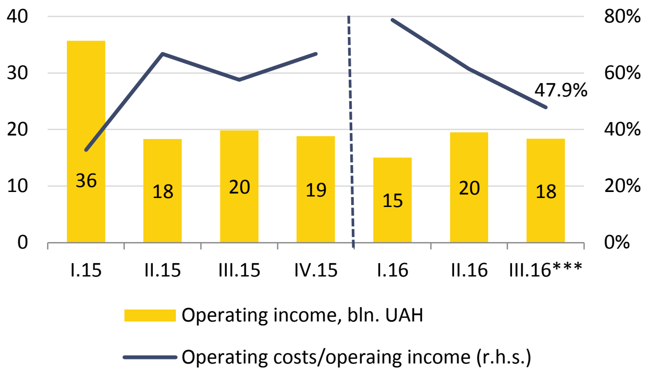
Financial results and return on equity of banks



** in two months of Q3.*

After significant losses in Q1, banks recovered operating efficiency to average of the last two years, 55%. The CIR* for July–August was 47.9%.

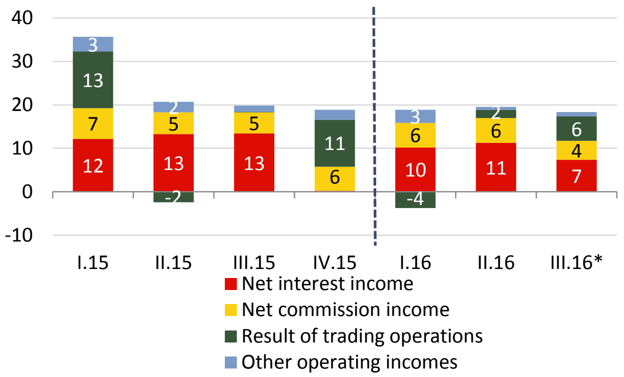
*Operating income and operating efficiency of banks***



** CIR (Cost-to-Income Ratio) – operating costs to operating income; **in respective quarter; *** in two months of Q3.*

Profitable trading operations were the key driver of operating income recovery, having gained UAH 6 billion in July-August 2016.

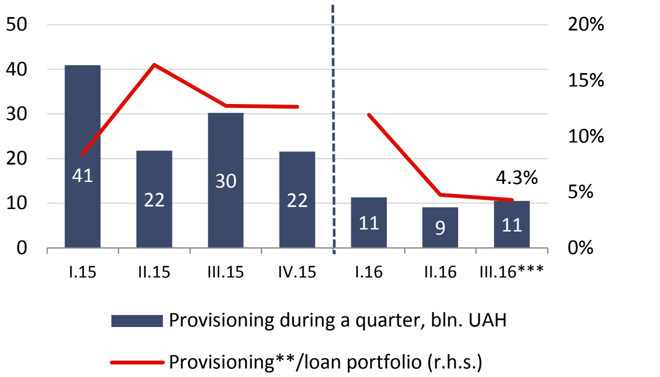
Components of operating income of banks, bln. UAH



**in two months of Q3.*

New loan loss provisions (4.3% of loan portfolio) were substantially lower in 2016 than last year (12.6%).

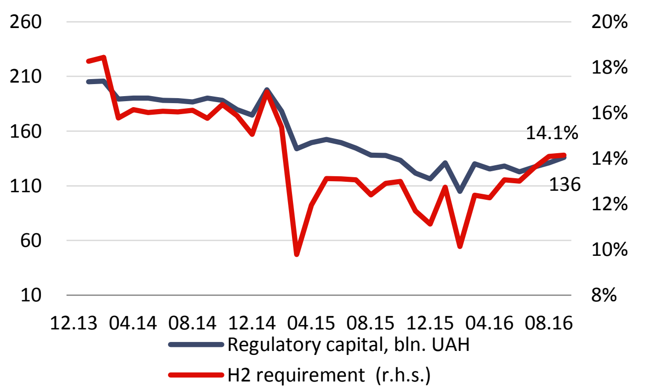
*Provisioning rates**



**ratio of provisioning to loan portfolio of banks; **annualized; ***for two months of Q3.*

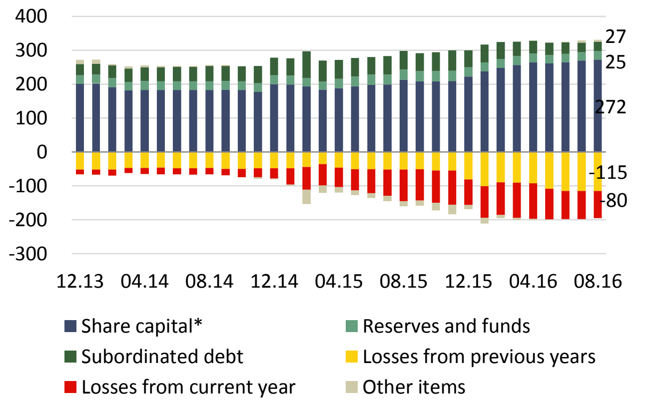
Lower RWA and recapitalization improved solvency of banking system, capital adequacy rose to 14.1%.

Regulatory capital and regulatory capital adequacy requirement



Banks increased share capital by UAH 49.7 billion or 22.3%.

Regulatory capital of banks, bln. UAH



** Includes registered and non-registered share capital.*

Notes:

Information source – National Bank of Ukraine unless otherwise specified.

Selection of banks – solvent for reporting date unless otherwise specified.

Banks classified into groups as of 01/01/2016 in line with resolution of the Committee on supervision and regulation of banks and oversight of payment systems of 31 December 2015 # 657.

Data provided does not include accrued interest at the end of the period (month, quarter, year) unless otherwise specified.

The sum of components may differ from the total due to rounding effect.

Reporting period – January-August 2016 unless otherwise specified.

Abbreviations

ATM	*automated teller machine (a cash dispenser or cash machine)*
bln.	*billion*
FEZ	*free economic zone /area*
FX	*foreign currency (foreign exchange)*
NBU	*the National Bank of Ukraine*
p.a.	*per annum*
pps	*percentage points*
POS	*point-of-sale*
r.h.s.	*right hand scale*
UAH	*Ukrainian hryvnia*
USD	*US dollar*