NATIONAL BANK OF UKRAINE

BANKING SECTOR REVIEW

Issue 3
May 2017

Macroeconomic stability has been holding since the start of the year, which has allowed the banking sector to consolidate the positive trends of past periods. Demand for banking services is recovering and banks are lending more proactively to retail customers. Banking interest rates are declining further and this trend is expected to continue. The funding base at banks has remained stable due to a recovery in deposits. The banking sector overall has generated higher profits, driven by growth in net commission and interest income, as well as lower provisioning. Six banks have been removed from the market since the start of 2017, while financial institutions still at risk in terms of capital adequacy account for less than 1.5% of total sector assets. The sector's key challenges include low operating efficiency at the state-owned banks and the low quality of their assets, which brings into focus the need for reforms at the state-owned banks.

Structure of the sector. In January-April 2017, six banks were declared insolvent. Four of those banks were removed from the market because of a failure to comply with the recapitalization programs approved upon the completion of a diagnostic study. All other banks that passed the diagnostic study complied with capital adequacy requirements, and most of them with a safe margin.

In Q1 2017, state-owned banks increased their share of total assets by 3.8 pps to 55.1% and of retail deposits by 1.4 pps to 60.9%. Consolidation in the banking sector also increased: the share of the top-20 banks in total net assets expanded by 1.2 pps to 90.6%.

Assets. New lending remains sluggish. The gross corporate loan portfolio shrank by UAH 13.1 billion, driven by FX segment (-2.5% in USD equivalent)*. Gross corporate lending in hryvnia remained virtually flat (+0.2%). Agriculture and the food-processing industry were predominantly the recipients of bank loans.

For the first time since the start of the crisis, retail lending in hryvnia resumed, growing 2.8%*. This excludes Privatbank, which partially replaced retail loans in the P2P segment with on-balance sheet loans.

Banks' total share of investment in public sector securities (domestic government bonds and NBU CDs) increased by 1.7 pps to 26.2% of net assets. The increase was primarily driven by the recapitalization of state-owned banks through domestic government bonds in Q1 2017 (UAH 26.4 billion) and the resulting growth in government bonds in their portfolios.

In May, the National Bank published for the first time statistics on NPLs based on the new approach defined by Regulation #351. According to the new rules, which are based on internationally accepted standards, loans past due over 90 days as well as those where probability of repayment is low are now classified as NPLs. Banks, including Privatbank, recognized real asset quality in full, boosting average NPLs for the sector to 55.1% (excluding off-balance sheet items).

Funding. In the quarter, banks were busy attracting retail deposits, growing them by UAH 4.5 billion or +1.1%. Hryvnia deposits increased by 4.7%*. A large proportion of this increase was due to Privatbank's transfer of deposits attracted under the P2P program onto its balance sheet. Excluding Privatbank, retail deposits increased by UAH 1.8 billion or 0.4%, with hryvnia deposits up +1.4%. The growth rate in corporate deposits was slower, partly because of negative sentiment related to the trade blockade of the ATO area. Deposited budgetary funds rose due to budget cycle fluctuations. The share of deposits from all clients in banks' liabilities increased from 73.8% to 74.9%.

The accumulated liquidity allowed banks to repay UAH 5.3 billion to the NBU (the share of NBU loans in banks' liabilities fell to 1.6%). However, liquidity is unevenly distributed throughout the banking sector: the state-owned banks enjoy the greatest resilience thanks to their respective recapitalizations.

Interest rates. After a short break following the Privatbank nationalization, interest rates have continued to decline. The interest rate on 12-month retail deposits decreased over January-April by 1.7 pps to 15.7% p.a. in hryvnia and by 1.0 pp to 4.6% p.a. in US dollars**. State-owned banks drove the decline in hryvnia deposit rates. The cost of retail dollar deposits fell to new historic lows because of limited demand for FX funds from banks with foreign capital.

Financial results and capital. After posting record losses in 2016, the banking sector generated profits of UAH 4.1 billion in Q1***. State-owned banks accounted for more than half of this amount, but this may partially revert later in the year owing to a potential need for additional provisions. The sector's operating efficiency improved: the cost-to-income ratio diminished to 49% in Q1 from 58% in 2016. Net commission income grew moderately on the back of greater demand for banking services. At the same time, the growth in net interest income was supported primarily by the lower cost of deposits. Most of the provisioning for loan losses based on the results of the diagnostic study already took place last year. As a result, provisioning in Q1 declined to UAH 7.0*** billion from UAH 11.3 billion in Q1 2016.

Prospects and risks. The conditions for a gradual recovery of the banking sector and of lending are in place. Continued economic growth, tamed inflation, and moderate volatility in the exchange rate are facilitating increasing demand from households and businesses for banking services. The 1 pp key policy rate cut to 13% in mid-April will also lower borrowing costs for households and corporates. The banking sector's funding base will remain stable and the average deposit maturity is poised to increase. According to a lending survey conducted in April, 88% of banks expect an increase in retail lending and 61% expect an increase in corporate lending over the next 12 months.

An important challenge for smaller banks is the NBU's requirement to ensure share capital and regulatory capital of at least UAH 200 million by 7 July 2017. The asset quality review for smaller banks is scheduled to be completed by the end of 2017, which will mark the end of the diagnostic study of the banking sector that began in 2015. Banks that are still at risk in terms of capital adequacy account for less than 1.5% of banking sector assets. This is a clear sign that stability in the banking sector has been restored after two years of clean-up.

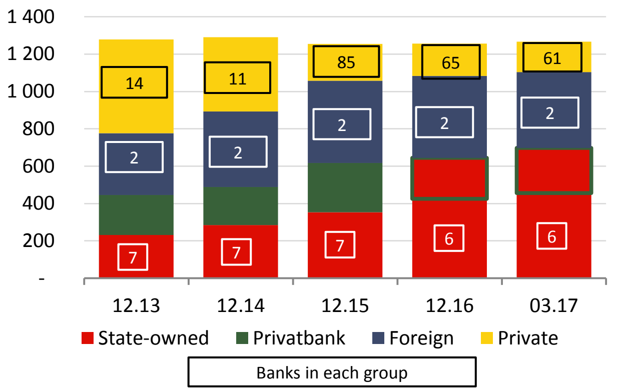
The banking sector's key challenge now is the low operating efficiency of state-owned banks. The largest state-owned lenders need a fundamental revision of business models and long-term development strategies. An important step in this direction is the adoption of legal amendments that allow the establishment of independent professional supervisory boards and the right to replace management (if necessary).

** At banks solvent as of the end of March 2017.*
***According to the Ukrainian Index of Retail Deposit Rates (UIRD).*
**** Number is different from the one previously reported in the Ukrainian version of the report due to corrections done by Privatbank after initial financial reports were submitted to NBU*

The Structure of the Sector

State-owned banks (SBs) dominate the sector, and in Q1 their share of net assets increased by 3.8 pps to 55.1%. The growth in SBs' assets offset decline related to the closure of six banks in January-April.

*Banks' net assets, UAH bn **



**In 2014-2016, solvent banks are grouped according to the classification in place as of 1 January 2016; in Q1, according to the new classification*

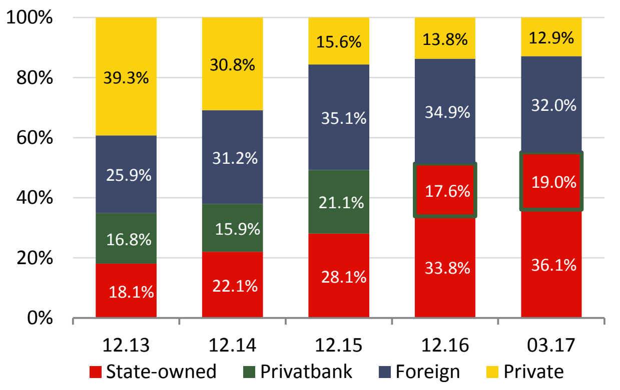
*Number of banks**

	2014	2015	2016	Apr.17
Solvent	**147**	**117**	**96**	**90**
- change	(-33)	(-30)	(-21)	(-6)
State-owned	**7**	**7**	**6**	**6**
- change	(0)	(0)	(-1)	(0)
Foreign	**25**	**25**	**25**	**25**
- change	(0)	(0)	(0)	(0)
Private	**115**	**85**	**65**	**59**
- change	(-33)	(-30)	(-20)	(-6)
Insolvent	**16**	**3**	**4**	**4**
- change	(16)	(-13)	(1)	(0)
In liquidation	21	64	84	90
- change	(19)	(43)	(20)	(6)

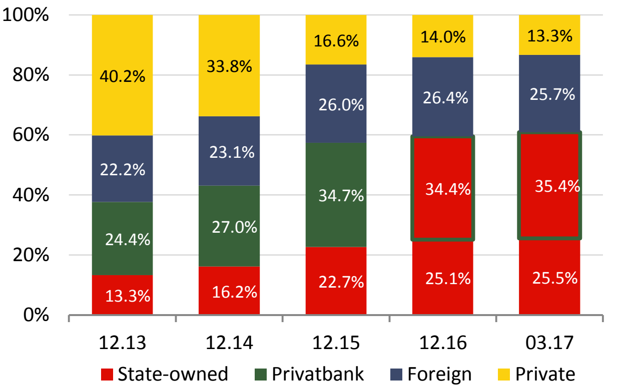
**As reported at period-end*

In Q1 SB's share of retail deposits increased by 1.4 pps to 60.9%, mostly as deposit inflows to Privatbank resumed.

Net assets by groups of banks

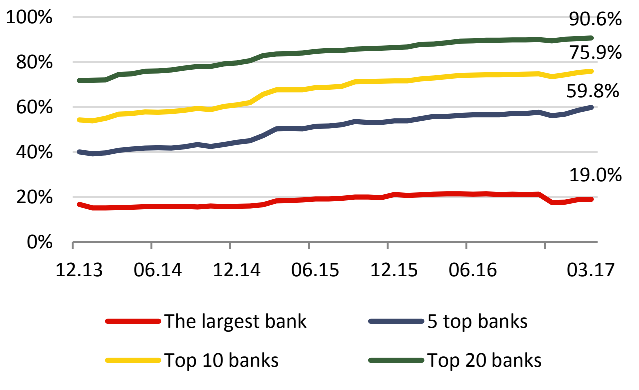


Retail deposits by groups of banks

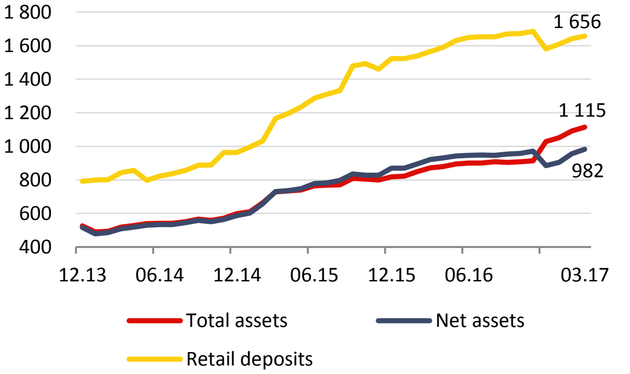


The sector is becoming more concentrated, with the 20 largest banks accounting for 90.6% of net sector assets (vs. 89.4% at the start of 2017). Privatbank's share increased by 1.6 pps to 19% after a recapitalization with government securities and consequent increase in domestic government bonds in the bank's portfolio.

Shares of the largest banks by net sector assets



*Concentration rate in the banking sector, HHI**

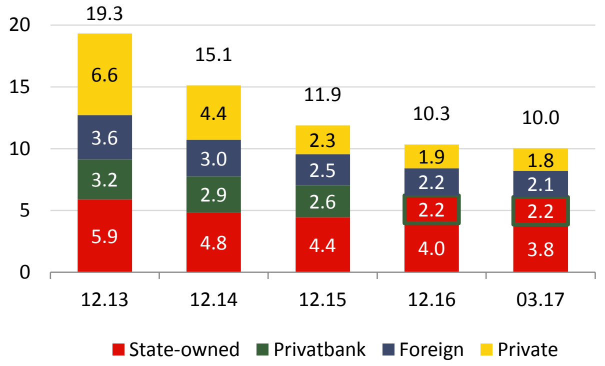


** The Herfindahl–Hirschman Index (HHI) is an indicator of concentration in the banking sector. It is calculated as the sum of the squared industry shares of individual banks. The index varies between 0 and 10,000; an indication of below 1,000 indicates a low concentration level*

Banking Infrastructure

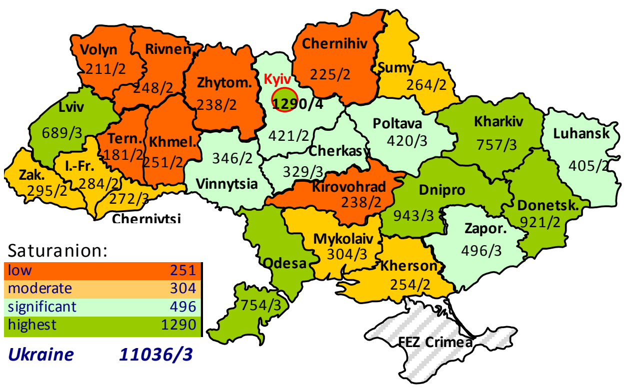
In Q1, the sector's branch network contracted further. SBs and foreign banks optimized their networks (by -115 and -91 branches, respectively). The decline in private banks' branches (-115) was driven by the removal of banks from the market.

*Number of bank structural units, thousands**



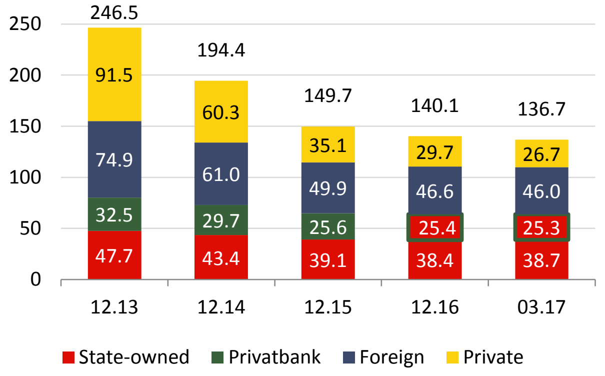
**Branches and head offices*

Number of operating bank branches across Ukraine as of 1 April 2017, units/units per 10,000 of inhabitants



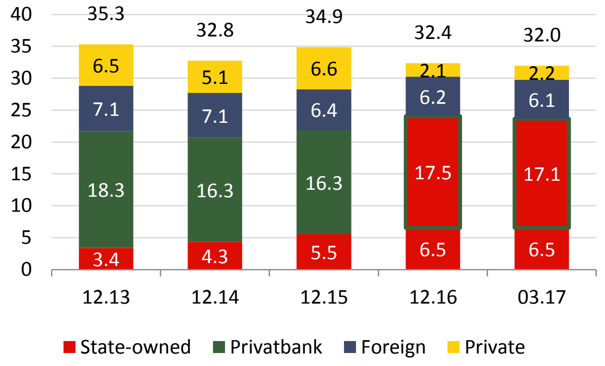
Banks continue to downsize headcounts, to 136,700 as of end-1Q.

Number of bank employees, thousands



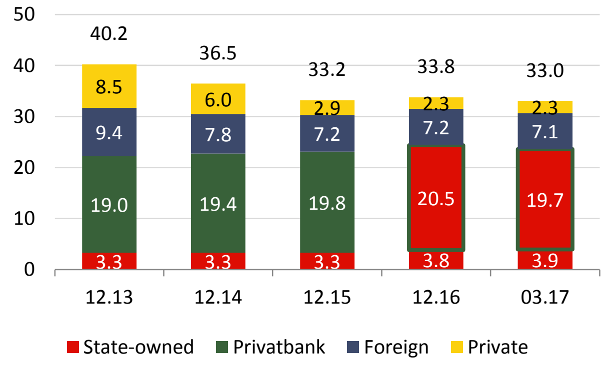
The number of bank cards has decreased marginally, mostly due to Privatbank.

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

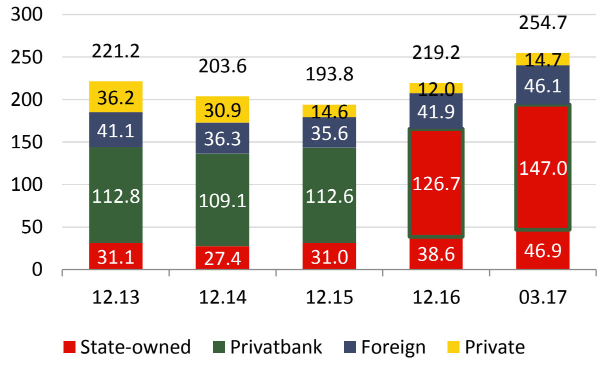


Banks are modifying their payment infrastructure. In Q1, the number of ATMs decreased slightly, while the POS network is expanding rapidly, with their number increasing by 16.2% to a record 225,000.

Number of ATMs, thousands



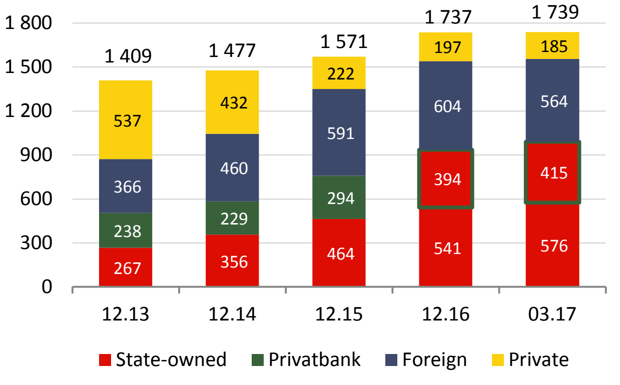
Number of bank POSs, thousands



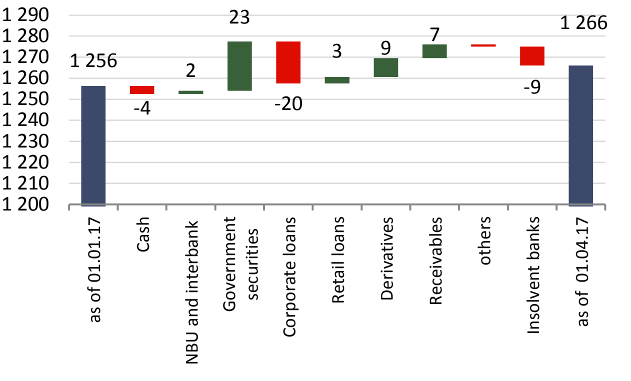
Assets

In Q1 2017, banks' total and net assets grew insignificantly (+0.1% and +0.8%, respectively). Most of the growth came on an increase in the government bond portfolio at Privatbank and other SBs. Retail lending increased marginally, while the corporate loan portfolio shrank owing to a gradual repayment of FX loans.

Total assets by groups of banks, UAH bn



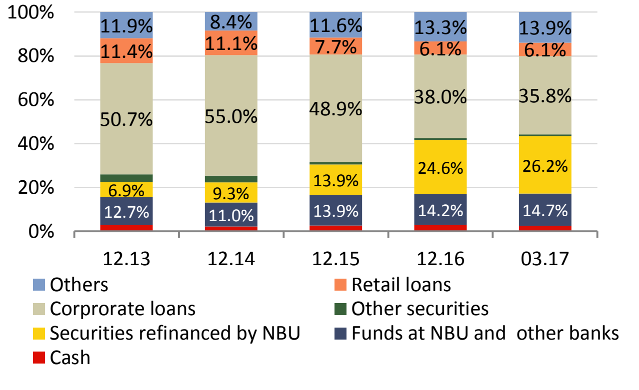
Change in net assets by components, UAH bn*



**Adjusted for loan loss provisions; Government securities include NBU certificates of deposit*

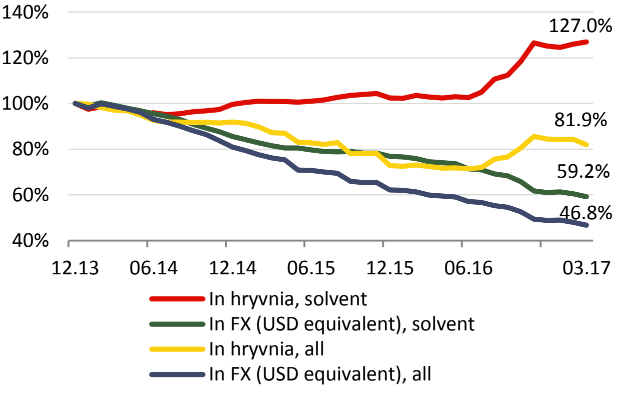
Government securities moderately grew their share of net assets (+1.7 pps in Q1).

Net assets by components



In Q1, corporate and retail loans grew by 1.4% in hryvnia, but declined by 2.9% in FX.

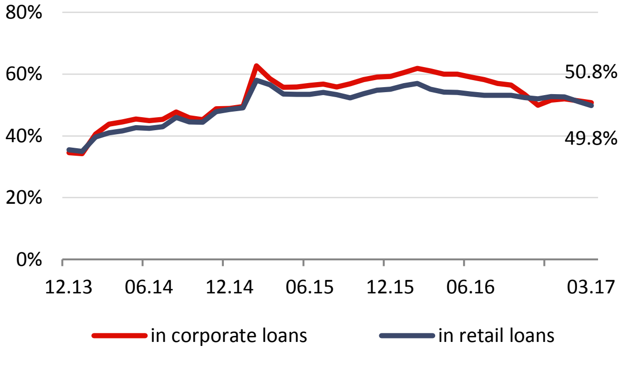
*Gross corporate and retail loans, 2013=100%**



**At banks solvent as of 1 April 2017*

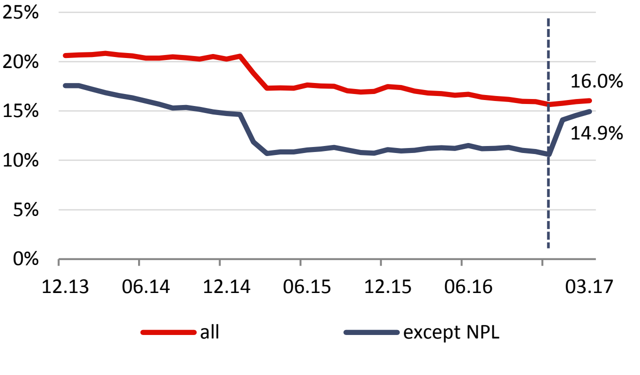
In Q1, the share of FX loans to corporates and households declined by 0.8 pps and 2.9 pps, respectively.

Share of gross FX loans



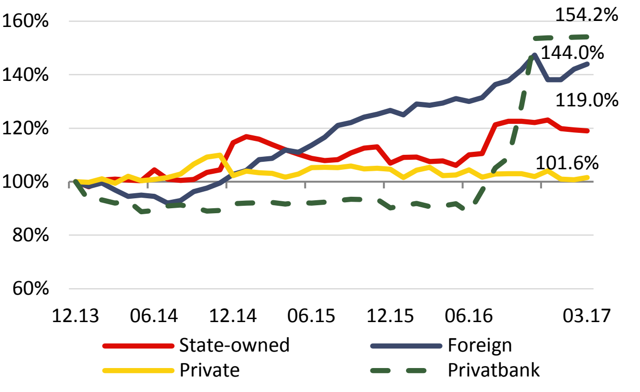
Households' share of the loan portfolio increased after SBs, including Privatbank, recognized real asset quality.

Share of retail loans in the total loan portfolio

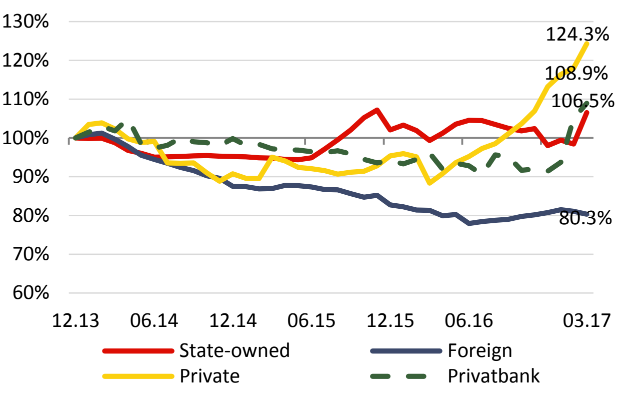


The growth in hryvnia retail loans (+8.1% in Q1) was driven primarily by Privatbank bringing P2P segment loans onto its balance sheet. Excluding this factor, the increase in loans at other banks was also substantial at +2.8%. New lending to corporates remains sluggish.

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



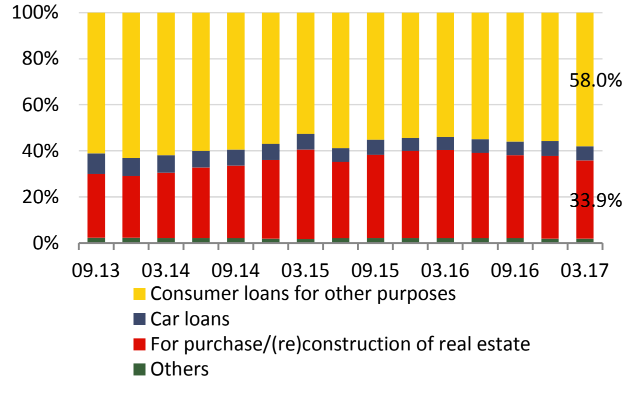
*Retail loans in hryvnia, 2013=100%**



**At banks solvent as of 1 April 2017, including accrued interest*

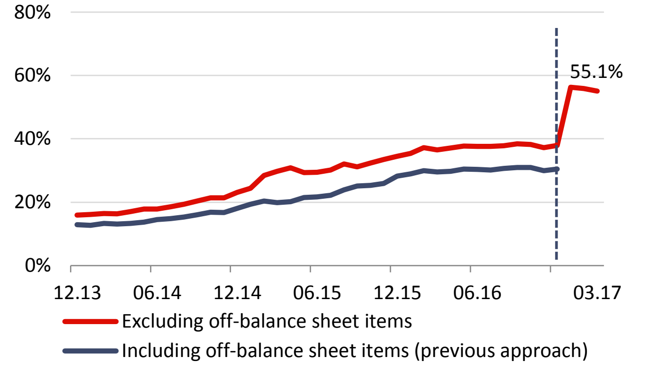
Retail lending intensified in the consumer segment.

Gross retail loans by type



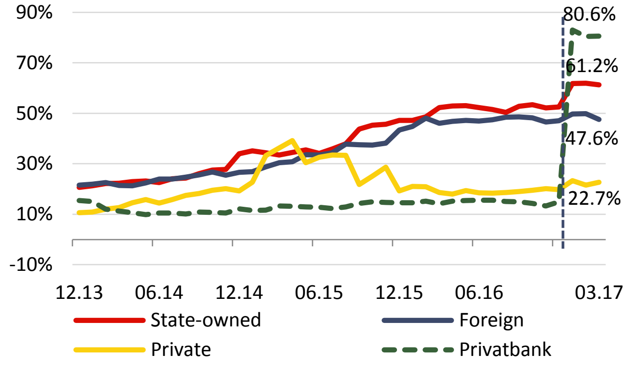
The share of NPLs stood at 55% according to new methodology and after Privatbank recognized real asset quality.

Share of NPLs in portfolios of reporting banks



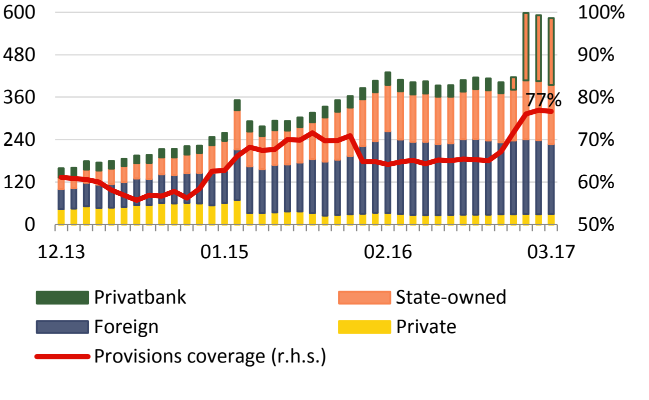
SBs have the worst loan quality.

*NPLs in portfolios of banks by groups**



After Privatbank recognized real asset quality and provisioned for those assets, the coverage of impaired assets by provisions rose from 71% to 77% over the quarter.

Impaired assets and their coverage by provisions, UAH bn

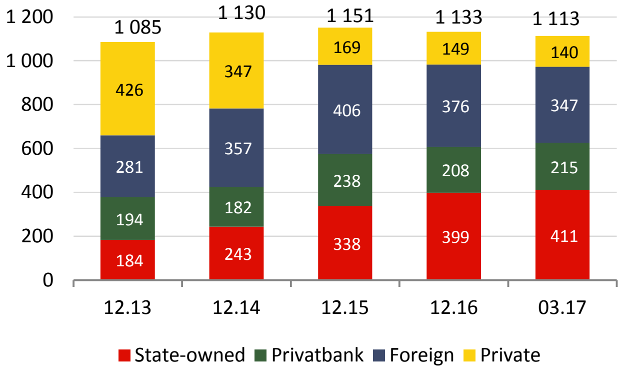


**Excluding off-balance sheet items*

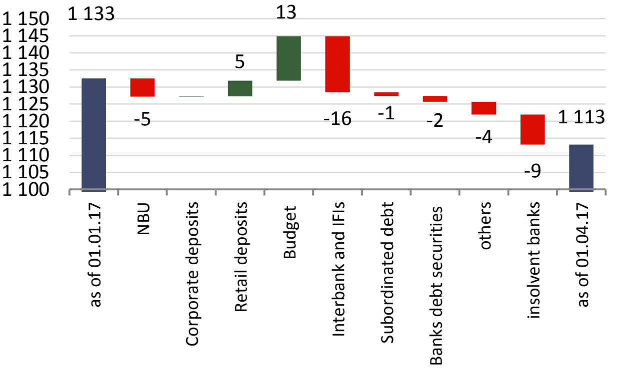
Funding

In Q1 2017, solvent banks' liabilities declined by 1.7%. Retail deposits and budget funds did not fully offset the outflow of interbank loans, including the repayment of stabilization loans by SBs to the NBU.

Liabilities by groups of banks, UAH bn

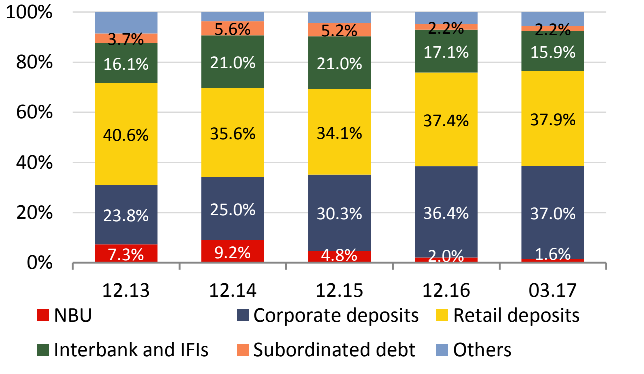


Change in liabilities by components, UAH bn



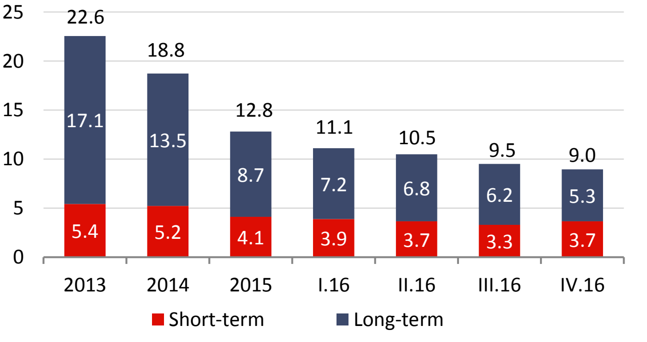
Client funds comprise the core of bank funding. Over Q1 2017, their share of liabilities increased by 1 pp to 74.9%.

Structure of liabilities



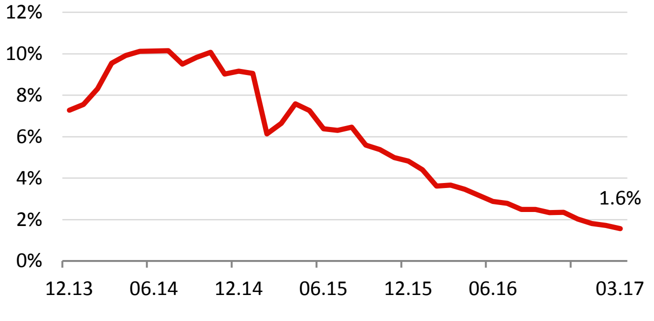
In 2016, banks' external debt shrank by USD 3.9 bn.

Banks' gross external debt, USD bn



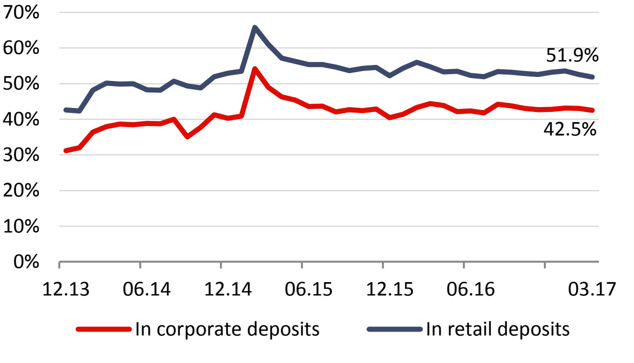
Liquidity in the banking system is high; as a result, the outstanding NBU loans fell to their lowest level since 2008.

The share of NBU funds in banks' liabilities



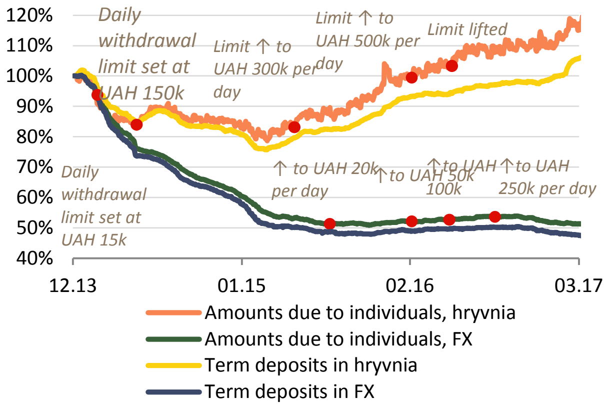
A stable exchange rate has led to a decrease in the dollarization of deposits, especially retail deposits.

Share of FX deposits



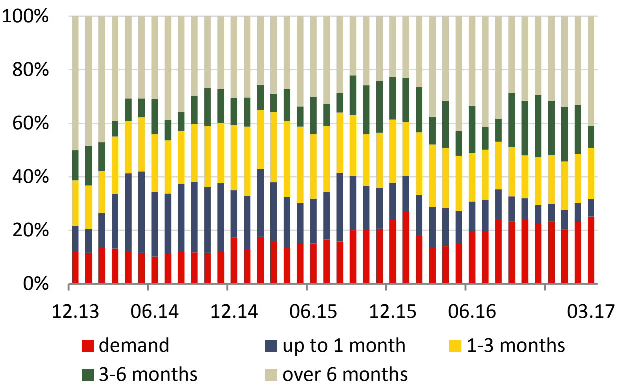
In Q1 2017, retail deposits increased by 4.7% in hryvnia, but declined by 1.9% in FX.

*Retail deposits, 2013=100%**



Deposits with maturity over 6 months have steadily grown their share in total deposits over the last seven months.

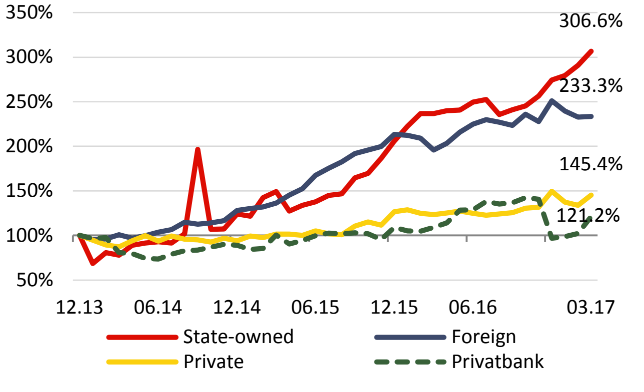
New retail deposits by maturity



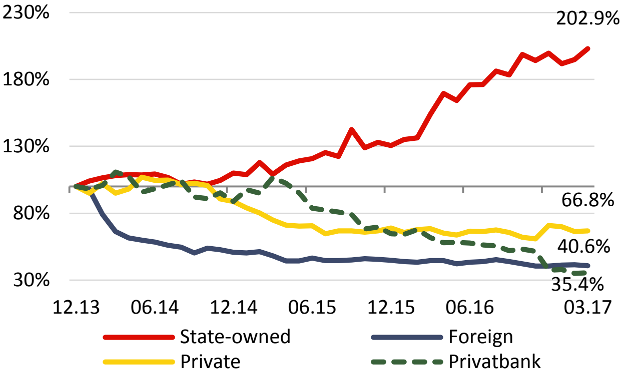
**At banks solvent as of 1 April 2017, including certificates of deposit; k = thousands*

In Q1 2017, corporate deposits in hryvnia at SBs grew by 14.3%, especially at Privatbank (+25.3%). Total corporate deposits in FX were flat, while private banks and Privatbank saw outflows of 5.7% and 5.5%, respectively.

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



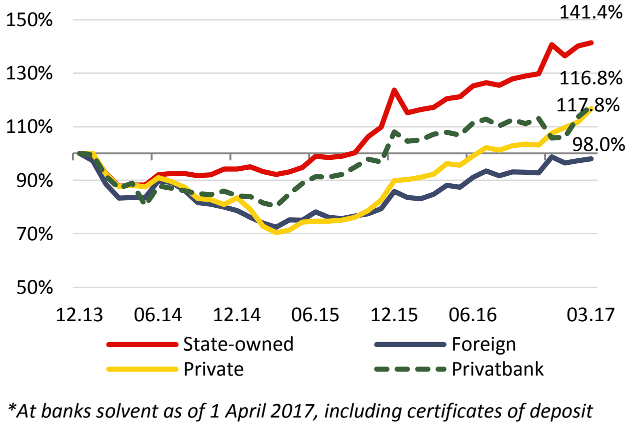
*Corporate deposits in FX (in USD equivalent) by groups of banks, 2013 = 100%**



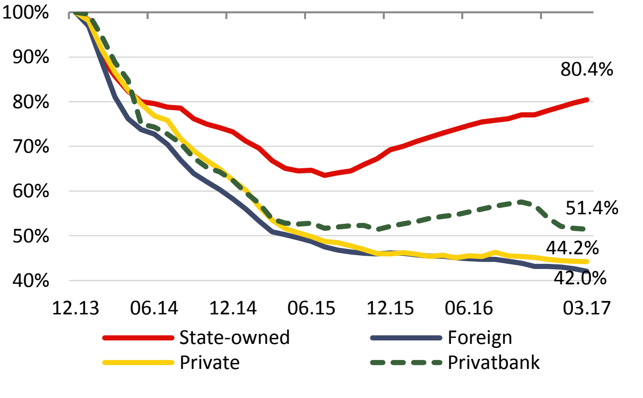
**At banks solvent as of 1 April 2017, including certificates of deposit*

Households increased their deposits in hryvnia at SBs (by 6.3% in total, by 11.3% at Privatbank due to the transfer onto the balance sheet of P2P funds) and at private banks (+8.6%). Deposits in FX declined at all groups, led by Privatbank (-4.8%).

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



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

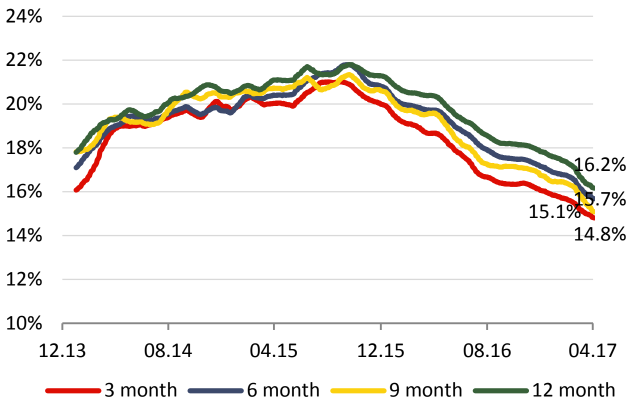


**At banks solvent as of 1 April 2017, including certificates of deposit*

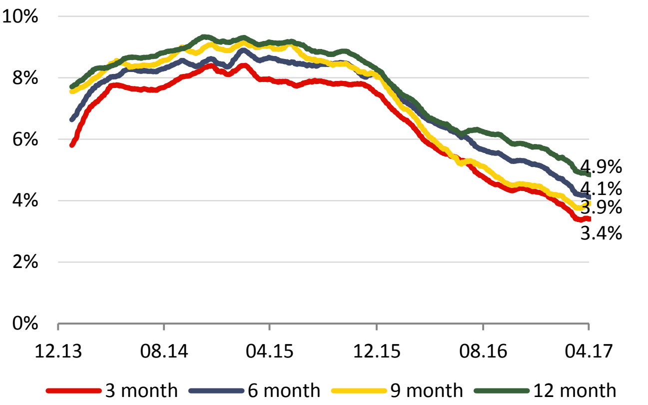
Interest Rates

In January-April, interest rates on retail deposits fell sharply. The cost of 12-month deposits in UAH and USD declined by 1.7 pps and 1.0 pp to 15.7% p.a. and 4.6% p.a., respectively. The decline in hryvnia rates was driven by the interest rate policy at SBs. Rates in USD reached new record lows.

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



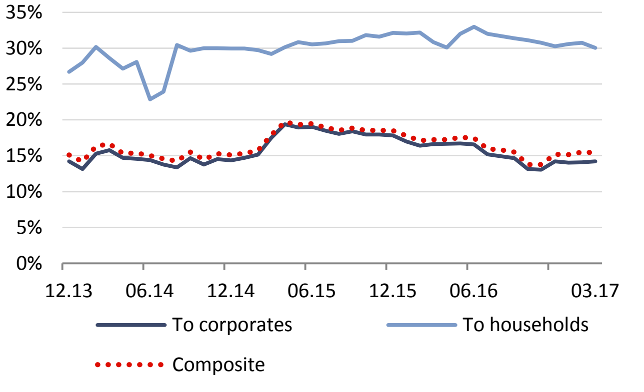
*Ukrainian Index of Retail Deposit rates in US dollars, % p.a.**



**Based on data from Thomson Reuters, 20-day moving average*

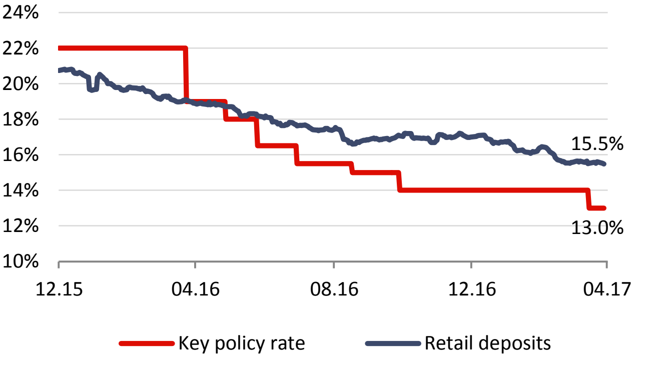
The cost of deposits reacts to policy rate cuts with a lag. Hryvnia retail deposits could, therefore, decline further.

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



**Excluding extensions and other loan contract amendments*

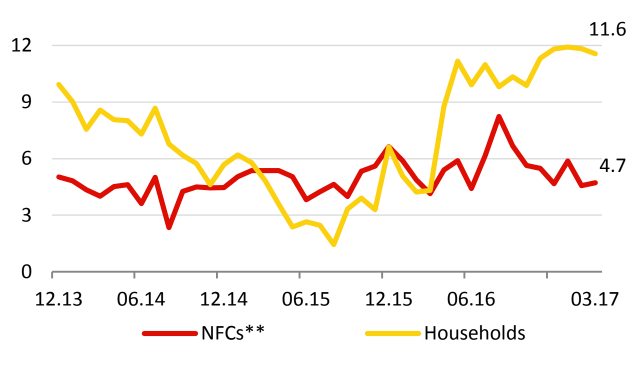
The NBU's key policy rate and the cost of new deposits in hryvnia, % p.a.*



**Based on a 5-day moving average of daily data*

The spread between interest and deposit rates has marginally widened in the retail segment and narrowed in the corporate segment.

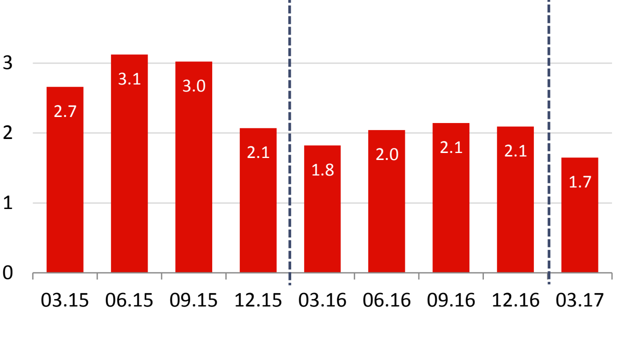
*Spread between interest rates on loans and deposits, pps**



**On outstanding loans and deposits, including at insolvent banks*
*** Non-financial corporations*

In Q1 2017, interest spread decreased.

*Interest rate spread, pps**

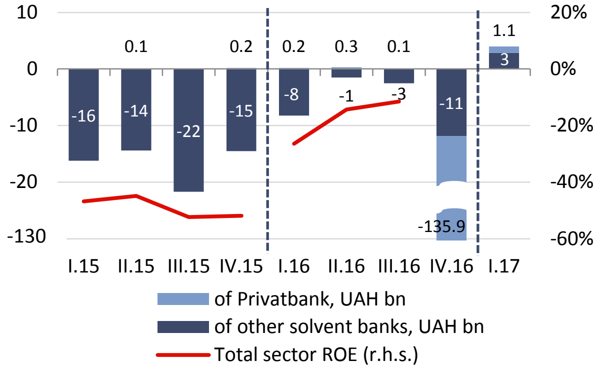


**In a given month, including insolvent banks*

Financial Results and Capital

After record losses in 2016, the sector generated UAH 4.1* billion in profit in Q1 2017, half of which came at SBs.

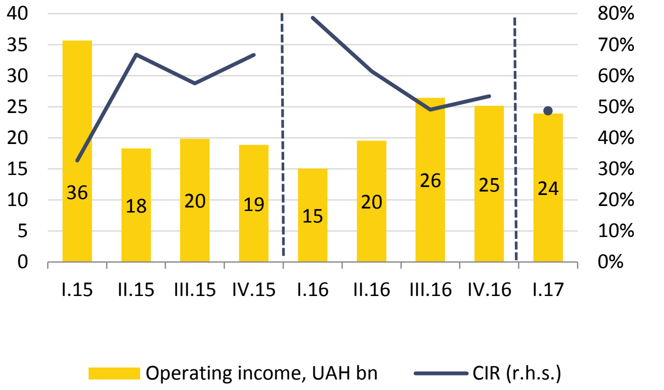
Banks' financial results and return on equity, by quarter



** Number is different from the one previously reported in the Ukrainian version of the report due to corrections done by Privatbank after initial financial reports were submitted to NBU*

Operating efficiency improved vs. last year, with the CIR* reaching 48.7% in Q1.

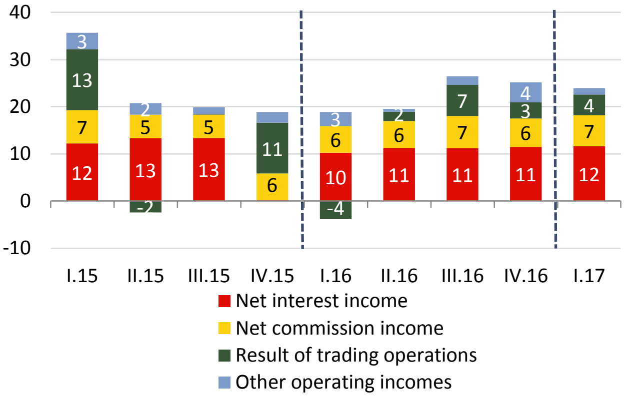
Banks' operating income and operating efficiency, by quarter



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

Net interest income at banks increased modestly due to the coupon income on domestic government bonds.

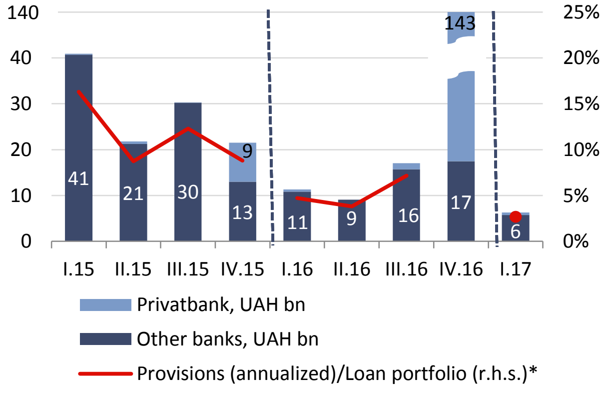
*Components of banks' operating profits, UAH bn**



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

Provisioning has fallen materially since the start of 2017.

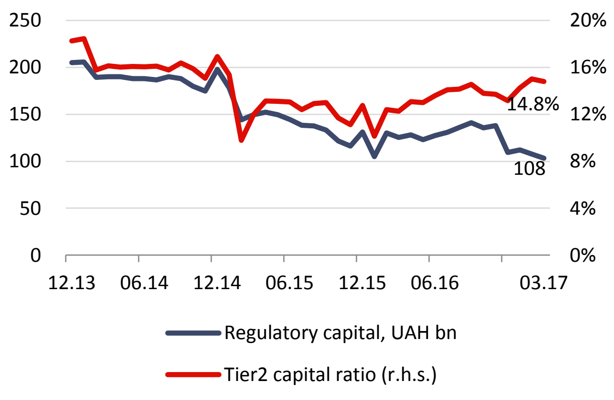
Loan loss provisions, by quarters



**The ratio of provisioning to the loan portfolio*

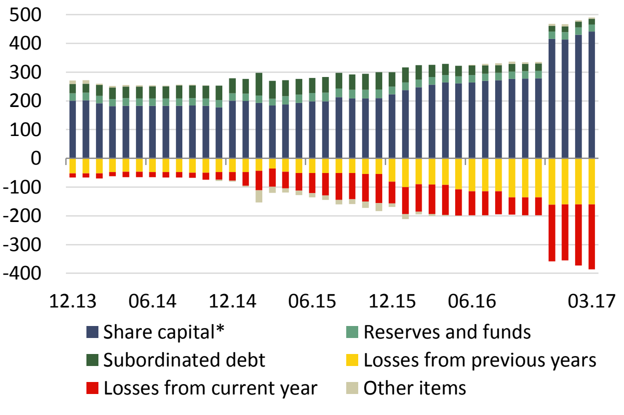
In Q1, capital adequacy improved for the sector overall and now exceeds minimum requirements.

Regulatory capital and regulatory capital adequacy levels



In Q1, share capital increased by UAH 25.5 billion, or 6%, mostly due to the recapitalization of SBs.

Banks' regulatory capital, UAH bn



** Includes registered and non-registered share capital*

Key indicators of Ukraine's banking sector[1]

	2008	2009	2010	2011	2012	2013	2014	2015	2016	Q1.17
Number of active banks	181	180	175	175	174	180	145	117	96	92
of which those with 100% foreign capital	17	18	20	22	22	19	19	17	17	17
General balance sheet indicators (UAH bn)[2]										
Total assets	967	1 002	1 090	1 212	1 264	1 409	1 477	1 571	1 737	1 739
of which in FX	528	489	476	492	503	513	667	197	788	757
Net assets	921	880	942	1 054	1 125	1 278	1 290	1 254	1 256	1 266
of which in FX	500	426	395	416	450	470	565	582	519	497
Gross corporate loans[3]	476	498	537	608	634	727	820	831	847	829
of which in FX	252	212	212	221	227	252	400	492	437	421
Net corporate loans[3]	453	434	463	530	553	648	710	614	477	452
Gross retail loans	273	236	205	197	184	189	208	176	157	155
of which in FX	198	172	143	113	84	67	101	97	83	77
Net retail deposits	254	203	168	158	133	145	144	96	76	78
Corporate deposits[3]	162	128	160	205	221	258	283	349	413	412
of which in FX	69	53	56	70	80	81	114	141	177	175
Retail deposits[4]	219	214	276	312	368	443	403	402	437	434
of which in FX	111	116	136	154	187	189	214	215	239	231
Change (yoy, %)										
Total assets		3.5%	8.8%	11.1%	4.3%	11.4%	4.8%	6.4%	10.6%	7.1%
Net assets		-4.4%	7.0%	11.9%	6.7%	13.7%	1.0%	-2.8%	0.2%	-2.5%
Gross corporate loans[3]		4.6%	7.8%	13.3%	4.2%	14.7%	12.8%	1.3%	2.0%	-3.2%
Gross retail loans		-13.4%	-13.1%	-4.0%	-6.7%	3.0%	10.3%	-15.7%	-10.4%	-10.4%
Corporate deposits[3]		-20.8%	25.1%	27.7%	7.9%	16.8%	9.5%	23.5%	18.2%	12.9%
Retail deposits[4]		-2.3%	28.7%	13.2%	18.1%	20.2%	-8.9%	-0.3%	8.7%	3.2%
Penetration rate[5] (%)										
Gross corporate loans[3]/ GDP	48.0%	52.6%	47.9%	45.1%	43.4%	47.7%	51.7%	41.8%	35.5%	30.1%
Net corporate loans[3]/ GDP	45.7%	45.9%	41.3%	39.3%	37.9%	42.6%	44.7%	30.9%	20.0%	16.4%
Gross retail loans / GDP	27.5%	24.9%	18.3%	14.6%	12.6%	12.4%	13.1%	8.8%	6.6%	5.6%
Net retail loans / GDP	25.6%	21.4%	15.0%	11.7%	9.1%	9.5%	9.1%	4.8%	3.2%	2.8%
Corporate deposits[3] / GDP	16.4%	13.5%	14.3%	15.2%	15.1%	17.0%	17.8%	17.6%	17.3%	14.9%
Retail deposits / GDP	22.1%	22.6%	24.6%	23.1%	25.2%	29.1%	25.4%	20.2%	18.3%	15.7%
Financial results (UAH bn)										
Net interest income	37.2	54.5	51.9	53.8	49.2	49.1	52.2	39.1	44.2	11.6
Net commission income	17.7	13.2	12.6	15.4	18.1	21.0	23.1	22.6	24.2	6.6
Loan loss provisions	24.0	75.4	46.2	36.5	22.3	28.0	84.4	114.5	198.3	6.3
Net profit/loss	7.2	-38.4	-13.0	-7.7	6.0	1.4	-33.1	-66.6	-159.4	5.1
Memo:										
UAH/USD (average of period)	5.27	7.79	7.94	7.97	7.99	7.99	11.89	21.84	25.55	27.00
UAH/USD (end of period)	7.70	7.99	7.96	7.99	7.99	7.99	15.77	24.00	27.19	26.98
UAH/euro (average of period)	7.71	10.87	10.53	11.09	10.27	10.61	15.72	24.23	28.29	28.82
UAH/euro (end of period)	10.86	11.45	10.57	10.30	10.54	11.04	19.23	26.22	28.42	28.96

[1] For solvent banks for each reporting period

[2] With accrued income/losses

[3] Including non-bank financial institutions

[4] Including certificates of deposit

[5] GDP according to National Accounts System methodology (NAS-2008); for 2008-2013, GDP includes the temporarily occupied territory of Crimea and the city of Sevastopil;
for 2014-2016, GDP excludes the temporarily occupied territory of Crimea, the city of Sevastopil and part of the ATO area;
2017 – NBU estimates

Notes:

Source: National Bank of Ukraine, unless otherwise specified

Selection of banks: Includes only solvent institutions for each reporting period or date, unless otherwise specified

Banks classified into groups as of 1 January 2016 in-line with Resolution #657 of by the Committee for the Supervision and Regulation of Banks and Oversight of Payment Systems of 31 December 2015. Data for 2017 are according to Decision #76-rsh of the NBU Board 10 February 2017

Data includes accrued interest at the end of the period (month, quarter, or year), unless otherwise specified

Gross loans: Loans not adjusted for provisions against banks' lending operations

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

Reporting Period: refers to Q1 2017, unless otherwise specified

Abbreviations:

ATM	*Automated Teller Machine (cash dispenser or cash machine)*
bn	*Billion*
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*
SBs	*State-owned banks*
UAH	*Ukrainian hryvnia*
USD	*US dollar*