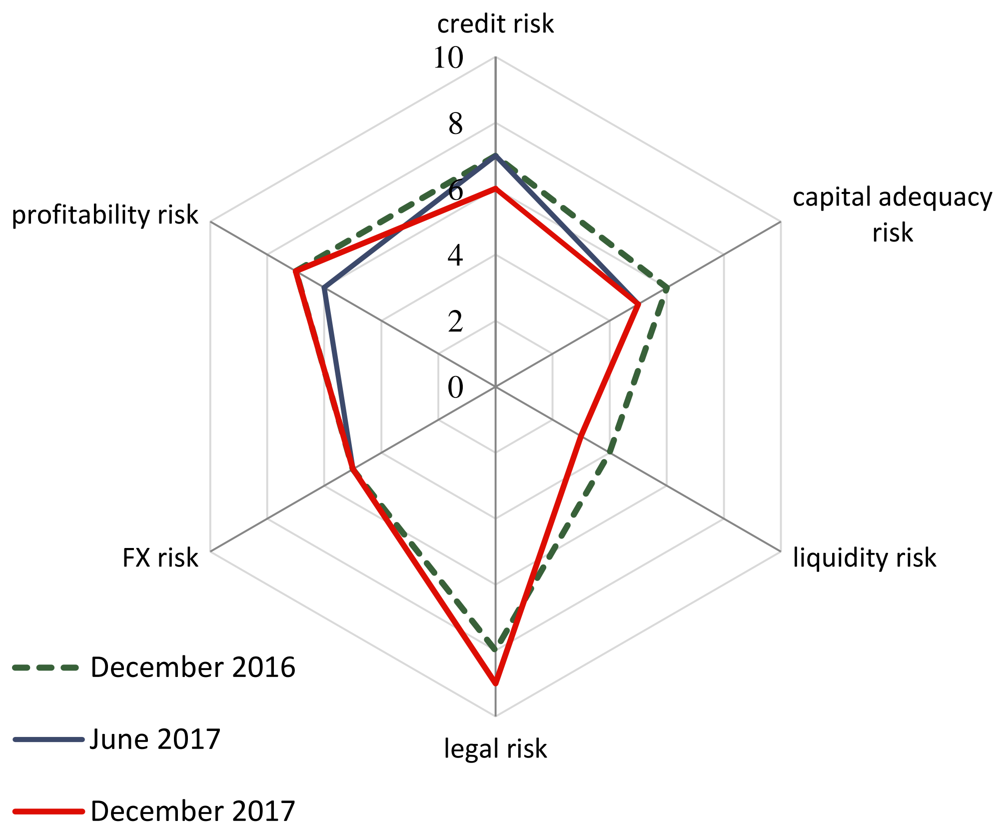
NATIONAL BANK OF UKRAINE

Financial Stability Report # 4

18 December 2017

Level of risks in H2 changed little

Risk map



- **Credit risk** (-1) – financial standing of clients improved, risk for new loans is low

  Capital adequacy risk (const) – IFRS 9 introduction may have a limited negative effect for the sector

  Liquidity risk (const) – low

  Legal risk (const) – virtually no progress on creditor rights protection

  FX risk (const) – moderate in view of shrinking FX share in loan portfolios

  Profitability risk (+1) – increased mainly on the back of IFRS 9 introduction and low efficiency of state-owned banks

In 2017, Financial Stress Index fell back to pre-crisis readings

Source: NBU

Macroeconomic risks are moderate but may rise in 2018

- Economic growth remained weak. Still, it helped to restore solvency of corporates and households.
- The GDP growth is expected to accelerate next year to over 3% on the back of recovery pf consumer and investment demand.
- Inflation stays above the NBU target level. National Bank expects CPI to slow down next year. However, overall inflation risks increased for 2018. This can impede medium- and long-term bank lending.
- The key medium-term macroeconomic risk is suspension of the IMF program. Without restart of IMF lending, Ukraine will find it very hard to roll-over more than USD 20 billion of foreign currency debt maturing in 2018-2020. The NBU believes it would reasonable to start negotiations on the launch on a new IMF in 2019.
- New fiscal risks emerge because of the launch of election cycle. High concentration of budgetary expenditures in December remains a problem. Implementation of long-term budget planning should solve the problem.

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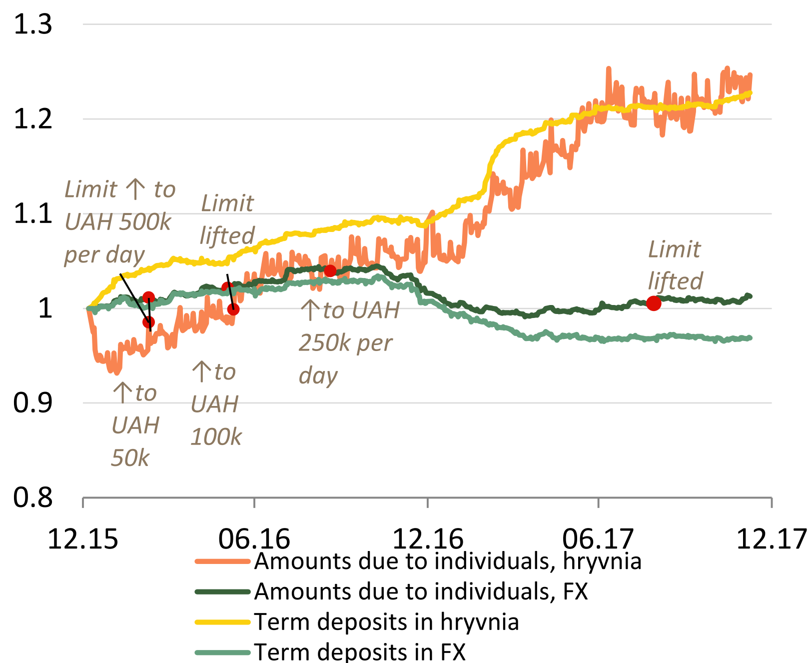
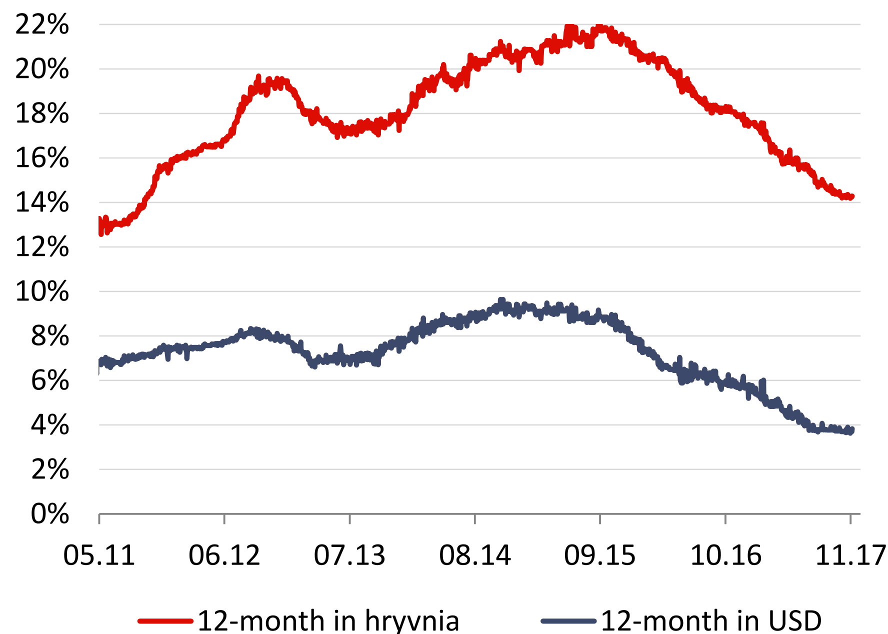
Retail deposit inflow slowed down

Deposits* (2015=100%)



Ukrainian Index of Retail Deposit Rates, % per annum

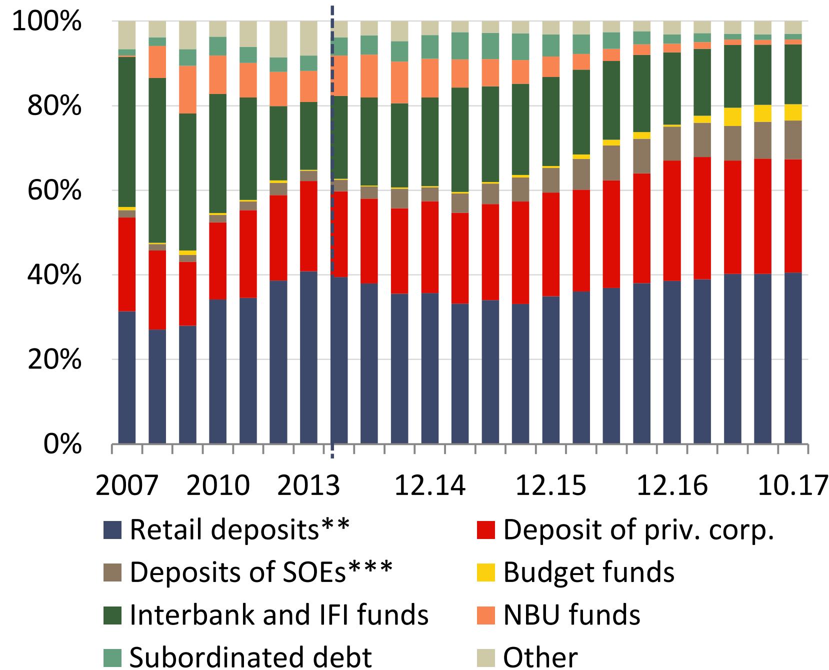


* *At banks solvent as of 1 October 2017*

- In H2, retail deposit inflow slowed down substantially because of lower interest rates and moderate hryvnia depreciation.
- FX deposit rates fell to historic lows; potential for further decrease is limited.
- Hryvnia deposit rate have not reached historic floor yet; however, they may do so in 2018 if inflation risks subside.
- Rates on new loans may hit all-time lows in a year or year and a half if macroeconomic risks do not materialize and creditor rights are enhanced.

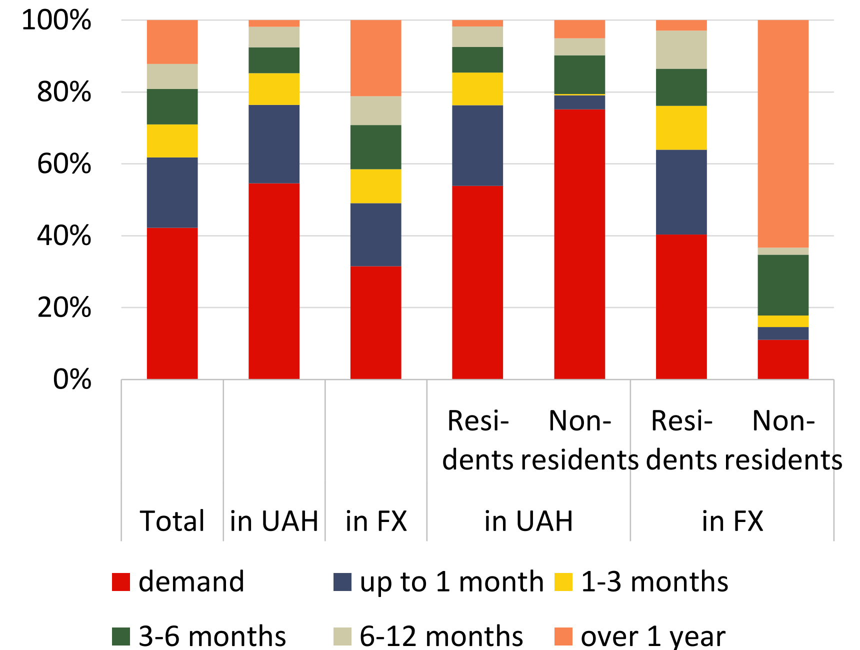
Short-term retail and corporate deposits dominate in liabilities

Composition of bank liabilities by instruments*



*With interest accrued, ** including certificates of deposit, ***state-owned enterprises*

Composition of liabilities by maturities as of 1 Nov. 2017



- Share of retail and corporate deposits in bank liabilities reached 77% hitting new historic highs.
- Over 2/3 of total bank liabilities and 4/5 of hryvnia liabilities are short-term (up to three month). Thus efficient liquidity management is required.
- Liability basis is to remain short-term over a few years.
- Implementation of new liquidity coverage requirement (LCR) will enhance bank resilience to liquidity shocks.

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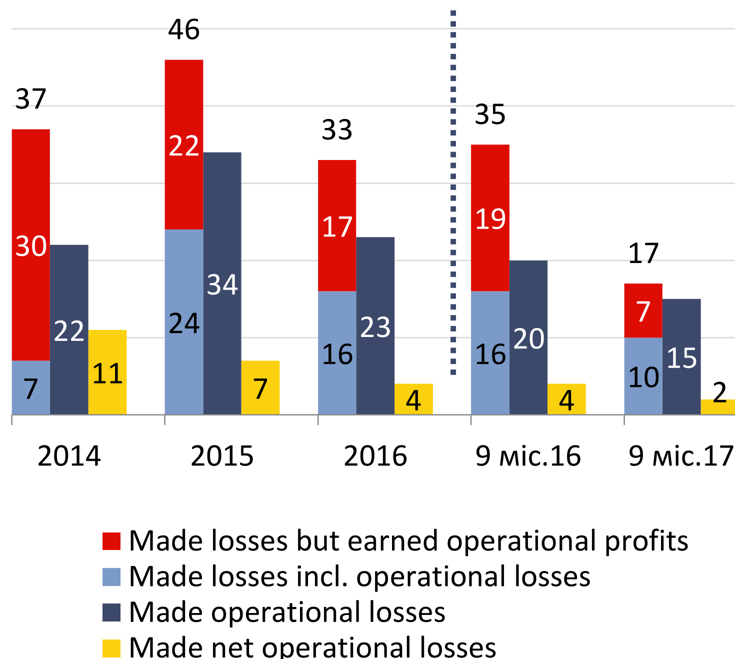
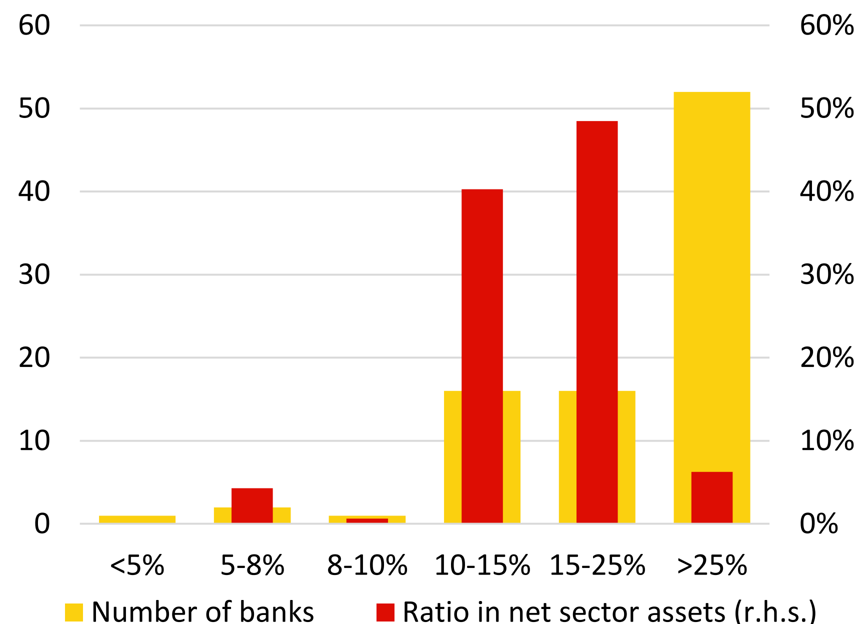
Financial performance of most banks substantially improved

Number of loss-making banks



Distribution of banks by regulatory capital adequacy as of 1 October 2017



- The number of loss-making banks has considerably reduced. A few institutions still make operational losses. They have to change their business models as soon as possible and cut operating costs in order to earn profits again.
- Capital adequacy rate is substantially above the minimum threshold at many banks.
- Banks’ transition to IFRS 9 can cause a reduction in equity because of the need for additional provisioning. Effect for regulatory capital will be insignificant as it is calculated with regard to prudential provisions (credit risk according to Regulation #351).

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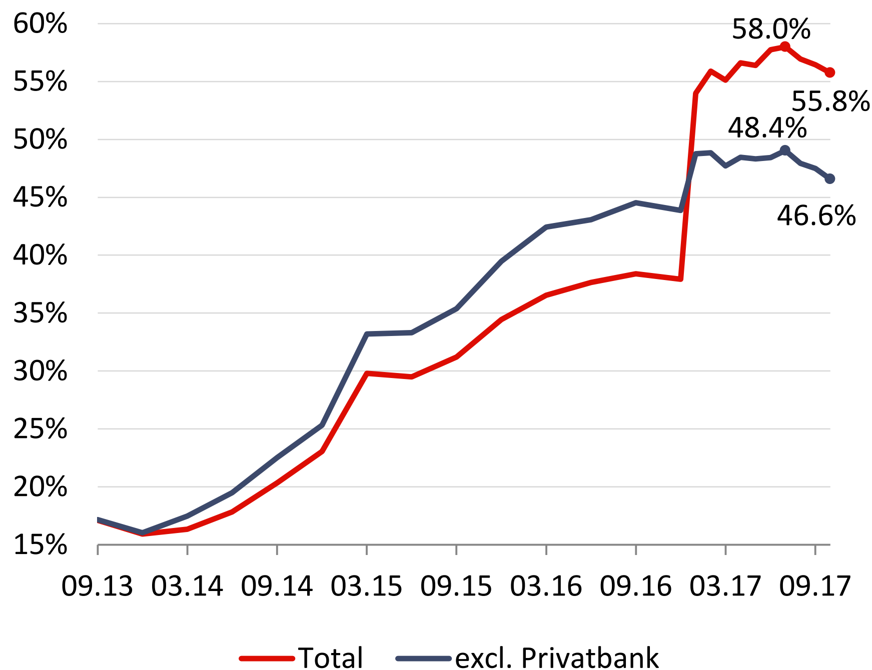
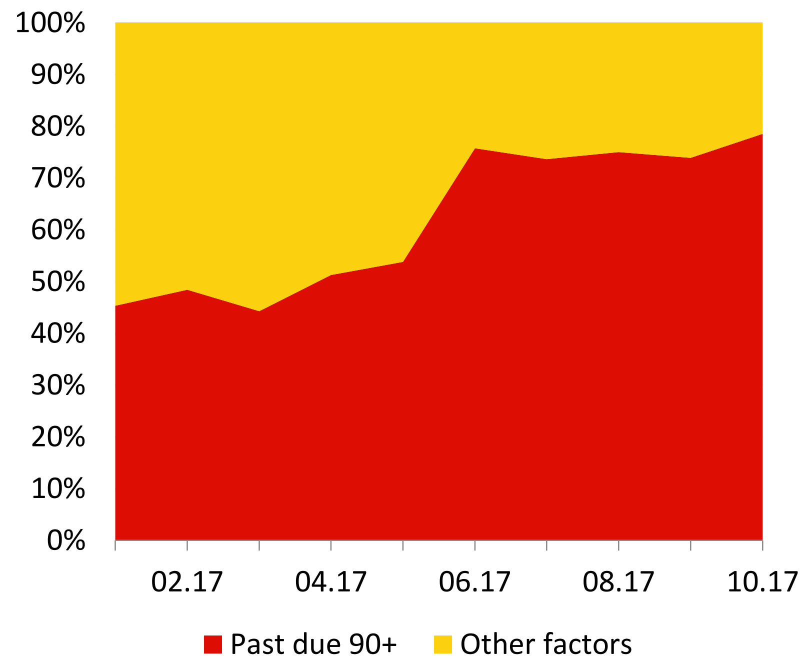
NPL rate began to go down

NPL rate, %



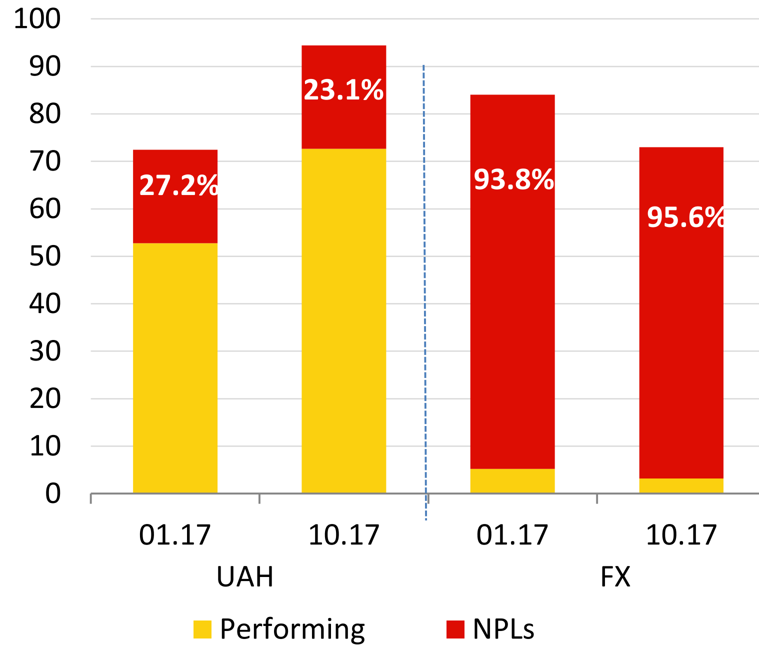
Corporate NPLs by default recognition criteria



- NPL rate peaked to 58% in July and started to decrease gradually.
- The major sign of default for corporate borrowers is that a loan is past due over 90 days.

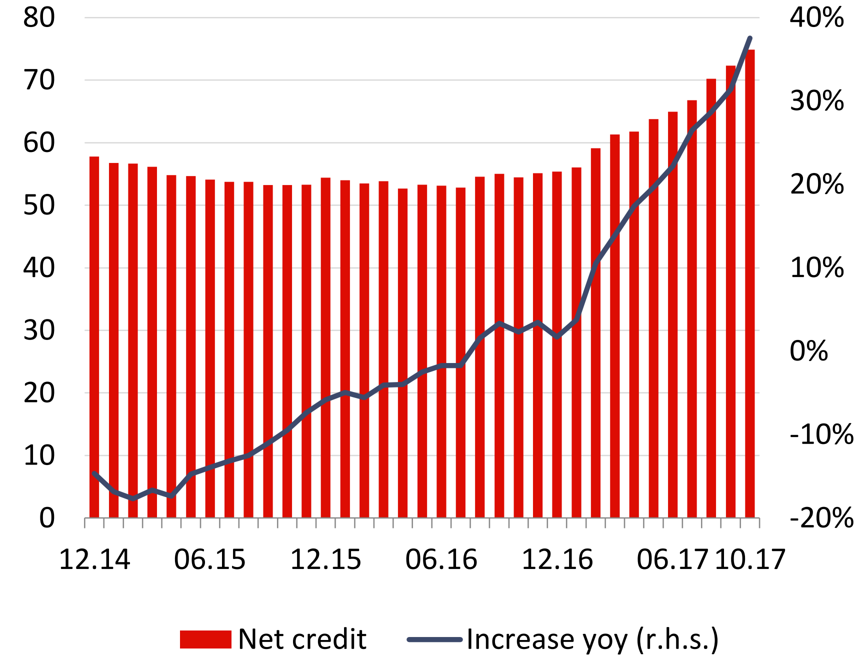
Lending is surging, but there is no need for immediate limiting

Gross retail loans*, UAH billion



** including individual entrepreneurs*

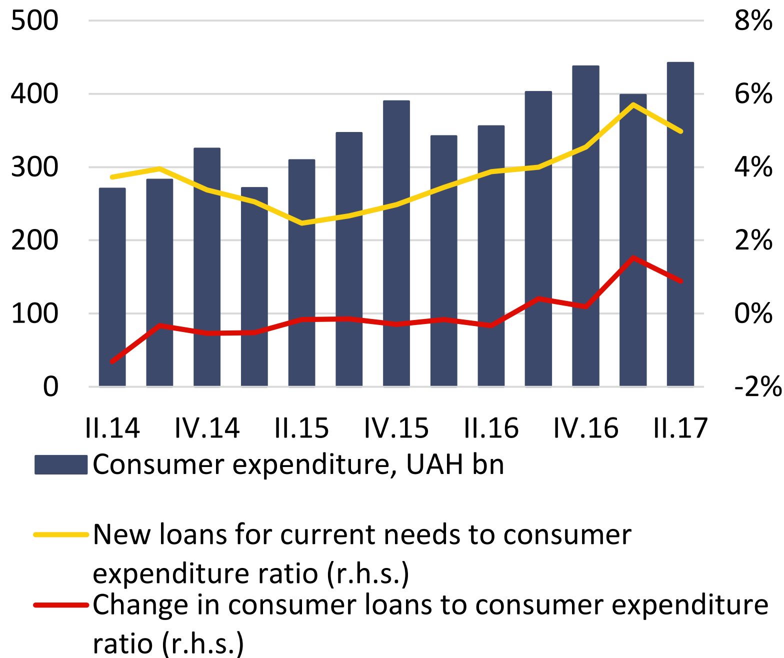
Net retail loans in hryvnia, UAH billion



- New consumer loans account for only 5% of household consumer spending, loan increase – for less than 1% of consumer spending.
- Penetration rate for retail lending remains extremely low even with regard to economic development level.
- Mortgages make less than 5% of new retail loans.

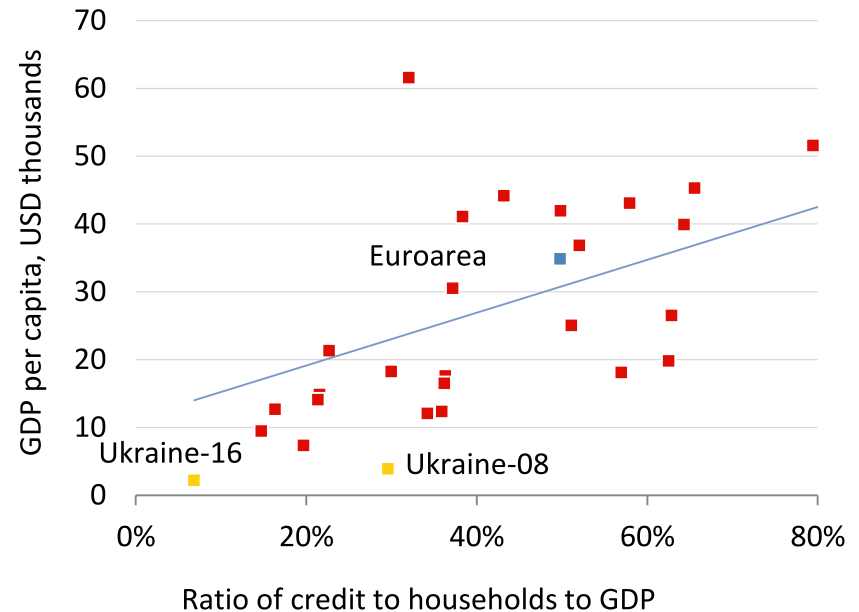
Contribution of lending to household consumption is not material so far

Bank lending and consumer expenditure*



*At banks solvent as of 1 October 2017

Consumer loan penetration and GDP in European countries

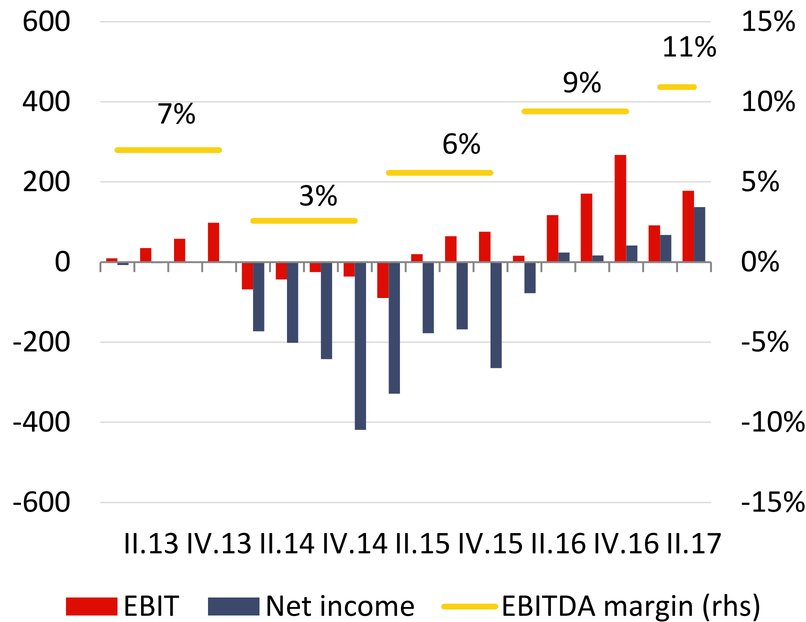


Source: ECB, IBRD, IMF, Eurostat, central banks, NBU

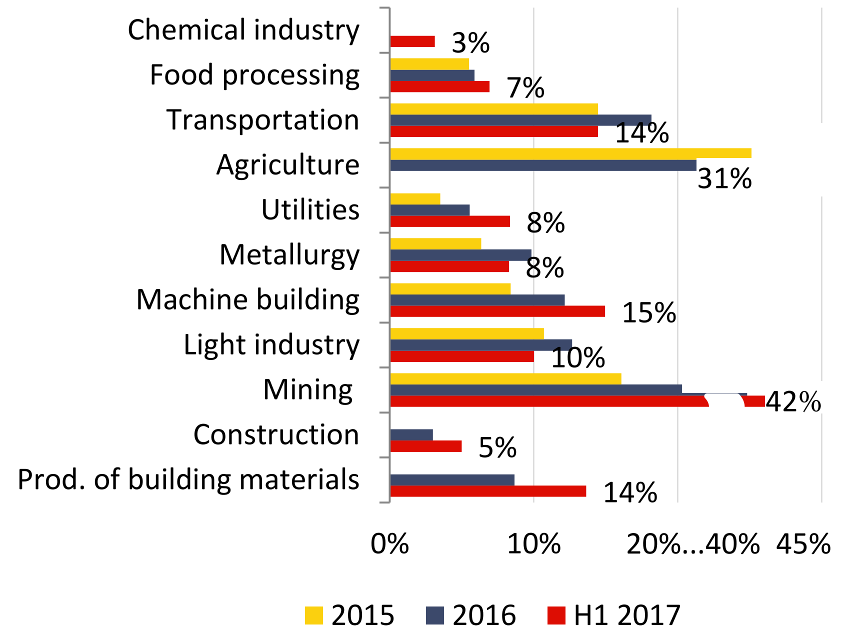
- In spite of high recovery rate volumes of consumer lending today do not pose systemic risks. The NBU does not yet see a need to act to restrain bank consumer lending.
- The NBU will remain vigilant on developments in retail lending. It will report on situation on the market twice annually.
- If necessary, the NBU will tighten requirements on credit risk assessment for retail loans or apply macroprudential measures to limit excessive credit growth. The NBU will communicate in advance about such intentions.

Financial stance of businesses does not impede lending recovery

Performance of non-financial companies, UAH billion



EBITDA margins by sectors, %



- Operating profitability has been growing in the real sector for the past two years. In 2017, average EBITDA margins of companies exceeded 10%.
- Profitability was increasing in most of basic industries. Metallurgy, transportation and light industry are the exceptions. In some industries margins exceed pre-crisis levels.
- Corporate lending started to recover in Q3. Currently, these are mostly short-term loans.
- Legal risks and weak creditor protection are key impediments to corporate lending.

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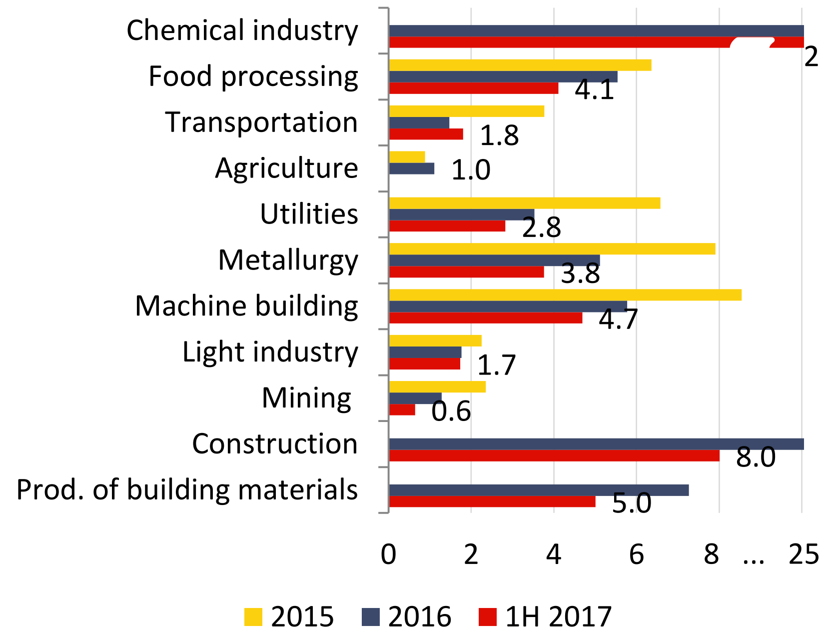
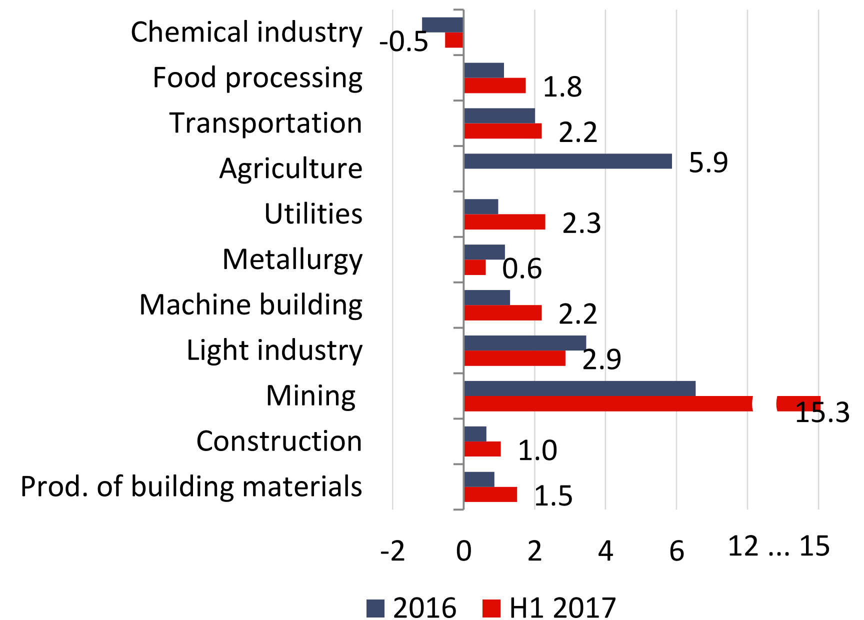
Companies from most industries can serve old and raise new loans

Leverage (ratio of debt to 12-month EBITDA) by sectors



Interest coverage ratio



- Leverage is no longer critical for most industries. Chemical industry and construction are in risk zone.
- Interest expenses are not a problem for all real sector industries except for construction where operating profits are not sufficient to cover high interests on former loans.
- Current debt readings indicate that companies from most industries can apply for new loans.
- Mining, power supply, transportation, and light industries have the most attractive debt readings.

5 to 7 industries face good borrowing prospects

Leverage and EBITDA margins, 2016

Debt/EBITDA

6
5
4
3
2
1
0

Dairy production
Machine building (excl. transportation)
Warehouse services
Food processing
Light industry
Pharmaceuticals
Transport servicing
Livestock raising
Mining
Growing grain crops
Natural gas production

0%
5%
10%
15%
20%
25%
30%
35%
40%
45%

EBITDA margins

- Focus on leverage and margins: debt/EBITDA <6, EBITDA margin 10-30%.
- The following industries are solvent and are fit for lending: cattle breeding, pharmaceuticals, transport servicing (ports, stevedores, terminals) and mining, light industry.
- Warehouse and silo services, certain segments of machine building (agricultural machinery, metal works equipment) bare higher risks yet are attractive for banks in the absence of big external shocks.
- Agricultural companies have no problems with getting loans.

Short-term loans: focus on pharmaceuticals and agriculture

Quick liquidity and EBITDA margins, 2016

Quick liquidity
0.6
0.5
0.4
0.3
0.2
0.1
0.0
0%
1%
2%
3%
4%
5%
6%
7%
8%
9%
10%
EBITDA margins
Wholesale pharmaceutical trade
Wholesale foodstuff trade
Wholesale chemicals trade
Retail foodstuff trade
Car trade
Wholesale trade in agricultural machinery
Wholesale trade in grain, tobacco, seeds and forage

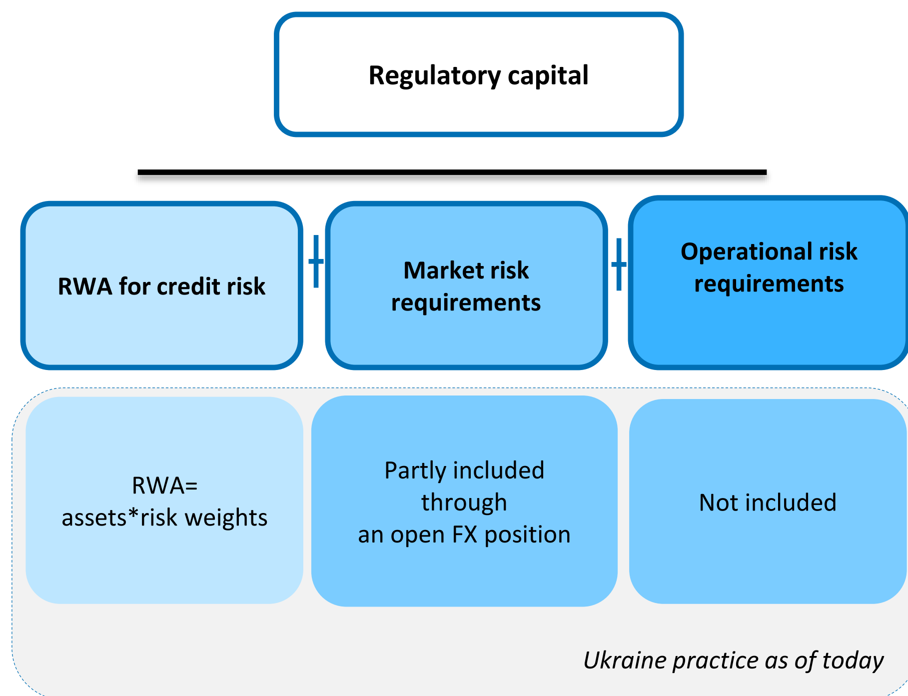
- Commerce: focus on businesses with moderate margins and need for current assets to cover cash gaps.
- Industries with EBITDA margin over 3% and quick liquidity ratio of 20-50% are attractive for lending.
- Companies that sell medications, agricultural products and foodstuffs, fertilizers, and agricultural machinery have most solvent demand for short-term loans.
- Prospects for wholesale fuel trade are unclear. Many big players are already borrowers. Some of them have a bad credit history or experience problems that are not related to finance.

Road map for reforms of capital and liquidity requirements

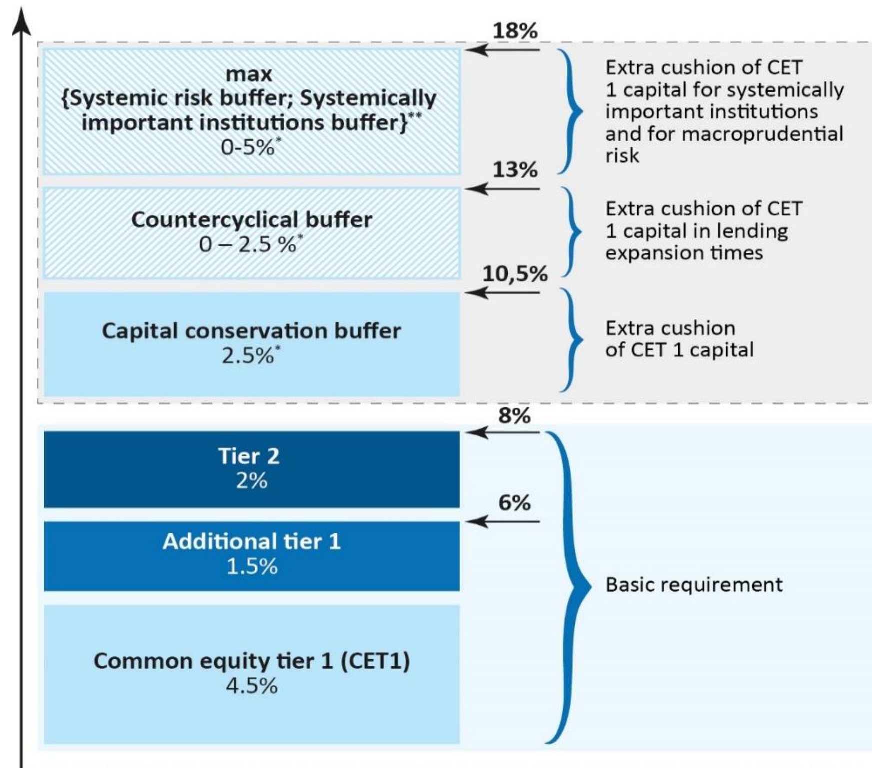
- Under Association agreement with the EU, Ukraine committed to implement European capital and liquidity requirements (CRR/CRD IV pack) based on the Basel Committee recommendations.
- Normalization of situation in banking sector allows for promoting capital and liquidity reforms in line with the commitments.
- Certain elements will be implemented with regard to national environment, which is compliment with CRR/CRD IV provisions.
- Regulations that lay down capital and liquidity requirements will be drafted in advance (1.5-2 years before obligatory fulfillment). Long-lasting test period for the requirements will be envisaged, quantitative impact study will be conducted.
- Expected implementation time for new requirements:
  - ✓ capital – new structure of capital, capital charge for market and operational risks - 2019, capital buffers – 2020 (after transitional period for banks' capitalization increase);
  - ✓ liquidity – 2018 (short-term - LCR), 2020 (long-term- NSFR).
- For effective implementation of new capital and liquidity rules NBU works in collaboration with World Bank and IMF experts.

Changing requirements to capital adequacy

Regulatory capital adequacy ratio calculation



Bank capital structure and capital buffers in the EU to CRD IV*



*Assumed buffers upper bounds (values can be lower); ** In some cases can be the sum of Systemically important institutions buffer and Systemic risk buffer;*

- The NBU will keep a standardized approach to capital adequacy assessment
- Capital requirements will cover market risks to the full extent and will start to cover operational risks.
- Capital buffers implementation is already envisaged since 2020, but their activation may take place later (except for capital conservation buffer that will be implemented according to a pre-set schedule).
- New capital structure and minimum capital requirements will be determined in 2018.

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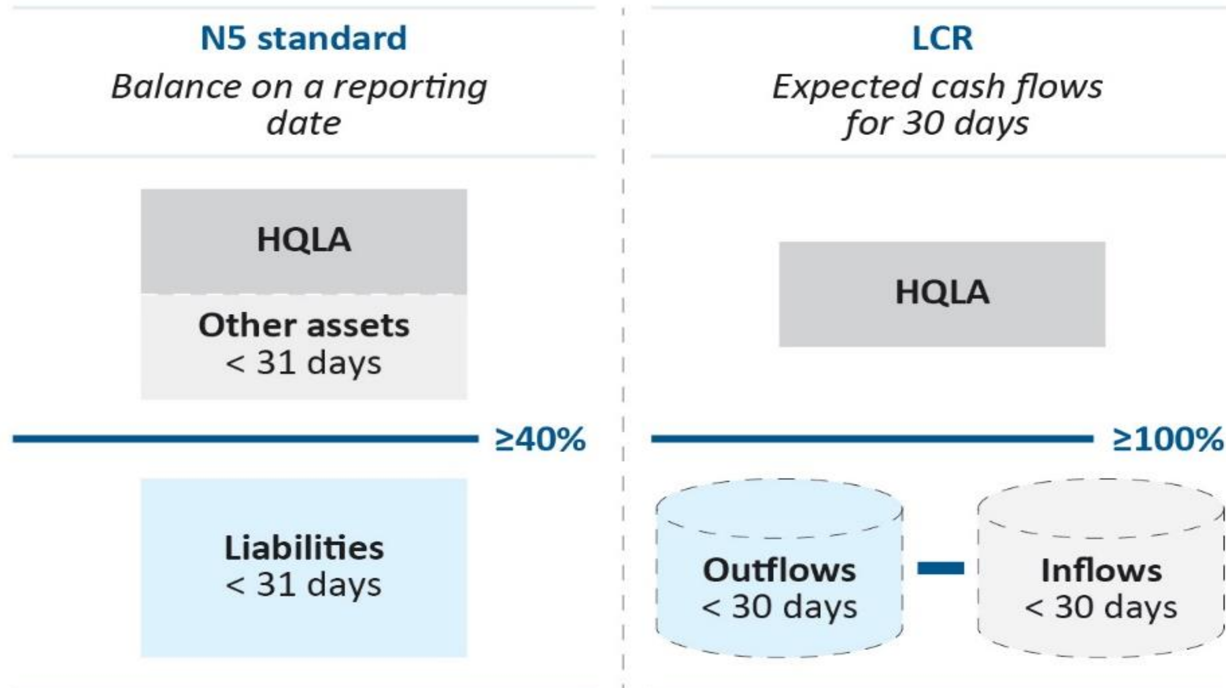
Changing liquidity requirements: LCR introduction

Current liquidity standard vs LCR



- New liquidity requirement LCR (liquidity coverage ratio) will be ultimately implemented in late 2018 after six months of test calculations.
- LCR will get along with current liquidity ratios until full implementation of all elements of liquidity management system.
- Long-term liquidity ratio NSFR (net stable funding ratio) will be developed in 2018 and implemented in early 2020.

Road map for reforming capital and liquidity standards

2017 2018 2019 2020

Capital requirements

New structure of regulatory capital

New calculation standards of RWA*

Leverage ratio

Capital buffers

Liquidity requirements

LCR ratio (short-term liquidity)

NSFR ratio (long-term liquidity)

– development of standards, – introduction.

** incl. introduction of market risk and operational risk requirements*

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Recommendations

Recommendations to authorities

- To approve the package of draft laws on financial sector reforms.
- To finalize strategy for reforming state-owned banks, to introduce independent supervisory boards in the state-owned banks.
- To spend funds from the Single Treasury Account more evenly throughout a year.
- To promote resilience to cyber-risks.

Recommendations to banks

- To implement in a timely manner models for assessment of expected losses in line with IFRS 9.
- To monitor and assess properly risks related to consumer lending.
- To keep conservative stance in dividend repayments (especially at state-owned banks).
- To apply provisions of draft regulation on risk management before it will officially take effect.
- To continue to resolve NPLs on balance sheets.
- To adhere to NBU recommendations on cyber-risks.

Plans and intentions of the NBU

- To introduce annual diagnostics of banks resilience (including stress-tests).
- To implement the Roadmap on Approximation to Basel III.
- To introduce liquidity coverage ratio (LCR).
- To enhance disclosure standards for banks’ financial and prudential reports.
- To require banks to develops programs for resolving NPLs on balance sheets.