NATIONAL BANK OF UKRAINE

BANKING SECTOR REVIEW

Issue 6
February 2018

The banking sector recovered in 2017, with nearly all key performance indicators of financial institutions improving. Consumer lending has been spiking since early 2017, while hryvnia corporate lending rebounded in H2 (apart from at PrivatBank). The NBU expects corporate lending to pick up in 2018. The funding base remained stable despite lower deposit rates. The decrease in deposit rates slowed only at the end of the year, when the NBU raised the key policy rate in response to higher inflation expectations. Although banks continued to book losses, this was due to only four banks incurring significant losses. The key risks to the banking sector were the considerable presence of the state and a large share of NPLs on the banks' balance sheets. Another risk for 2018 is that the expectations of businesses and households could deteriorate if cooperation with international financial intuitions (the IFIs) is not resumed.

The structure of the sector. In 2017, 14 banks left the market, of which four became financial companies and one merged with another one. In early 2017, these banks accounted for 1.7% of net sector assets. The percentage of state-owned banks in net assets rose by 3.6 pp, to 54.9%. The growth in the share of private banks was driven by active lending and the purchase of several foreign-owned banks. Concentration increased noticeably, with the 20 largest banks accounting for 90.7% of the banking sector's net assets (+1.3 pp yoy).

Assets. The banking sector's net assets grew by 6.4%, to UAH 1,336 billion in 2017, and most pronouncedly in Q4 (4.3%). The recapitalization of state-owned banks increased the domestic government bond portfolio of the sector by UAH 107 billion[1]. At the same time, interbank loans and deposits at the NBU dropped by UAH 27 billion.

Net loans adjusted for provisions were practically unchanged when calculated at a fixed rate. The foreign currency loan portfolio shrunk pronouncedly, on the back of written-off and restructured loans, which was offset by a rise in hryvnia lending.

In 2017, foreign and state-owned banks generated the largest increases in net hryvnia corporate loans (17.5% and 12.8% respectively). PrivatBank's net hryvnia loans dropped by 79.5% yoy, as the bank made provisions for loans to companies related to its former shareholders. State monopolies, trading, and agricultural companies were mainly responsible for corporate lending growth. The restructuring of foreign currency loans increased the hryvnia loan portfolio by one fourth.

Retail lending grew rapidly, contributing 42% to the net hryvnia loan growth. Loans by PrivatBank and private banks increased at the highest pace (by over 60% yoy), driven by consumer loans. Despite a rebound in mortgage lending, the writing-off of legacy loans reduced the percentage of mortgage loans in the retail loan portfolio.

New lending improved the quality of the loan portfolios of all the banks (apart from PrivatBank) due to statistical effects. The NPL rate declined by 3.2 pp, to 54.5%[2] in H2. The percentage of these loans, excluding state- and Russian-owned banks, was 28.4%.

Funding. In 2017, hryvnia household deposits grew by 22.4%[1], while foreign currency ones were unchanged. Q2 and December saw the largest deposit inflows. PrivatBank and Oschadbank generated the largest growth in hryvnia and foreign currency household deposits respectively. Foreign-owned banks reported the biggest drops in foreign currency household deposits.

Hryvnia corporate deposits grew by 13.6% in 2017 (by 11.1% in December), driven by increased budgetary spending at the end of the year. Foreign currency corporate deposits declined by 10% in the US dollar equivalent.

Interest Rates Interest rates on retail hryvnia loans decreased by 3.2 pp, to 14.3% per annum in 2017[3]. However, recent decisions by the NBU to raise its key policy rate pushed up rates on short-term (up to six months) hryvnia deposits – by 0.2-0.4 pp since the first rate hike. Rates on retail foreign currency deposits have remained at a historically low level of 3.7% per annum. Rates on corporate and retail hryvnia loans remained largely unchanged.

Financials and Capital The banking sector's operating income increased 10% yoy, but administrative costs grew faster, resulting in an increase in operating profit before provisioning by 8% to UAH 40.7 billion. Due to significant provisioning, the banking sector booked losses of UAH 24.4 billion in 2017. The losses were mostly generated by four banks, in particular by PrivatBank and two banks with Russian capital. The number of loss-making banks decreased from 33 in 2016 to 18 in 2017, while the number of banks that posted an operating loss before provisioning was down, from 23 to 14. The final indicators in the financial statements of the banks for 2017 may still change by the end of April, following the results of their annual audits.

Prospects and Risks In 2018, the banking sector could face risks associated, among other things, with suspended cooperation with the IFIs possible worsening of the economic expectations of households and businesses as a result. This, in turn, will impact lending and the banks' pricing policies for assets and liabilities.

Consumer lending is expected to show steep growth in 2018. The banks will increase mortgage lending. However, its share in the banks' new loans portfolio will not be significant. The NBU expects banks to boost hryvnia lending to the corporate sector as the financial standing of the real sector improves. The banks' operating profits remained will virtually not change. The transition to the IFRS 9 standard will have a material, one-time impact on the banks' equity.

Since the start of 2018, the NBU has been stepping up its efforts to implement the EU Directives and Basel Guidelines. In 2018, the banks will implement the Liquidity Coverage Ratio (LCR) - a new liquidity requirement. New rules for calculating regulatory capital, in particular the eligibility of its components, will be put in place. Furthermore, the NBU will introduce an annual assessment of the banks' resilience, which will encompass an asset quality analysis (for all banks) and stress testing (for the 25 banks that together account for 95% of the system's assets).

The high NPL rate remains a major challenge to the banking sector, and this particularly concerns state-owned banks. The banks need to step up their efforts to workout NPLs, and finalize their NPL resolution plans for 2018.

[1] Solvent banks as of the end of 2017.

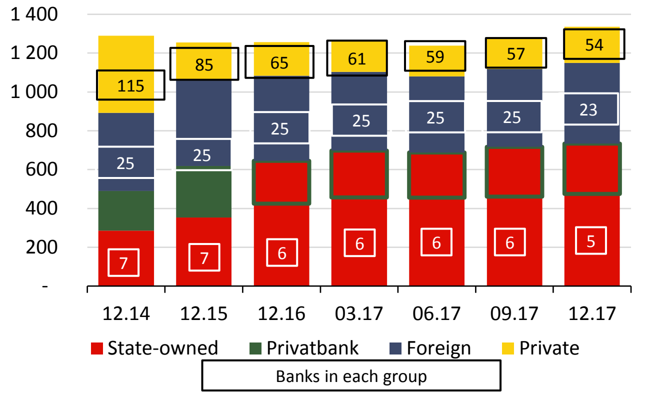
[2] Held by all reporting banks.

[3] Based on the Ukrainian Index of Household Deposit Rates.

The Structure of the Sector

In 2017, the net assets of solvent banks grew by 6.4% to UAH 1.34 trillion The number of solvent banks decreased by 14 banks. Of these banks, eight were shut down for not complying with capital requirements, one due to a non-transparent ownership structure, four were converted into financial companies, and one bank was merged with another one.

*Banks' net assets, UAH billion**



* Solvent banks were grouped under the relevant classification over the years specified

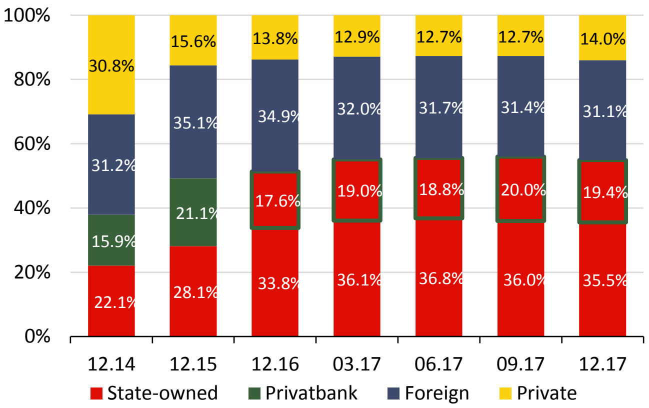
*Number of banks**

	2014	2015	2016	Mar-17	Jun-17	Sep-17	Dec-17
Solvent	**147**	**117**	**96**	**92**	**90**	**88**	**82**
- change	-33	-30	-21	-4	-2	-2	-6
State-owned	**7**	**7**	**6**	**6**	**6**	**6**	**5**
- change	0	0	-1	0	0	0	-1
Foreign-owned	**25**	**25**	**25**	**25**	**25**	**25**	**23**
- change	0	0	0	0	0	0	-2
Private	**115**	**85**	**65**	**61**	**59**	**57**	**54**
- change	-33	-30	-20	-4	-2	-2	-3
Insolvent	**16**	**3**	**4**	**3**	**3**	**4**	**2**
- change	16	-13	1	-1	0	1	-2
Under liquidation	21	64	84	89	91	92	95
- change	19	43	20	5	2	1	3

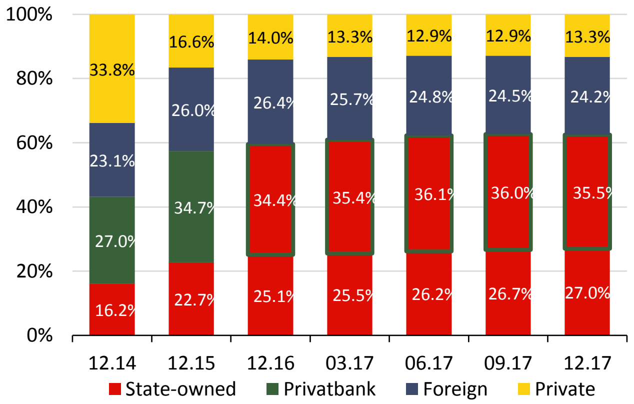
* As of end of period

The net assets of state-owned banks grew by 3.6 pp, to 54.9% The share of these banks in retail deposits rose by 2.9 pp to 62.5%. Q4 saw an increase in the shares of Ukrainian private banks, both in assets and deposits.

Net assets by groups of banks

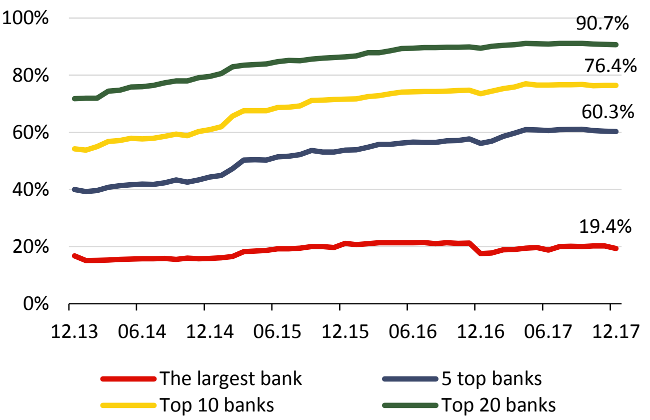


Retail deposits by groups of banks

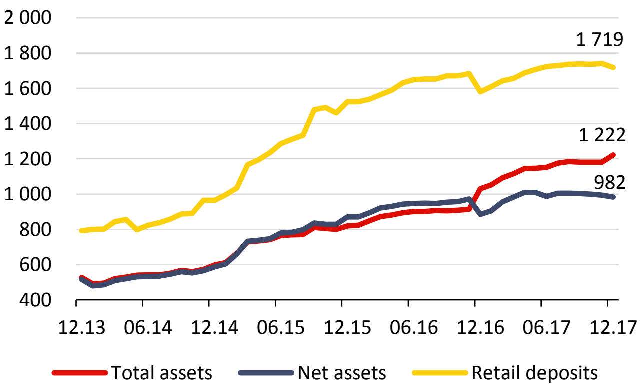


Concentration in the banking sector increased by 1.3 pp in 2017, with top 20 banks accounting for 90.7% of net assets.

Shares of the largest banks by net sector assets



*Concentration rate in the banking sector, HHI**

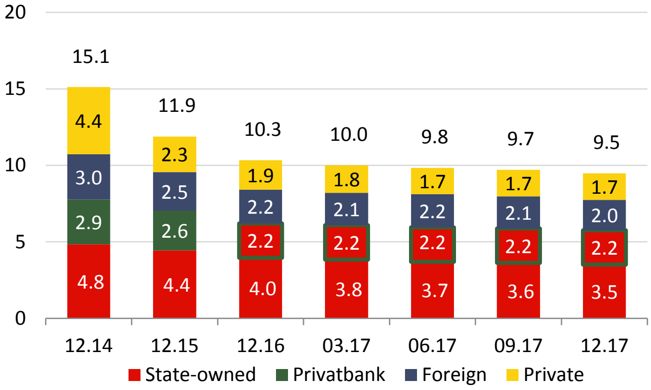


* *The Herfindahl-Hirschman Index (HHI) is an indicator of banking sector concentration. It is calculated as the sum of the banks' squared market shares. The index ranges from 0 to 10,000 – values below 1,000 indicate a low degree of market concentration.*

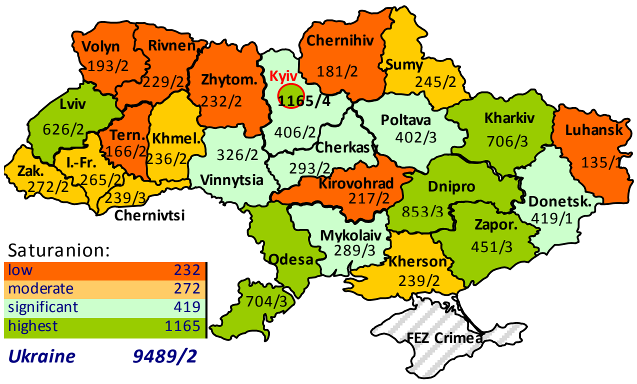
Banking Infrastructure

In 2017, state-owned banks put the most effort into reorganizing their networks. In particular, Oschadbank closed 443 branches. Meanwhile, some foreign-owned banks were sold to new owners, and some private banks left the market.

*Number of structural units of banks, thousands**



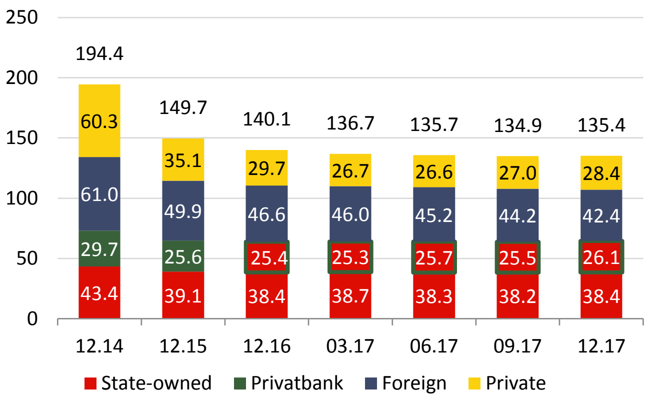
Operating banking units by regions as of 1 January 2018, units per 10,000 individuals



* *Branches and head-offices*

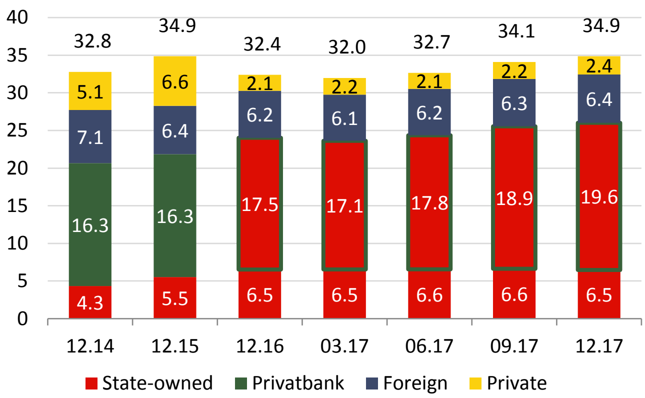
In 2017, state-owned banks, including PrivatBank, increased their staff by 673 people, while private and foreign-owned ones cut their staff by 5,455 people.

Headcount at banks, thousand employees



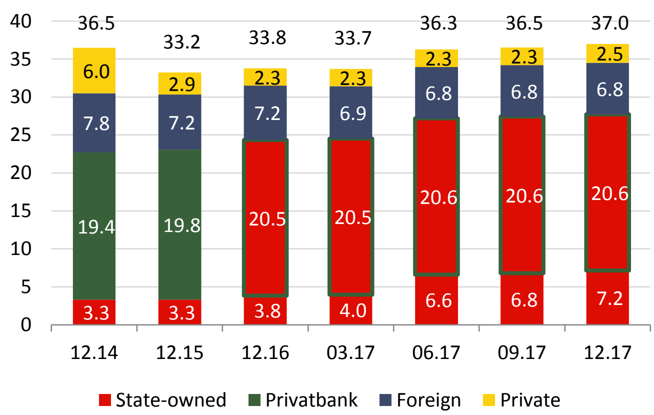
In 2017, the growth in the payment card market was driven by PrivatBank's new payroll card schemes, with the number of active bank cards rising by 2.1 million.

Number of active bank cards by bank groups, million pcs



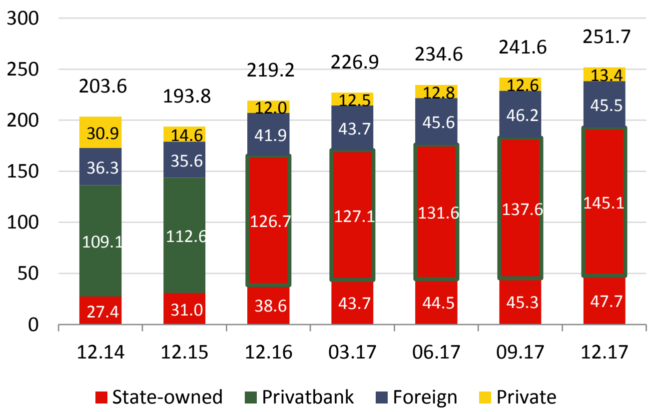
The payment infrastructure expanded, with the number of ATMs and POS terminals growing by 3,231 and 32,461 respectively. The growth in the number of ATMs was mainly due to state-owned banks changing their accounting methodology. PrivatBank accounted for over a half of the growth in POS terminals (18,373 units over the year).

Number of ATMs, thousand units*



* *Number of self-service bank machines (ATMs, deposit ATMs, Self-Service Kiosks)*

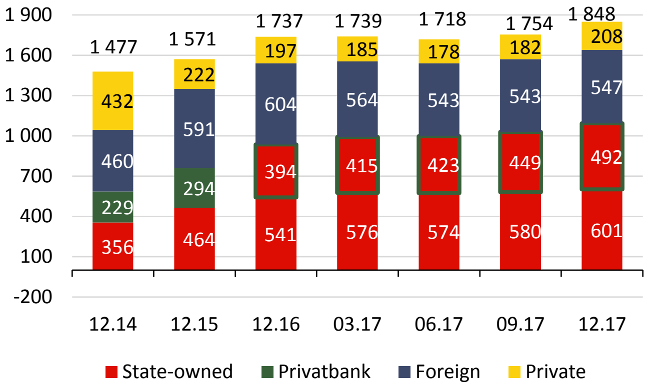
Number of banks' POSs, thousand units



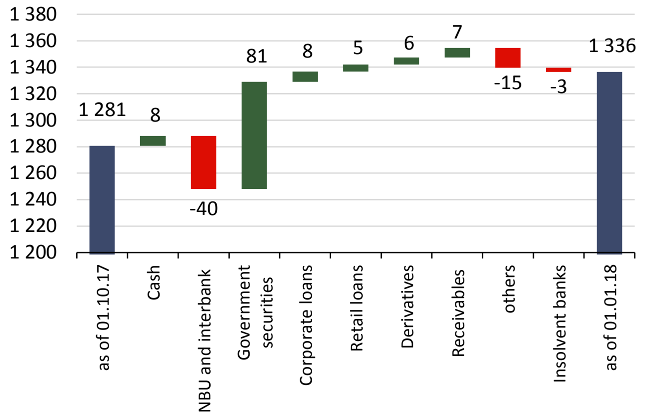
Assets

In 2017, the banks' total assets increased by 6.4%, to UAH 1.85 trillion, with the highest growth rate posted by state-owned banks (+17%). In Q4, banks' portfolio of domestic government bonds grew substantially mostly due to additional capitalization of state-owned banks. At the same time, interbank loans and deposits at the NBU decreased. Gross corporate and retail loans trended upwards.

Total assets by bank groups, UAH billion



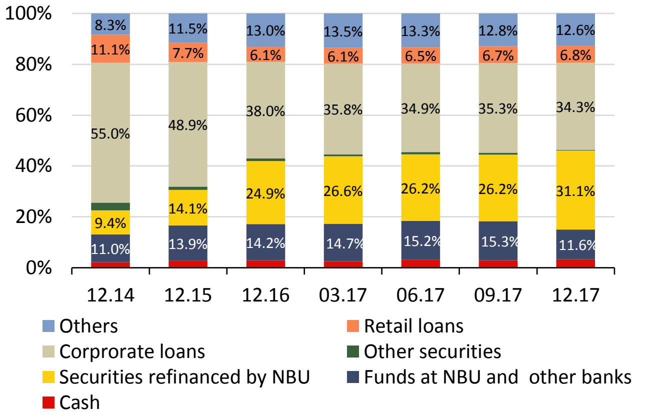
Change in net assets by components, UAH billion*



** Adjusted by the amount of provisions for active banking operations; government securities include NBU certificates of deposit*

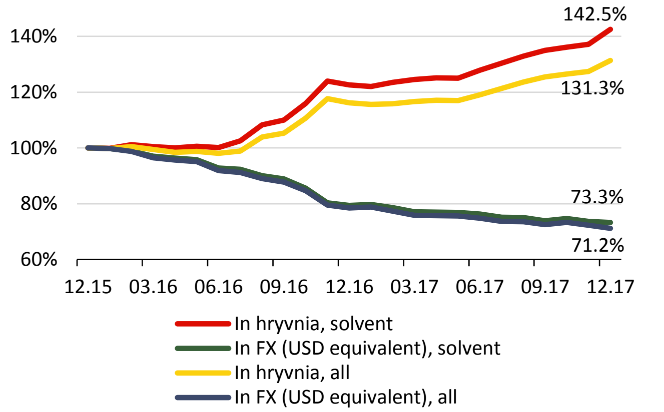
The share of state securities in the banks' portfolios grew by 6.2 pp to 31.1% during the year - nearing the share of corporate loans.

Net assets by components



In 2017, the hryvnia loan portfolio grew on the back of new lending, rather than foreign currency debt conversions, as was the case in 2016.

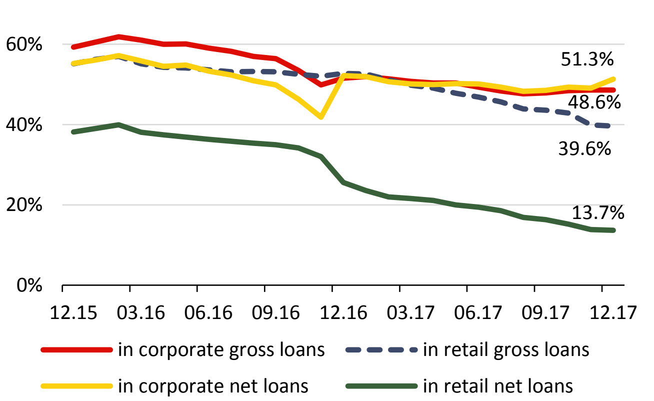
*Gross corporate and retail loans, 2015=100%**



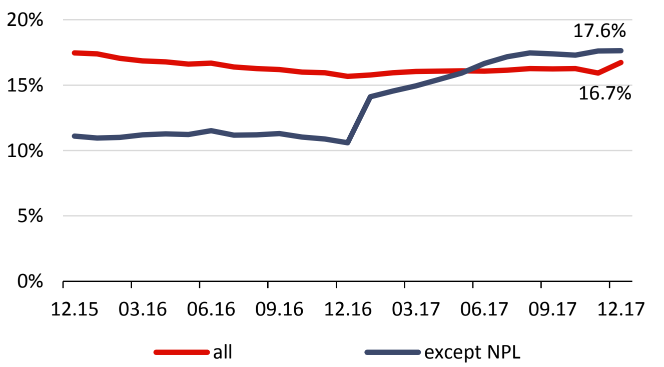
** At banks solvent as of 1 January 2018*

During the year, the dollarization rate for retail loans decreased from 25.6% to 13.7% on the back of revived household lending. The decrease dollarization rate for corporate loans was held back by new FX corporate loans in H2 2017.

FX loans ratio

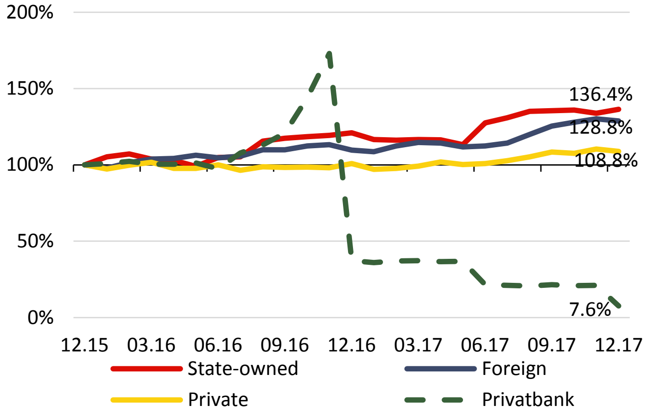


Retail loans in the total loan portfolio



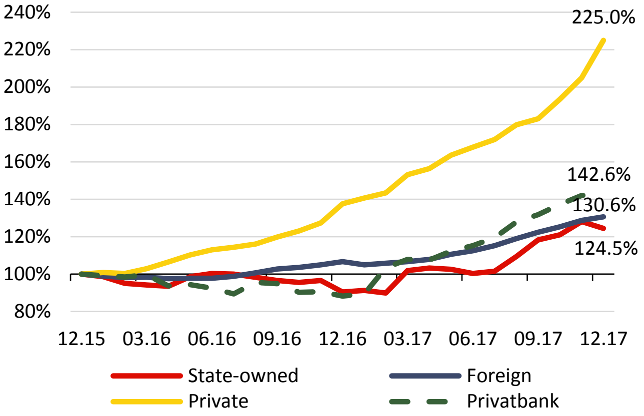
Over the year, hryvnia corporate loans grew only 0.7% because of significant provisions by PrivatBank. The corporate loan portfolios at the state-owned and foreign banks increased, by 12.8% and 17.5% respectively. Net retail hryvnia loans grew by 42.2% over the year, with the highest growth rate reported by private banks (+63.5%) and PrivatBank (+61.6%).

*Net corporate loans in UAH, 2015=100%**



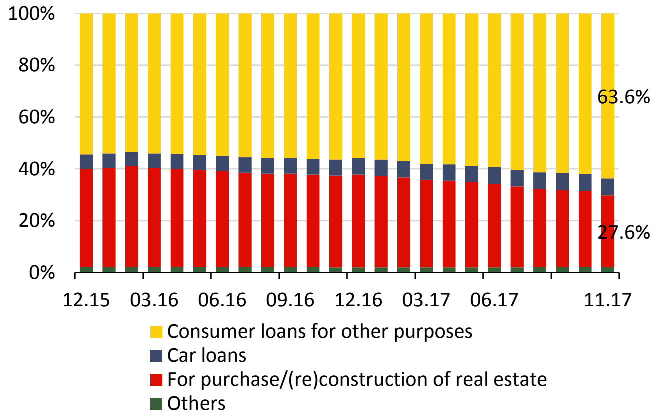
* At banks solvent as of 1 January 2018, including accrued interest

*Net retail loans in UAH, 2015=100%**



An upsurge of consumer lending took its share in the structure of retail loans up by 7.8 pp to 63.6%. The share of mortgages decreased by 8.2 pp.

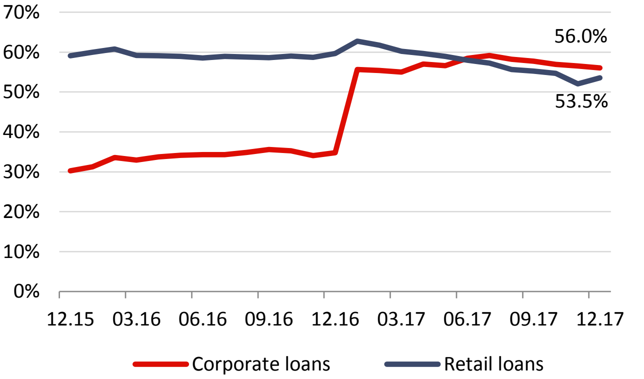
Gross retail loans by type*



* At all banks

The quality of the retail portfolio saw a marked improvement: new loan disbursements helped reduce the share of NPLs by 6.1 pp over the year

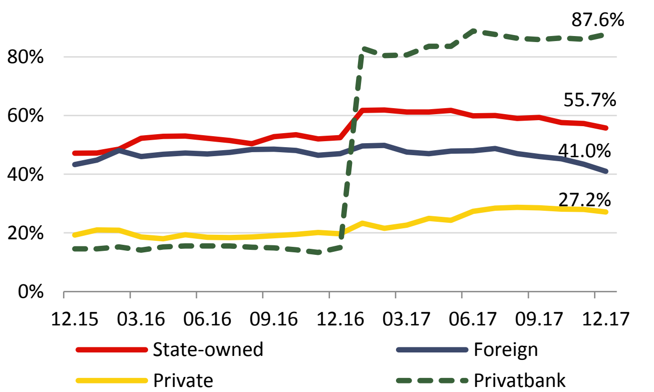
*Non-performing loans in the portfolios of reporting banks**



* Excluding off-balance sheet accounts, all banks

Since July 2017, the NPL ratio has been decreasing in all groups of banks, apart from PrivatBank.

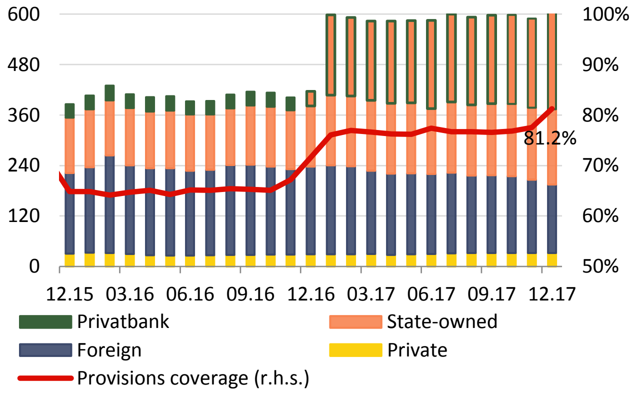
*Non-performing loans in loan portfolios by bank groups**



* Excluding off-balance sheet accounts, including interbank loans, all banks

In December, provisions for NPLs increased significantly due to additional provisioning by state-owned banks.

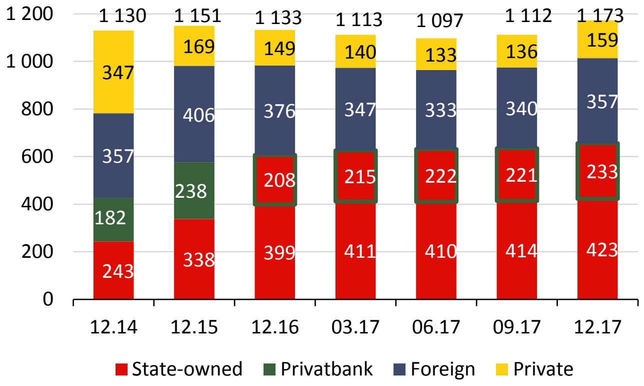
Non-performing exposures and provisions, UAH billion



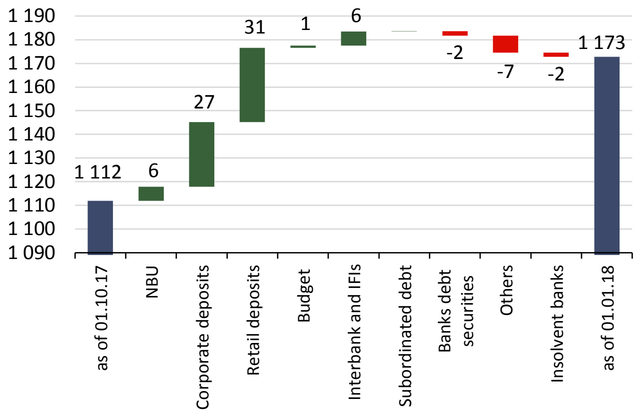
Funding

In 2017, the banks' total liabilities increased by 3.6% to UAH 1.17 trillion. The performance of all groups of banks improved. It was mainly due to an increase in deposits and money in budget accounts. Other liability components decreased.

Liabilities by groups of banks, UAH billion

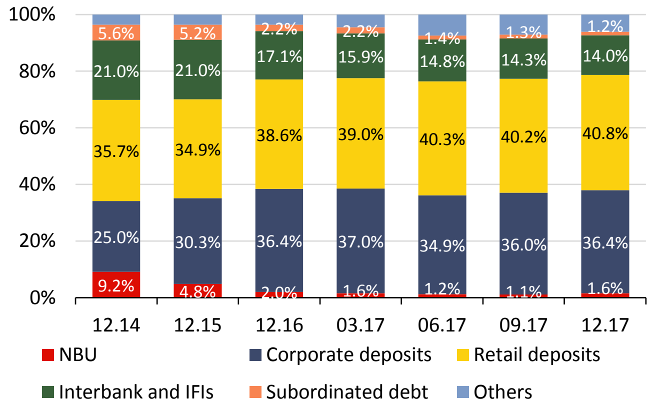


Change in liabilities by items, UAH billion



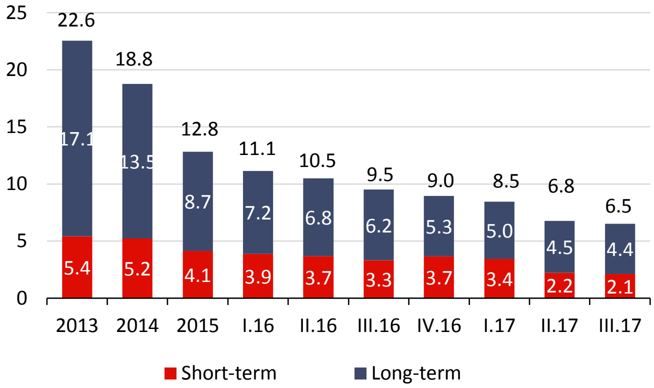
In 2017, the percentage of corporate and retail deposits in liabilities rose by 2.1 pp, to 77.1%.

The structure of liabilities



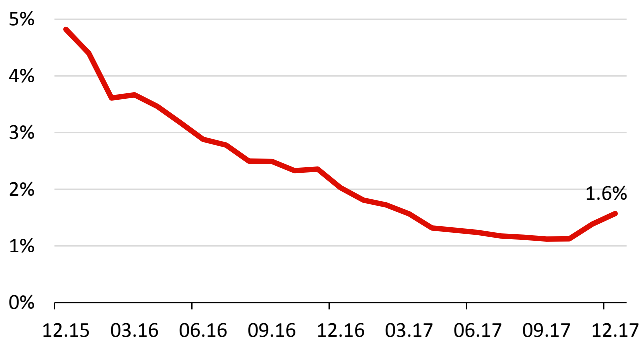
Over the first nine months of 2017, outstanding foreign loans to Ukrainian banks declined by USD 1.4 billion, while deposits from non-residents dropped by USD 900 million.

Banks' gross external debt, USD billion



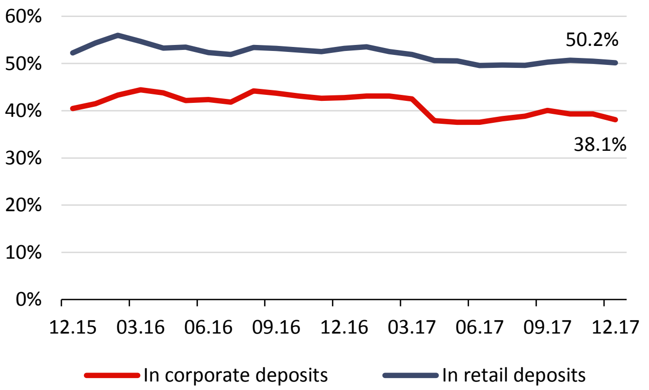
Nov.-Dec. saw an increase in the share of NBU funds, due to the NBU granting loans with maturities over 30 days to state-owned banks and to one foreign-owned bank.

NBU funds in banks' liabilities



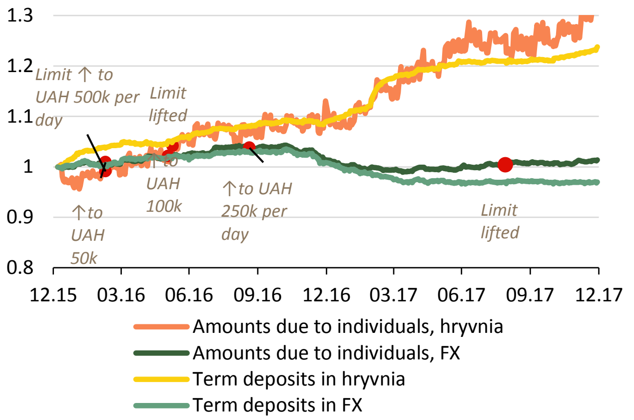
The deposit dollarization rate dropped by 3.6 pp to 44.4%

FX deposits



Higher public social spending pushed up retail deposits.

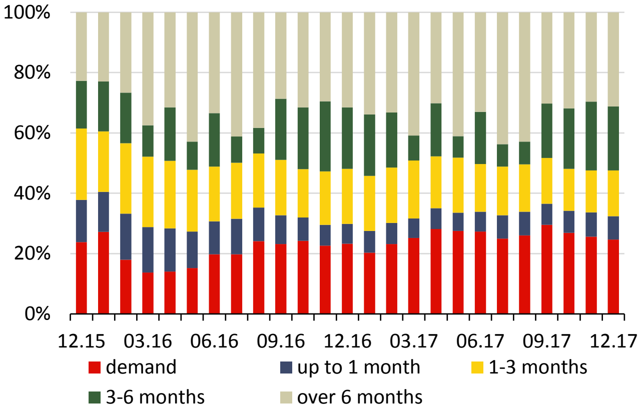
*Retail deposits, 2015=100%**



* At banks solvent as of 1 January 2018, including certificates of deposit

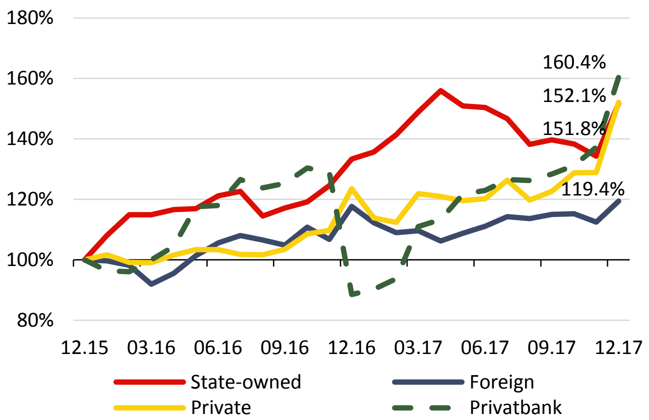
An increase in inflation expectations in Q3 had a negative affect for deposits' maturities and resulted in a significant drop in deposits with maturities over six months.

New retail deposits by maturity



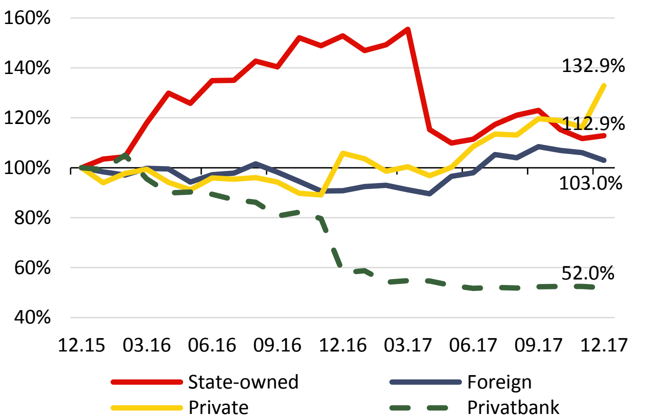
Hryvnia corporate deposits grew by 13.6% over the year, largely due to the deposits of state monopolies and trading companies. The largest growth occurred in the last months of the year. In April 2017, FX corporate deposits declined noticeably, mainly due to the confiscation of funds belonging to ex-president's entourage.

*Corporate deposits in hryvnia by groups of banks, 2015 = 100%**



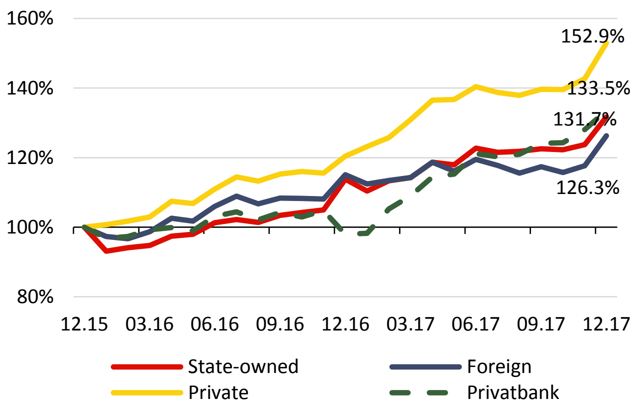
* At banks solvent as of 1 January 2018, including certificates of deposit

*Corporate deposits in FX (in USD equivalent) by groups of banks, 2015 = 100%**



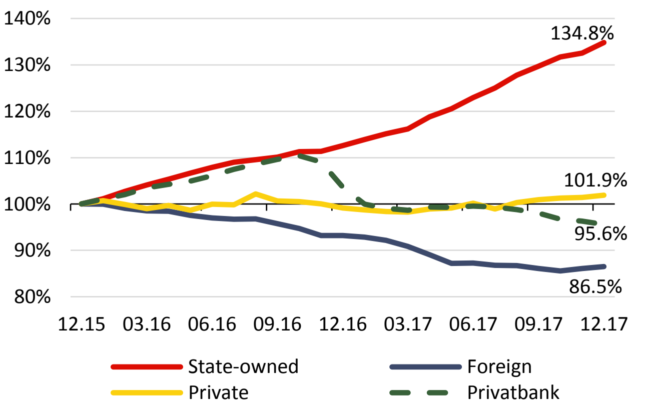
Hryvnia households deposits with PrivatBank and privately owned banks grew most of all (by 36.3% and 27% respectively). The increase in retail FX deposits was mainly generated by Oschadbank and private banks. Last year, the deposits offered by foreign-owned banks were not attractive to households due to their lower interest rates.

*Corporate deposits in UAH by bank groups, 2013 = 100%**



* At banks solvent as of 1 January 2018, including certificates of deposit

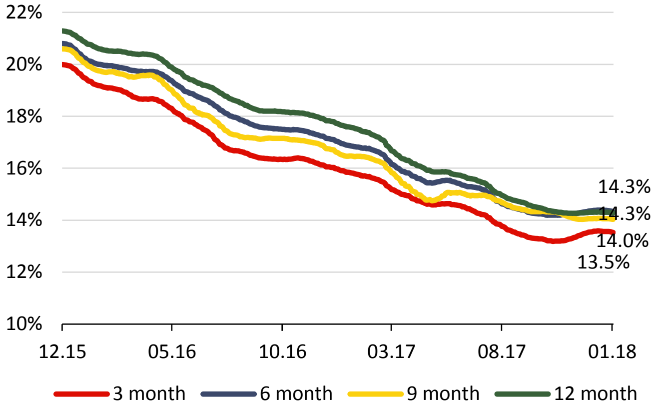
*Corporate deposits in FX (USD equivalent) by bank groups, 2013 = 100%**



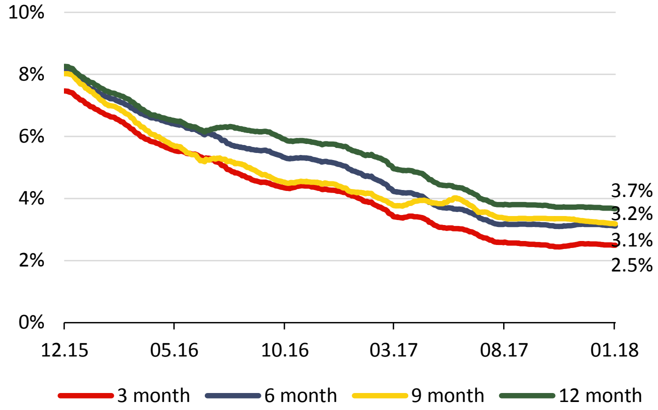
Interest Rates

Over the first 10 months of 2017, the rates on bank deposits were decreasing across the maturities. Rising inflation expectations and hikes in the NBU's key policy rate led to increases in rates on three- and six-month deposits, with their yield approximating to one-year deposits. Interest rates on retail FX remain at historical lows.

*Ukrainian Index of Retail Deposit rates in UAH, % per annum**



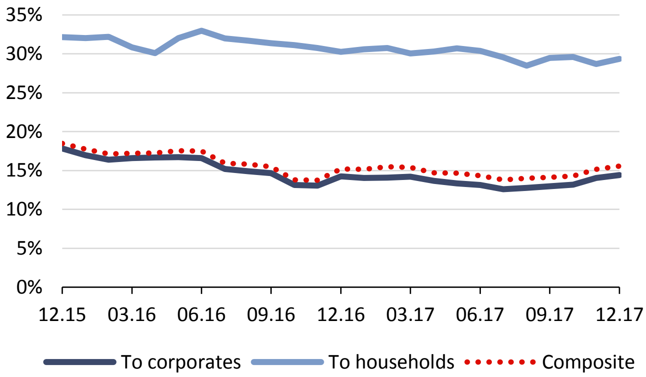
*Ukrainian Index of Retail Deposit rates in USD, % per annum**



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

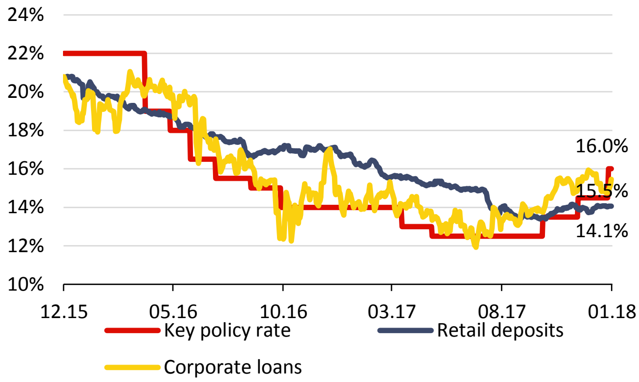
After certain loan rates decreases in H1, the banks started raising rates even before the NBU hiked its key policy rate. By the end of 2017, interest rates on corporate and retail loans had reached the level seen at the beginning of the year.

Interest rates on new loans, % per annum*



** No loan rescheduling or any other amendments to lending terms*

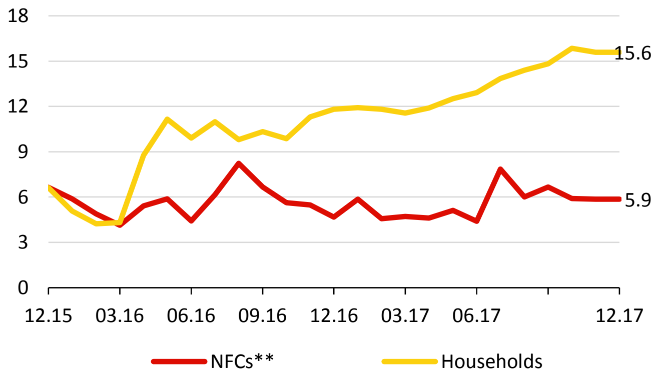
The NBU's key policy rate, price of new loans and deposits in hryvnia, % per annum*



** Daily rates, 5-day moving average*

The spread between loan and deposit rates increased due to lower costs of deposits.

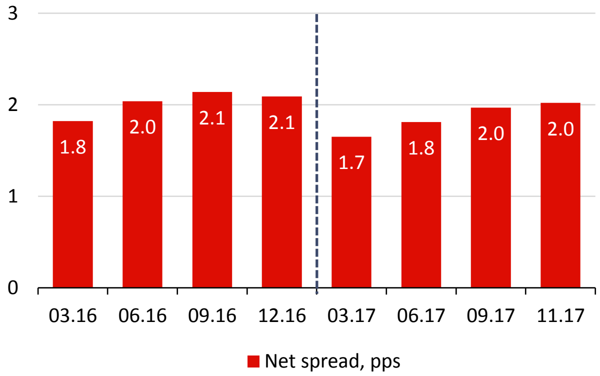
*Spread between interest rates on loans and deposits, pps**



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

In 2017, the interest spread was lower compared to that in 2016.

*Interest rate spread, pps**

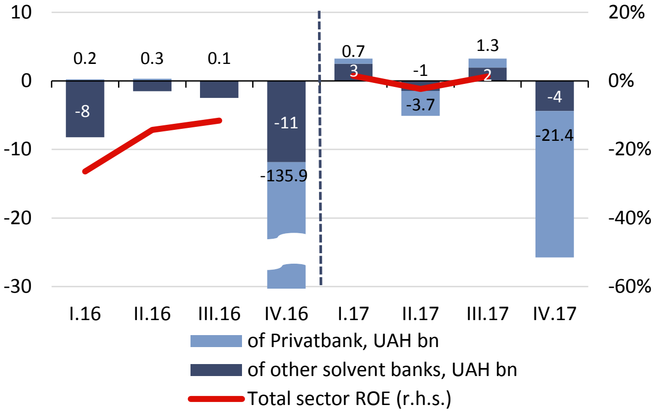


** In a given month, including insolvent banks*

Financial Results and Capital

In 2017, the banking sector booked losses (UAH -24.4 billion) mostly as a result of significant provisions made by PrivatBank.

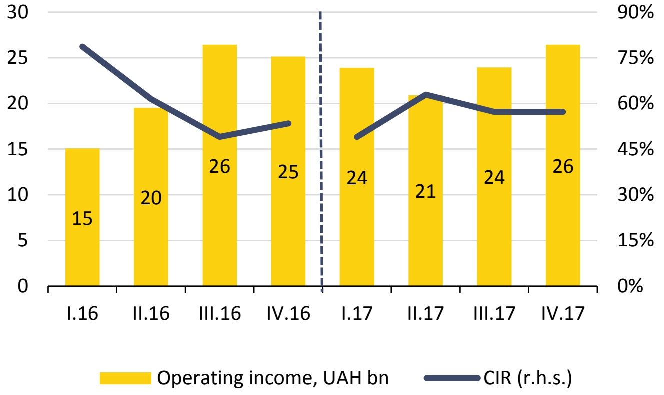
Profit/loss and return on equity*



** For the quarter here and below adjusted data for the first three quarters of 2017 are used*

Operating performance* throughout the year was on average sustainable: 58.4%, against 58.3% in 2016.

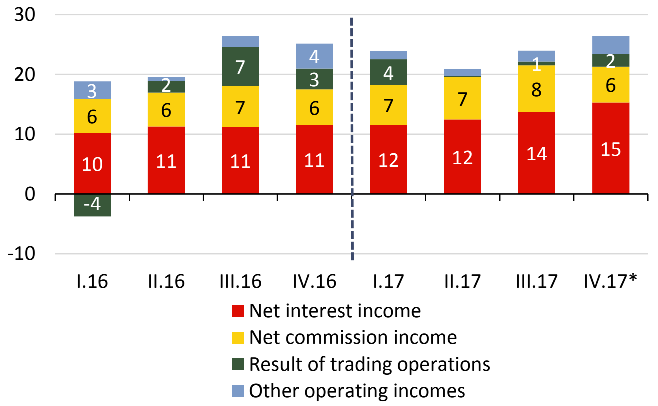
Operating income and operating efficiency of banks



** The CIR (cost-to-income ratio) measures the ratio of operating expenses to operating income*

Net interest income was primarily determined by retail operations: lower rates on deposits and a revival of consumer lending.

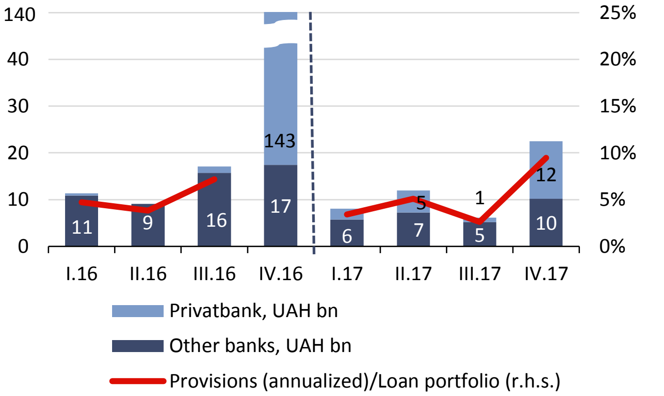
Operating income components for the period, UAH billion



** Some components may be adjusted. As of 1 January 2018, some banks did not fully adopt the new chart of accounts*

In December, the banks' provisions grew due to the transition to IFRS 9, in particular at PrivatBank and banks with Russian state capital.

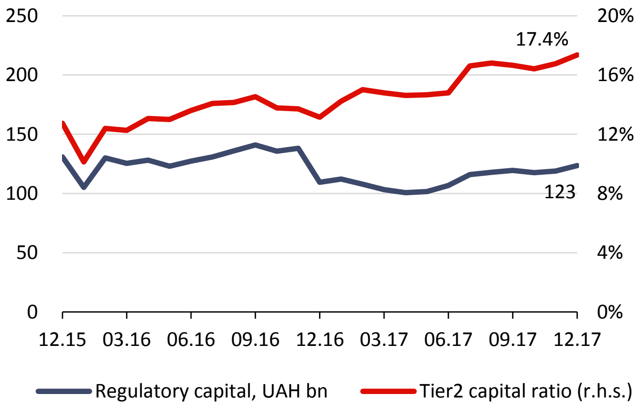
*Loan loss provisions**



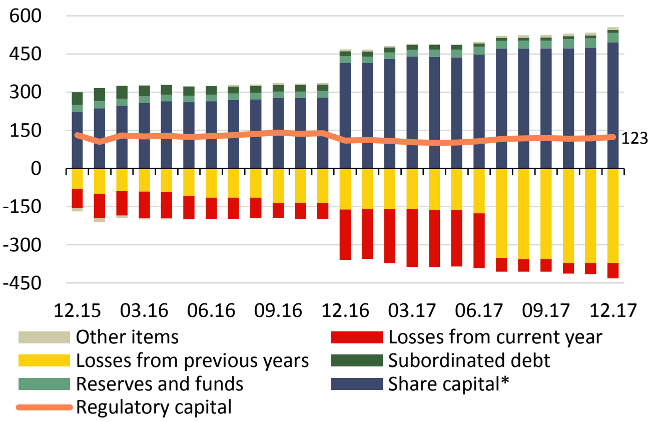
** Ratio of provisions to bank loan portfolios*

During the year, the banks' share capital increased by UAH 84 billion, or by 20.4%, mainly as a result of the additional recapitalization of state-owned banks. Regulatory capital grew by UAH 16.4 billion** or by 15.3%. Capital adequacy ratio increased across the sector.**

Regulatory capital and regulatory capital adequacy levels



Banks' regulatory capital, UAH billion



** Registered and unregistered share capital*

*** At banks solvent as of 1 January 2018*

Key indicators of Ukraine's banking sector[1]

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Number of operating banks	181	180	175	175	174	180	145	117	96	82
including 100% foreign-owned banks	17	18	20	22	22	19	19	17	17	16
General balance sheet ratios (UAH billion)[2]										
Total assets	967	1 002	1 090	1 212	1 264	1 409	1 477	1 571	1 737	1 848
including in foreign currency	528	489	476	492	503	513	667	800	788	755
Net assets	921	880	942	1 054	1 125	1 278	1 290	1 254	1 256	1 336
including in foreign currency	500	426	395	416	450	470	565	582	519	507
Gross corporate loans[3]	476	498	537	608	634	727	820	831	847	870
including in foreign currency	252	212	212	221	227	252	400	492	437	423
Net corporate loans[3]	453	434	463	530	553	648	710	614	477	458
Gross retail loans	273	236	205	197	184	189	208	176	157	171
including in foreign currency	198	172	143	113	84	67	101	97	83	68
Net retail loans	254	203	168	158	133	145	144	96	76	91
Corporate deposits[3]	162	128	160	205	221	258	283	349	413	427
including in foreign currency	69	53	56	70	80	81	114	141	177	163
Retail deposits[4]	219	214	276	312	368	443	403	402	437	479
including in foreign currency	111	116	136	154	187	189	214	215	239	243
Change (yoy, %)										
Total assets		3.5%	8.8%	11.1%	4.3%	11.4%	4.8%	6.4%	10.6%	6.4%
Net assets		-4.0%	7.0%	11.9%	6.7%	13.7%	1.0%	-2.8%	0.2%	6.4%
Gross corporate loans[3]		4.6%	7.8%	13.3%	4.2%	14.7%	12.8%	1.3%	2.0%	2.7%
Gross retail loans		-13.0%	-13.0%	-4.0%	-6.7%	3.0%	10.3%	-16.0%	-10.0%	8.6%
Corporate deposits[3]		-21.0%	25.0%	27.7%	7.9%	16.8%	9.5%	23.5%	18.2%	3.4%
Retail deposits[4]		-2.3%	28.7%	13.2%	18.1%	20.2%	-8.9%	-0.3%	8.7%	9.3%
Penetration[5] (%)										
Gross corporate loans[3]/ GDP	48.0%	52.6%	47.9%	45.1%	43.4%	47.7%	51.7%	41.8%	35.5%	29.7%
Net corporate loans[3]/GDP	45.7%	45.9%	41.3%	39.3%	37.9%	42.6%	44.7%	30.9%	20.0%	15.6%
Gross retail loans/GDP	27.5%	24.9%	18.3%	14.6%	12.6%	12.4%	13.1%	8.8%	6.6%	5.8%
Net retail loans/GDP	25.6%	21.4%	15.0%	11.7%	9.1%	9.5%	9.1%	4.8%	3.2%	3.1%
Corporate deposits[3]/ GDP	16.4%	13.5%	14.3%	15.2%	15.1%	17.0%	17.8%	17.6%	17.3%	14.6%
Retail deposits/GDP	22.1%	22.6%	24.6%	23.1%	25.2%	29.1%	25.4%	20.2%	18.3%	16.3%
Profit or loss[6] (UAH billion)										
Net interest income	37.2	54.5	51.9	53.8	49.2	49.1	52.2	39.1	44.2	53.1
Net commission income	17.7	13.2	12.6	15.4	18.1	21.0	23.1	22.6	24.2	27.5
Provisions	24.0	75.4	46.2	36.5	22.3	28.0	84.4	114.5	198.3	48.7
Net profit/loss	7.2	-38.4	-13.0	-7.7	6.0	1.4	-33.1	-66.6	-159.4	-24.4
Memo items:										
UAH/USD (period average)	5.27	7.79	7.94	7.97	7.99	7.99	11.89	21.84	25.55	26.60
UAH/USD (end-of-period)	7.70	7.99	7.96	7.99	7.99	7.99	15.77	24.00	27.20	28.07
UAH/EUR (period average)	7.71	10.87	10.53	11.09	10.27	10.61	15.72	24.23	28.29	30.00
UAH/EUR (end-of-period)	10.86	11.45	10.57	10.30	10.54	11.04	19.23	26.22	28.42	33.50

[1] Data for solvent banks for each reporting date

[2] Including accrued income/expenses

[3] Including non-banking financial institutions

[4] Including certificates of deposits

[5] GDP is calculated as defined in the 2008 national accounts system methodology. From 2008 through 2013 it includes data for the temporarily occupied Republic of Crimea and City of Sevastopol; from 2014 through 2016 it excludes data for the temporarily occupied Republic of Crimea and City of Sevastopol and a part of the ATO zone.

[6] Data for the first three quarters of 2017, taking into consideration adjustment entries. Data as of 1 January 2018 may be adjusted after the end of the annual audit.

Notes:

Source: National Bank of Ukraine (unless otherwise stated)

The sample of banks consists of banks solvent as of each reporting date unless otherwise stated.

Banking groups up to 2016 were based on decision No.657 by the Committee on Banking Regulation and Supervision and Oversight of Payment Systems dated 31 December 2015. 2017 data is prepared in accordance with decision No.76-D by the NBU Board dated 10 February 2017.

The data includes accrued interest as of the end of the period (month, quarter, year) unless otherwise stated.

Gross loans are loans not adjusted by provisions for active banking operations.

Rounding may cause the sum of components to differ from the total.

Data as of 1 January 2018 may be adjusted after the end of the annual audit, as the banks have been allowed to carry over account balances for accounting income and expenses in accordance with Resolution No. 89 dated 11 September 2017, depending on available technical capacities.

Terms and Abbreviations:

ATM	*Automated teller machine*
ATO	*Anti-terrorist operation*
CIR	*Cost-to-Income Ratio*
FX	*Foreign currency/exchange*
GDP	*Gross domestic product*
IFI	*International Financial Institution*
NBU	*National Bank of Ukraine*
NPL	*Non-performing loan*
P2P	*Peer-to-peer lending, direct lending between non-related parties*
POS	*Point of sale*
ROE	*Return on equity*
UIRD	*Ukrainian Index of Retail Deposit Rates*

pp	*percentage point*
UAH	*hryvnia*
USD	*US dollar*
eq.	*equivalent*
Q	*quarter*
H	*half of year*
k	*thousand*
bn	*billion*
r.h.s.	*right-hand scale*
yoy	*year-on-year*