BANKING SECTOR REVIEW

Issue 2
February 2017

The last year was a landmark for Ukrainian banking sector – the clean-up of the system is almost over, Privatbank became state-owned in December. Banks continue to fulfill their re-capitalization plans based on diagnostics results. Most of them have already implemented the three-year plans. While finalizing the balance clean-up from distressed assets, banks increased provisioning in the second half of 2016. Coupled with provisioning for NPLs at Privatbank, this resulted in record high losses of the banking sector. By now, these losses are covered via additional capital injections. The expected fall in deposit rates at state-owned banks is to lower the funding costs for the whole banking system. Provisioning is also to subside materially. Thus, the sector should start making profits again (Privatbank aside). In 2017, banks will focus on adaption of new approaches to credit risk assessment and preparing for IFRS 9 standard implementation effective 2018.

Sector structure. The transfer of Privatbank into the state ownership at the end of December has changed drastically the banking sector structure. The share of state-owned banks (SOBs) in net assets has swollen to 51.3% (from 28.1% in the early 2016), in retail deposits – almost tripled, to 59.5%. In 2016, 17 banks were declared insolvent; another 4 banks were withdrawn from market on shareholders' requests. Thus, the concentration increased: the share of top-20 banks in net assets rose by 3.0 pps in the year to 89.4%.

Assets. New lending was limited in the first half of 2016. However, it revived in the second half, primarily due to loans from SOBs to state-owned monopolies. Gross corporate loans in hryvnia increased by UAH 87 billion (+27%) while loans in FX decreased by USD 4.1 billion (in USD equivalent), partially driven by refinancing in hryvnia. Retail lending also shrunk.

Under weak lending banks were building up government securities portfolio. Total share of bank investment into securities refinanced by the NBU (T-bills and CDs of the NBU) was 24.6% of the net sector assets at the beginning of 2017 (+10.6 pps for the year, of which 5.1 pps due to increase of government bonds in Privatbank portfolio).

Reported share of NPLs (loans in quality categories IV and V) was 30.5% at the end of 2016. This is much lower than findings of diagnostics study. Banks transition to new rules of loan classification in accordance with introduction of Regulation on credit risk assessment (Regulation # 351) and recognition of real quality of credit portfolio of the Privatbank should approximate the reported share of NPLs to diagnostics results. New definition of NPLs is primarily based on event of past due of 90+ days.

Funding. Deposits by bank clients increased by UAH 117.6 billion* in hryvnia terms mostly due to inflow of corporate deposits. Thanks to that, banks repaid UAH 30.2 billion they had previously borrowed from the NBU. They also substituted with deposits subordinated debt converted into equity and interbank loans from parent corporations. Retail deposits in hryvnia hiked by 9.1%, in FX – by 1%. Gradual lifting of restrictions on withdrawal from deposits had a positive effect on public confidence in banks and on deposits growth. The share of retail and corporate deposits in banks' liabilities rose from 64.0% to 73.4% in 2016.

Interest rates. Banking sector liquidity improved through the year due to return of clients' deposits. Moreover, the NBU has repeatedly cut its key policy rate in 2016, from 22% to 14%. These factors combined facilitated decrease of deposit interest rates of banks. E.g., the 12-month deposit rate fell in 2016 by 3.8 pps to 17.5% p.a. in hryvnia and by 2.2 pps to 5.7% in USD**. In Q4, the rate decrease slowed down because of uncertainty around the Privatbank. The cost of deposits in euro and US dollars fell to historical minimums as demand for FX funding remains low.

Lower funding costs allowed banks to cut interest rates on corporate loans even more than the rates on retail deposits fell. However, the cost of new loans is still high. Therefore, money are borrowed mostly for short term to finance working capital.

Financial results and capital. Last year, the operating efficiency of the banking sector declined a little: CIR (cost to income ratio) was 58% compared to 52% in 2015. Net interest income diminished because of funding costs, which were still high. This was partly offset by gradual increase in net fee and commission income thanks to recovery of demand for banking services and higher fees. In 2016, the losses of the banking sector reached record highs – UAH 159 billion, driven by provisioning for the Privatbank loan portfolio. For the rest of the banks provisioning diminished and total losses slipped to UAH 23 billion from UAH 66 billion in 2015.

Outlook and risks. The "reloading" of the banking sector will proceed in 2017. After grave shocks in previous years, banks implement long-term planning, introduce new approaches to risk-management, and look for new clients.

Finalized clean-up of the banking sector and appropriate macroeconomic conditions will facilitate the inflow of retail and corporate deposits to banks. The NBU expects the inflow of deposits to accelerate this year comparing to 2016. The resolution of the Privatbank solvency problem (the bank offered too high retail deposit rates) lays foundations for gradual decrease in deposit rates and cheaper credit in 2017.

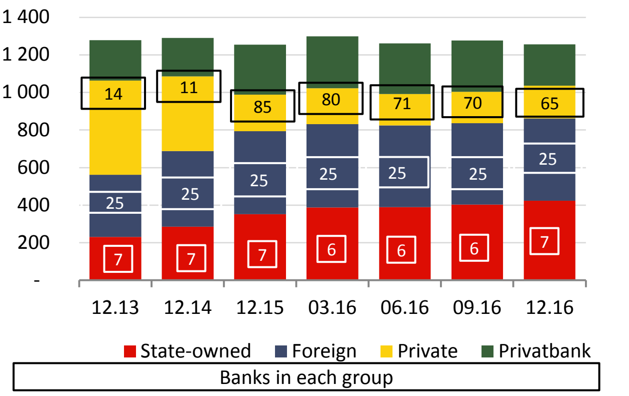
The key task for banks this year is restarting lending to real sector and households. Leverage of corporate borrowers gradually improves due to rising incomes and profits. However, there is still a lack of good borrowers with transparent financial reports. Banks feel upbeat: according to the NBU survey, over 70% of financial institutions expect the growth of corporate credit portfolio over the next 12 month. The issue of creditor rights protection stays high on agenda as the progress on it in previous years is insignificant.

** At banks solvent as of the end of 2016.*
*** According to Ukrainian Index of Retail Deposit Rates (UIRD).*

Sector structure

With nationalization of the Privatbank the clean-up of Ukrainian banking sector reached its terminal stage. The share of the state-owned banks (SOBs) in net-assets expanded to 51.3%. Over 2016 and early 2017, 20 banks were withdrawn from the market; shareholders at another 4 banks took decision on self-liquidation of the institutions.

*Banks' net assets, bln. UAH**



* *Solvent banks divided into groups according to classification as of 01/01/16*

*** As of 01/01/17, the Privatbank is classified as state-owned bank, prior to that – as a private bank.*

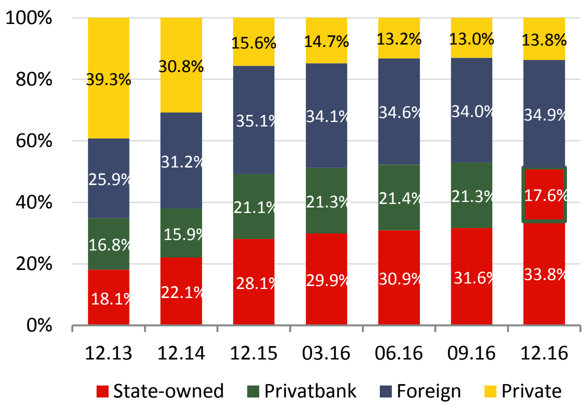
Number of banks

	2014	2015	2016	01.17
Solvent	**147**	**117**	**96**	**93**
- change	(-33)	(-30)	(-21)	(-3)
State-owned	**7**	**7**	**6**	**6**
- change	(0)	(0)	(-1)	(-1)
Foreign	**25**	**25**	**25**	**25**
- change	(0)	(0)	(0)	(0)
Private	**115**	**85**	**65**	**62**
- зміна	(-33)	(-30)	(-20)	(-3)
Insolvent	**16**	**3**	**4**	**7**
- change	(16)	(-13)	(1)	(3)
Under liquidation	21	64	84	84
- change	(19)	(43)	(20)	(0)

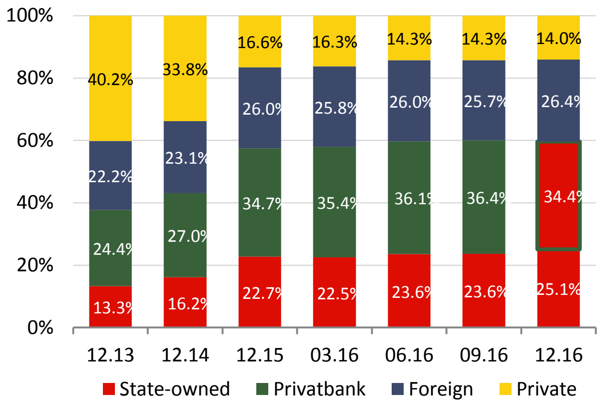
* *Figures reported at the end of the period.*

Share of SOBs in retail deposits increased to 59.6%. However, their share in net assets is 51.3%.

Net assets by groups of banks

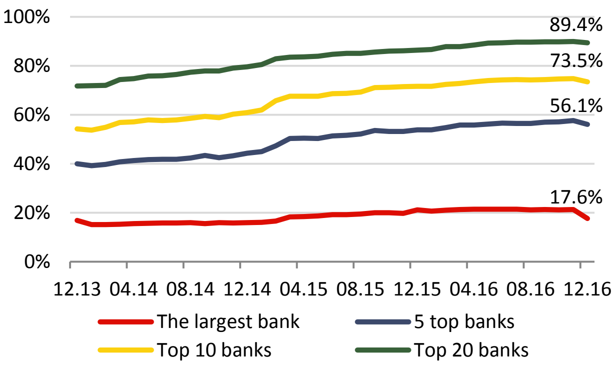


Retail deposits by groups of banks

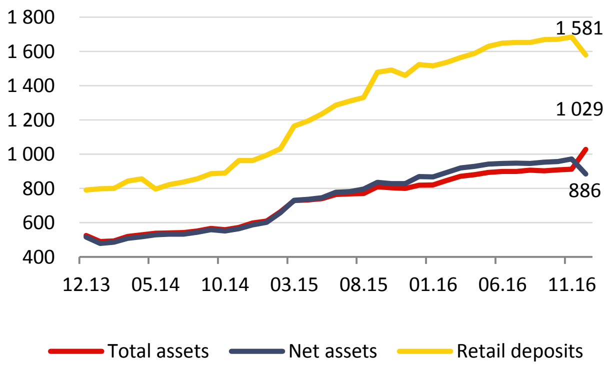


The concentration in the sector increases further: as of early 2017, top-20 banks make 89.4% of the system assets (86.4% a year ago). Changes in concentration indicator are driven by the processes related to the Privatbank nationalization (recognition by the bank of the real credit quality, provisioning, increase in government bonds in its portfolio and retail deposits outflow).

Shares of the largest banks in net sector assets



*Concentration rate in banking sector, HHI**

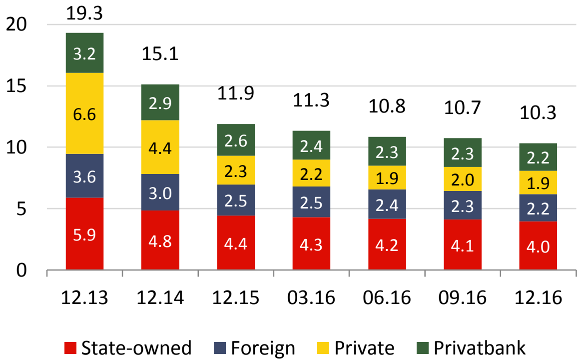


* *Herfindahl–Hirschman Index (HHI) — concentration indicator for banking market. It is calculated as a sum of square shares of individual banks in total. It varies in the range between 0 and 10 000 (up to 1000 –concentration on the market is low).*

Banking infrastructure

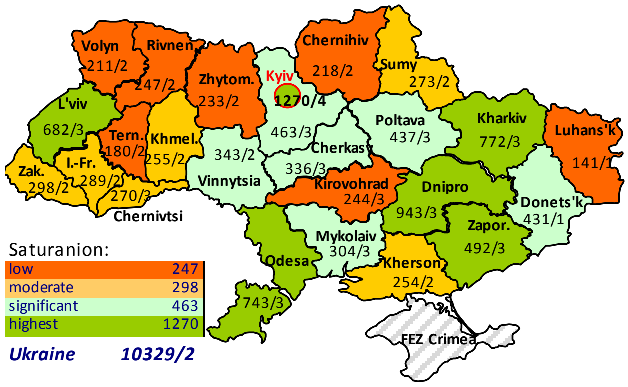
Withdrawal of banks from the market and optimization of branch networks at two largest banks led to a significant fall in a number of branches (to 10.3 thousand) over the last year.

*Number of structural units of banks, thousands**



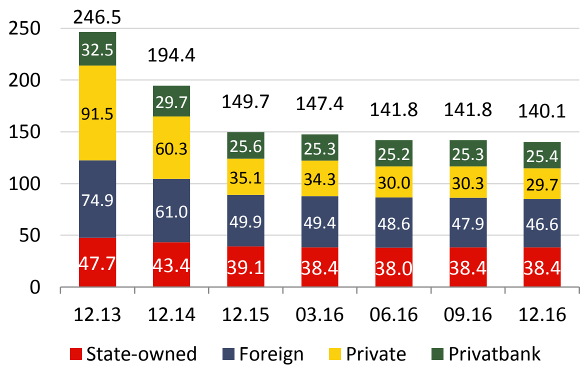
* branches and head-offices

Number of operating bank branches across regions as of 01/01/17, units/units per 10 000 of inhabitants



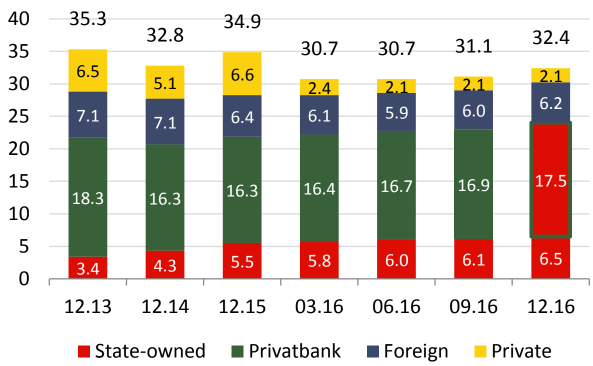
The headcount of bank employees decreased at slower rate. In 2016, it declined by 9.6 thousand to 140 thousand.

Headcount of bank employees, thousands



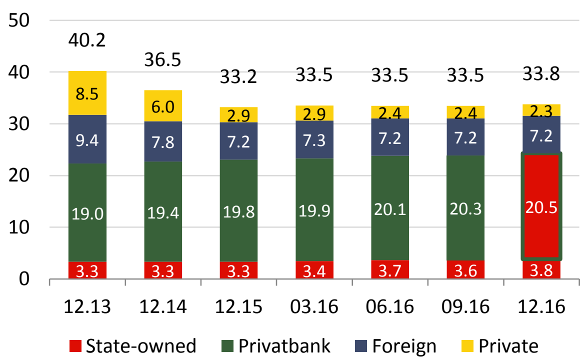
The Privatbank and other SOBs issued the most bank cards.

Number of active bank cards by groups of issuing banks, millions

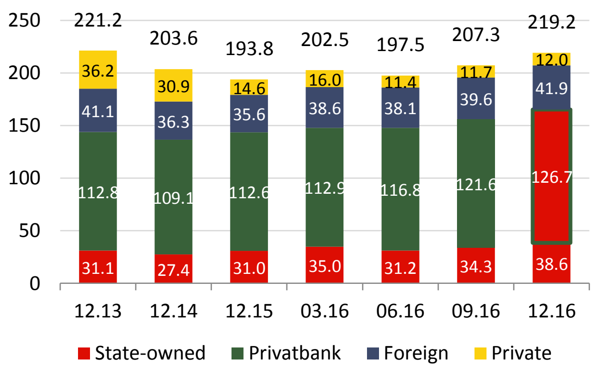


The development of payment infrastructure by leading banks set off the losses from withdrawal of financial institutions from the market. The number of ATMs marginally increased to 33.8 thousand. The expansion of the POSs network was more vigorous – by 24.5 thousand over the past year.

Number of ATMs, thousands



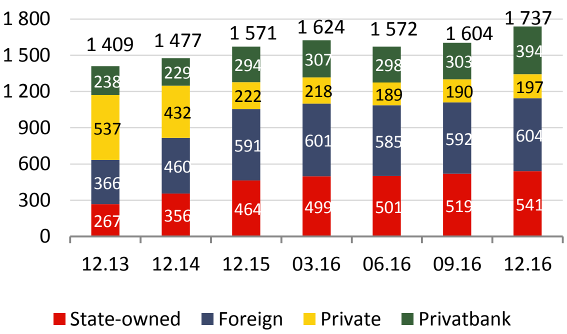
Number of banks' POSs, thousands.



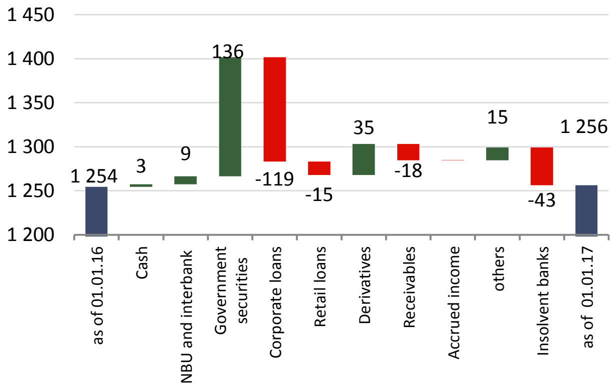
Assets

Total banking assets increased by 10.6% while net assets remained virtually unchanged (+0.2%). The major driver of the total assets growth was swelling government bond and derivatives portfolio of the Privatbank resulting from its privatization. Other banks were mostly lending to corporates and investing into government bonds. In 2016, the negative statistical effect from the bank withdrawal from the markets lingers.

Total assets by groups, bln. UAH



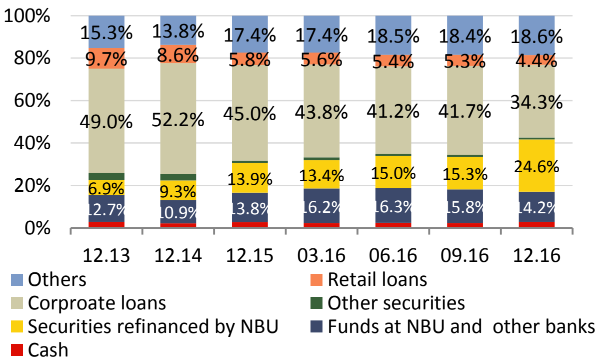
Change of total assets by components, bln. UAH



Government securities include NBU's certificates of deposit

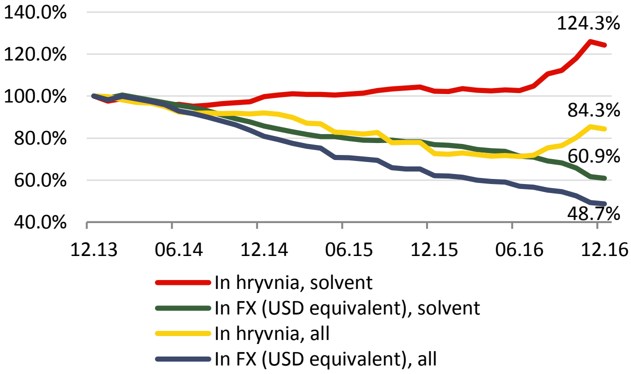
In 2016, investment in government securities increased the most in net assets composition (by 10.6 pps).

Net assets by components



Gross credit in hryvnia* increased by 21.5% in 2016, loans in FX – decreased by 20.7%.

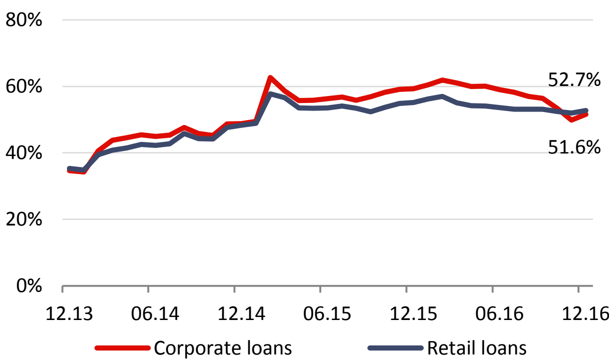
*Gross corporate and retail loans, 2013=100%**



** * by solvent banks as of 01/01/17, accrued interest included*

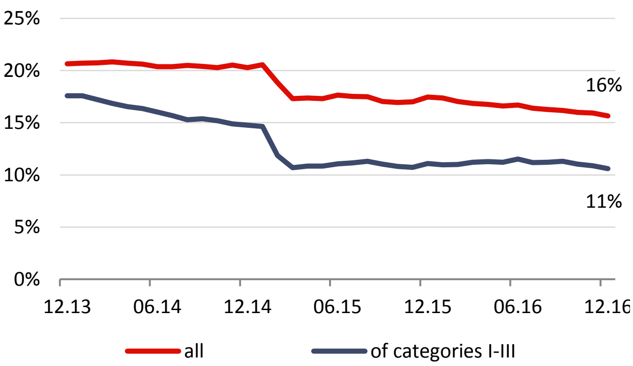
The currency composition of the credit portfolio did not change materially over the last year.

*Share of FX loans**



Retail loans make a minor proportion of credit portfolio of banks.

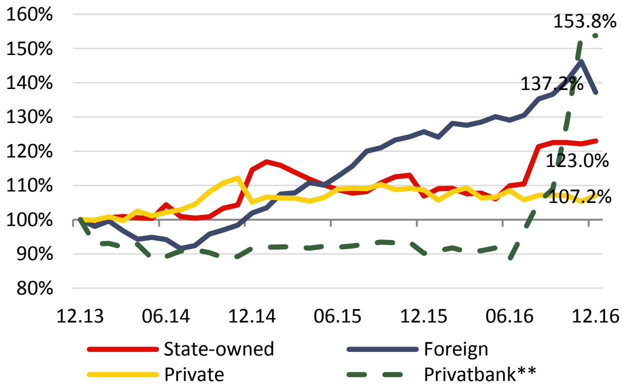
*Share of retail loans**



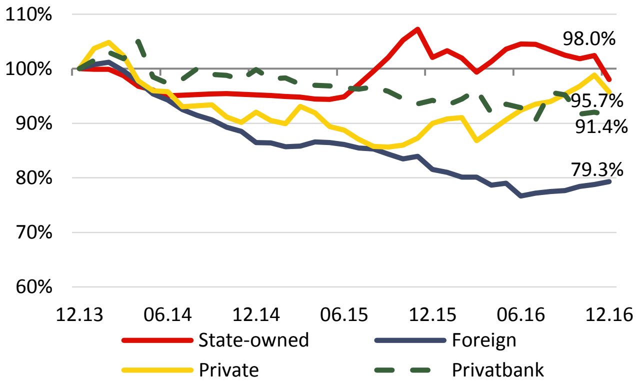
** For solvent banks as of 01/01/17, accrued interest included.*

In the second half of 2016, SOBs and foreign banks restarted lending in hryvnia and converted FX loans into hryvnia loans. Credit portfolio of SOBs and foreign banks increased by 15.1% and 9.1%, respectively. Foreign banks and SOBs restart retail lending.

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



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

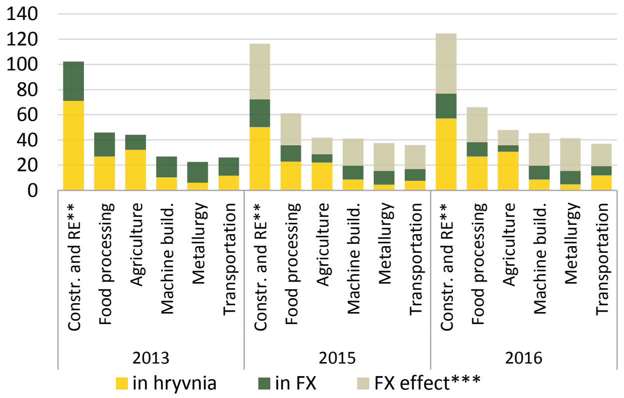


** For solvent banks as of 01/01/17, accrued interest included.*

*** the sharp rise is due to conversion of FX loans to related parties into hryvnia loans*

In 2016, change in lending to different sectors was uneven. Credit to agriculture increased the most – by 25*.

Lending to sectors of economy, bln. UAH



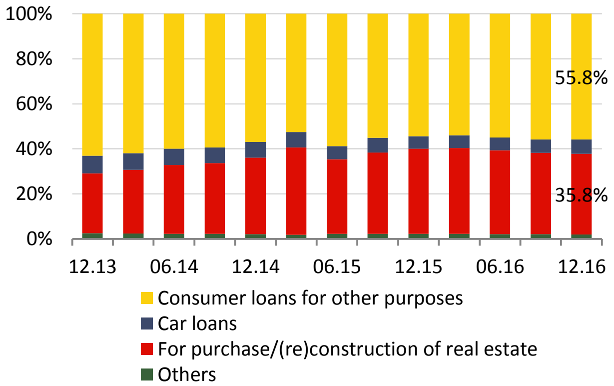
** at the rate fixed in early 2014 (UAH 7.933 for USD 1)*

*** construction and real estate*

**** FX effect calculated at fixed rate at the beginning of 2014*

Last year, consumer loans and car loans to households increased (+1.4 and +0.7 pps respectively), mortgages – decreased.

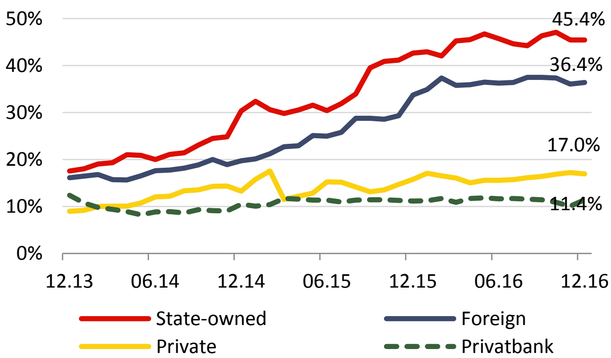
Retail loans by type*



** not adjusted for provisions*

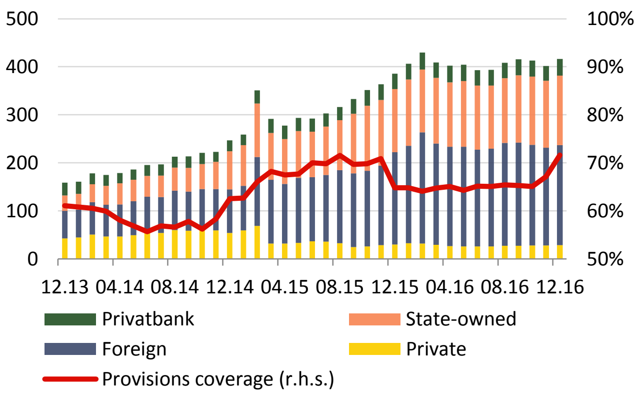
Banks extensively recognized NPLs in Q1 2016 and in December after the Privatbank nationalization. Share of NPLs broadened to 30.5%.

Share of NPLs in portfolio of banks



Due to the Privatbank effect, the ratio of coverage of impaired assets by provisions increased by 7 pps over the year (at the Privatbank – from 46% to 79% in December).

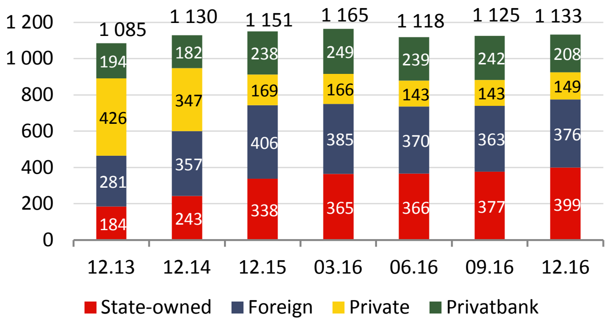
Impaired assets, bln. UAH, and impaired assets coverage by LLP, % (r.h.s.)



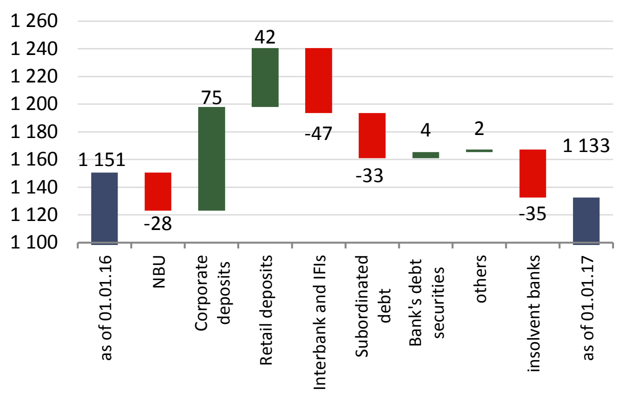
Funding

Over 2016, total liabilities of solvent banks has not change much. New retail and corporate deposits substituted as sources of funding NBU loans and partially subordinated debt and interbank loans, which were converted into capital.

Liabilities by groups of banks, bln. UAH.

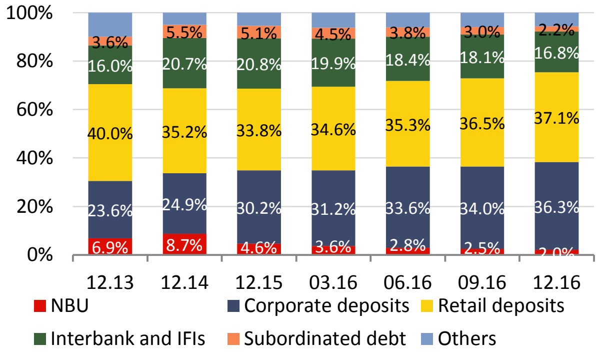


Change in liabilities by items, bln. UAH



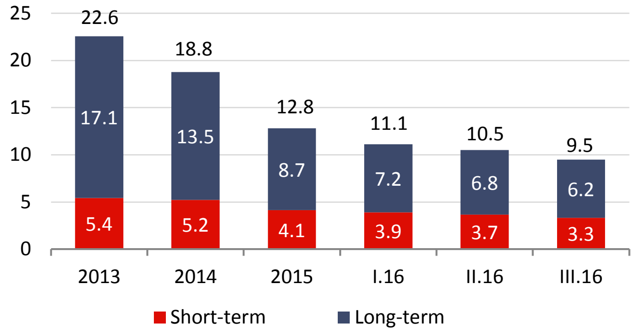
Banks rely further on clients' deposits. Their share in liabilities increased over the last year by 9.4 pps to 73.4%.

Liabilities by items



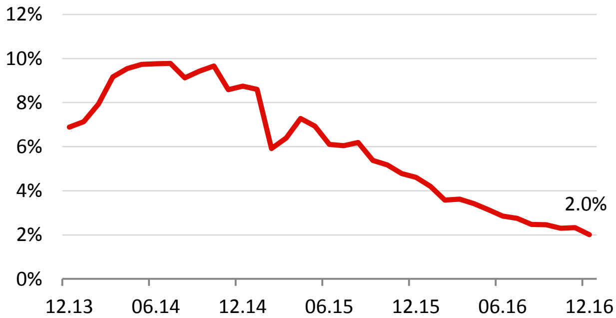
External debt of banks declined by USD 3.3 billion in Q1-Q3 2016, mostly due to conversion into capital.

Gross external debt of banks, bln. USD



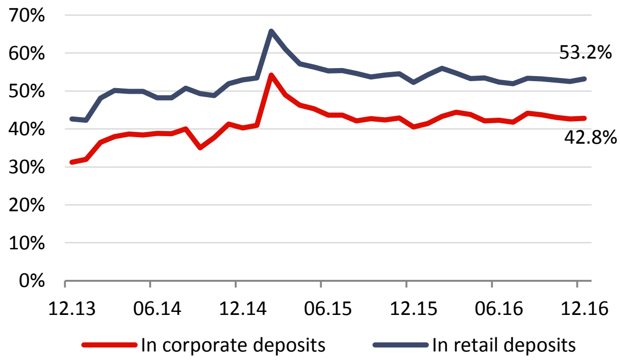
Liquidity of solvent banks improved. This allowed them to repay the NBU loans. Share of the NBU loans slumped to 2.0% of liabilities.

Share of NBU funds in banks' liabilities



Dollarization of deposits increased by 1.4 pps because of hryvnia depreciation effect.

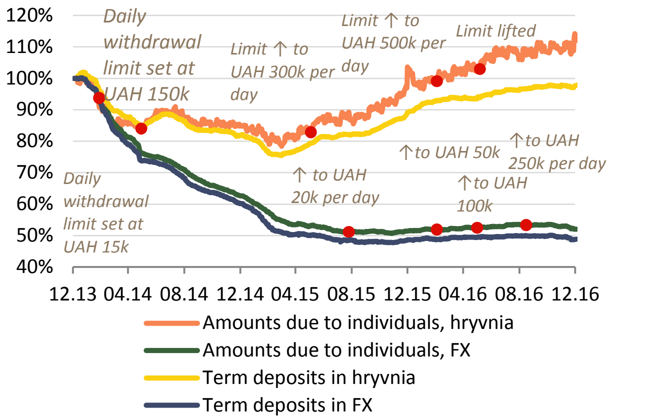
*Share of FX deposits**



** accrued interest included*

In 2016, retail deposits in hryvnia increased by 9.1%, in FX – by 1%.

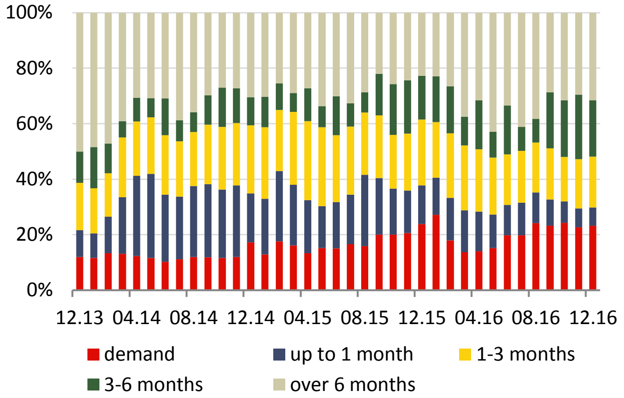
*Accounts due to individuals including certificates of deposit, 2013=100%**



** For solvent banks as of 01/01/17, including accrued interest; k - thousands*

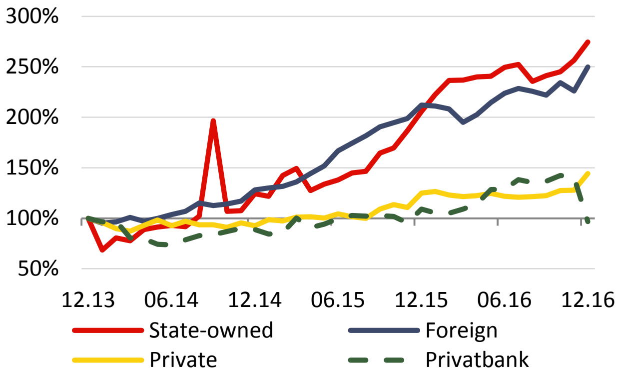
Composition of deposits improved in terms of maturity over 2016

*New retail deposits by maturity**

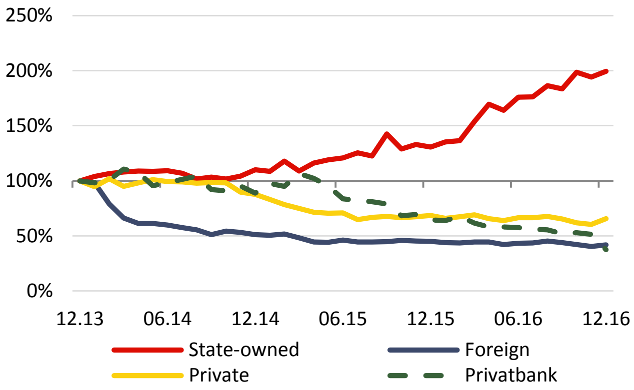


In 2016, corporate deposits increased the most at SOBs (excluding the Privatbank) – by 33.4% in hryvnia and by 52.9% in FX, respectively.

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



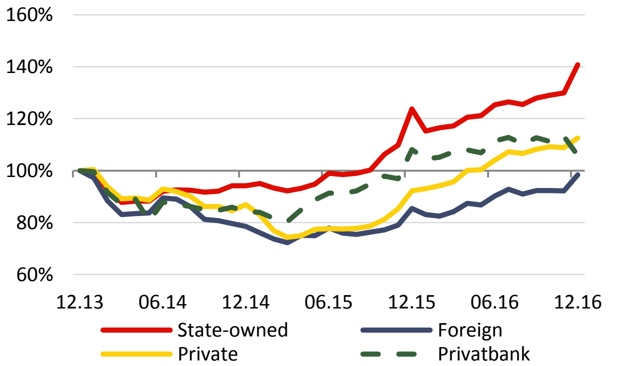
*Corporate deposits in FX (USD equivalent) by groups of banks, 2013 = 100%**



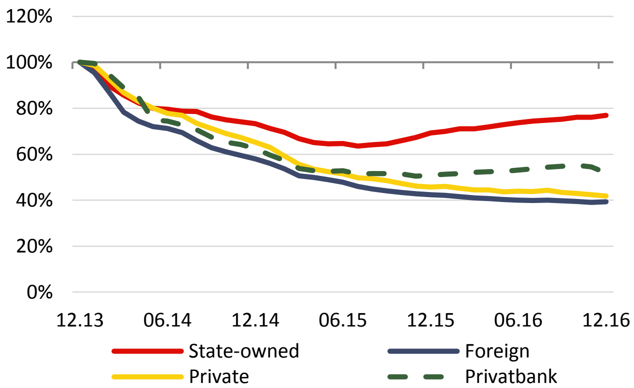
** For solvent banks as of 01/01/17, including accrued interest*

Households trust SOBs the most: they (including the Privatbank) account for 60.4% of hryvnia deposits and 58.7% of FX deposits. The highest rate of deposit growth was reported for private banks – 22% over 2016.

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



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

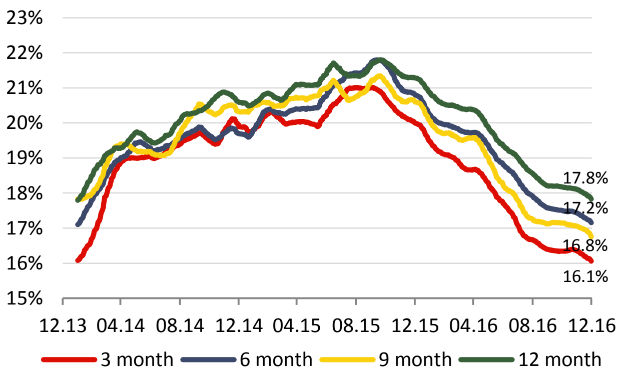


** For solvent banks as of 01/01/17, including accrued interest*

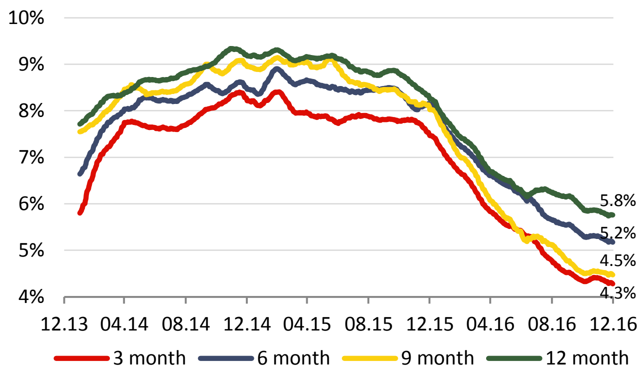
Interest rates

At the end of 2016, the decline of retail deposit rates decelerated due to uncertainty on the eve of the Privatbank nationalization. Another factor slowing down the rates decrease was competition between SOBs for retail and corporate deposits. By the end of December, the rate on 12-month deposits was 17.5% and 5.7% p.a. in hryvnia and FX respectively. Rates on USD deposits are at historical lows.

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



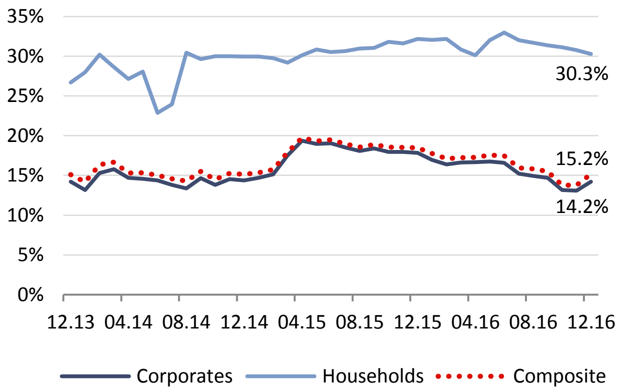
*Ukrainian Index of Retail Deposit in FX, % p.a.***



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

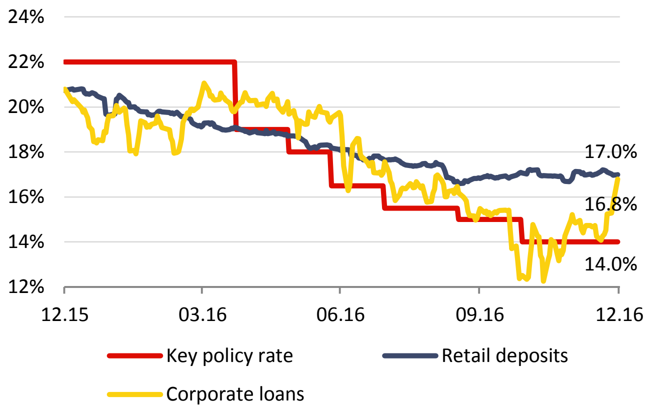
In the second half of 2016, the cost of new corporate loans was decreasing faster than the rates on retail loans and deposits.

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



**excluding prolongations and other credit contract amendments.*

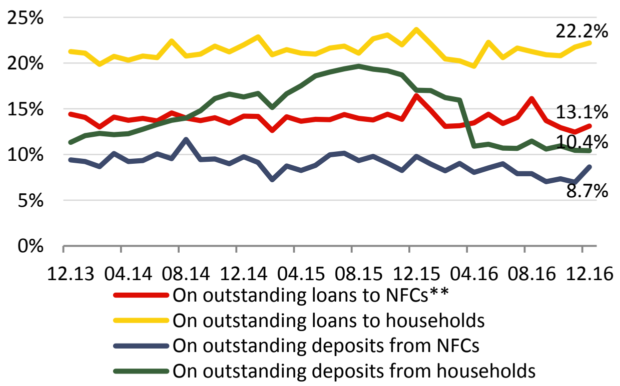
Key policy rate, price of new loans and deposits in hryvnia, % p.a.*



** based on daily data.*

Over the year, retail deposits became substantially cheaper – unlike corporate deposits.

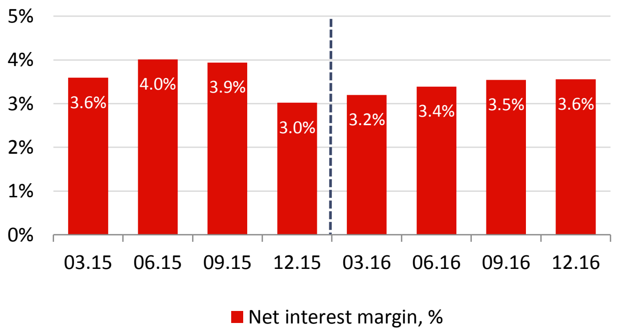
*Interest rates on loan and deposit portfolios, % p.a.**



** Insolvent banks included; ** Non-financial corporations*

Return on credit operations was stable through the year.

*Efficiency of interest operations**

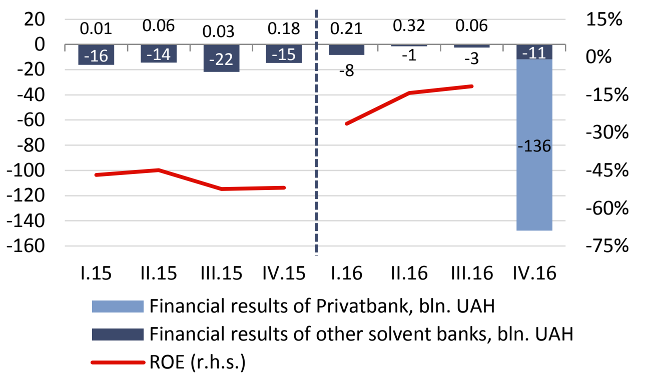


** In respective month, insolvent banks included.*

Financial results and capital

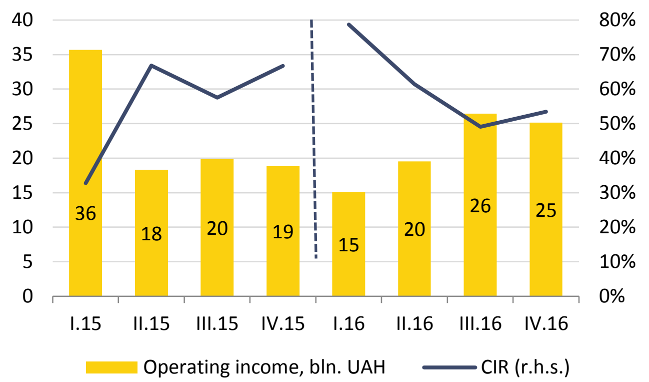
Last year, the sector made UAH 159 billion of losses, of which UAH 136 billion the Privatbank reported in December.

Financial results and return on equity of banks



In the second half of 2016, operating efficiency notably improved.

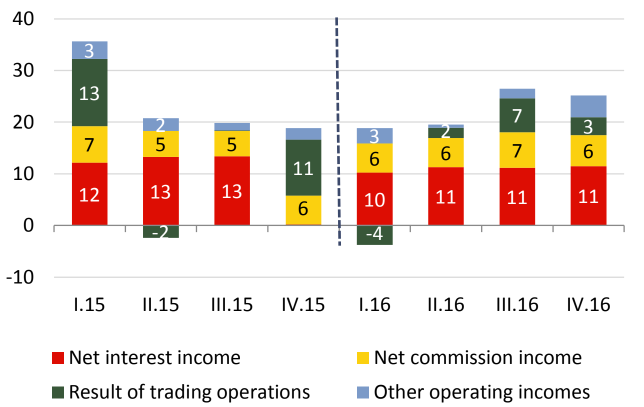
*Operating income and operating efficiency of banks**



** CIR (Cost-to-Income Ratio) – – operating costs to operating income*

The net interest income of banks somewhat declined. However, net commission income gradually increased in the back of recovery of demand for banking services.

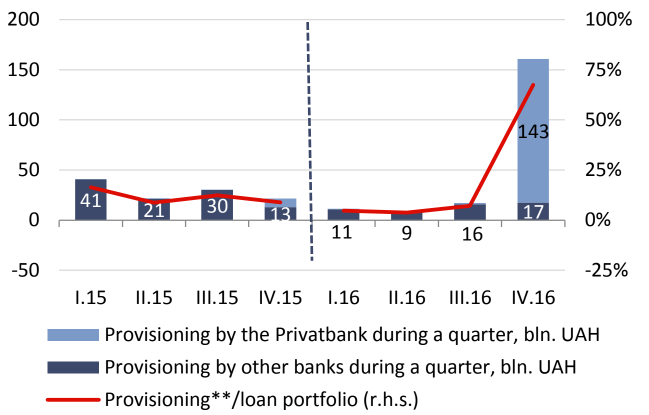
Components of operating income of banks, bln. UAH*



** the absence of net interest income in Q4 2015 is a one-off effect of the transition of banks to IFRS*

The provisioning rate was lower (9% of loan portfolio) than the year before (13%) excluding the provisions of UAH 145 billion by the Privatbank.

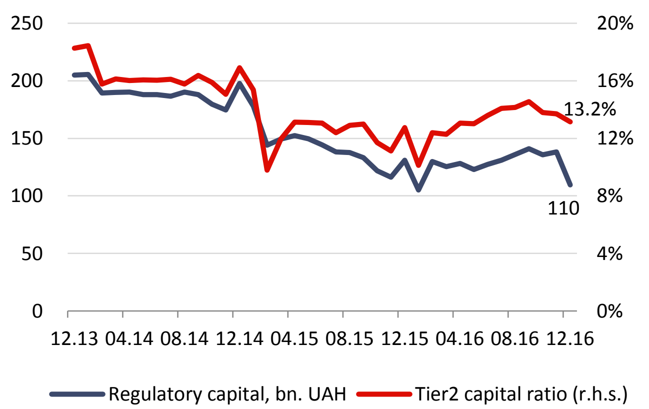
*Provisioning rates**



** ratio of provisioning to loan portfolio of banks; ** annualized*

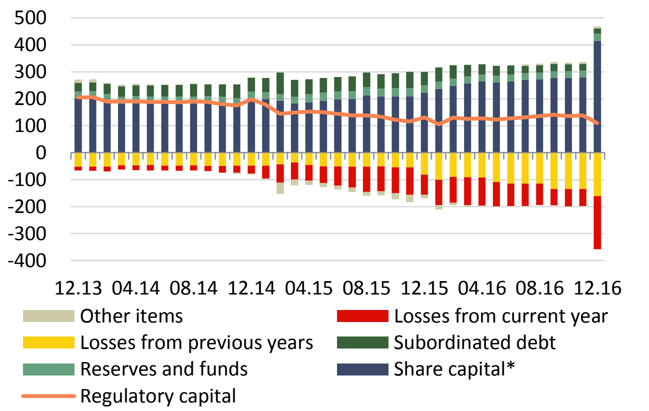
Capital adequacy indicator for the sector as a whole exceeded minimal regulatory requirements with good margins.

Regulatory capital and regulatory capital adequacy requirement



Banks increased share capital by UAH 158 billion or 86%. This was primarily driven by the Privatbank re-capitalization.

Regulatory capital of banks, bln. UAH



** Includes registered and non-registered share capital; in December 2016 – effect of resolution of the issue of lack of regulatory capital at the Privatbank through nationalization of the latter.*

Notes:

Information source – National Bank of Ukraine unless otherwise specified.

Selection of banks – solvent for each 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, or year) unless otherwise specified.

Gross loans – loans not adjusted for provisions against credit operations of banks.

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

Reporting period – January-December 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*
NPLs	*non-performing loans*
p.a.	*per annum*
pps	*percentage points*
POS	*point-of-sale*
r.h.s.	*right hand scale*
SOBs	*State-owned banks*
UAH	*Ukrainian hryvnia*
USD	*US dollar*