National Bank of Ukraine

Financial Stability Report December 2020

21 December 2020

Resume

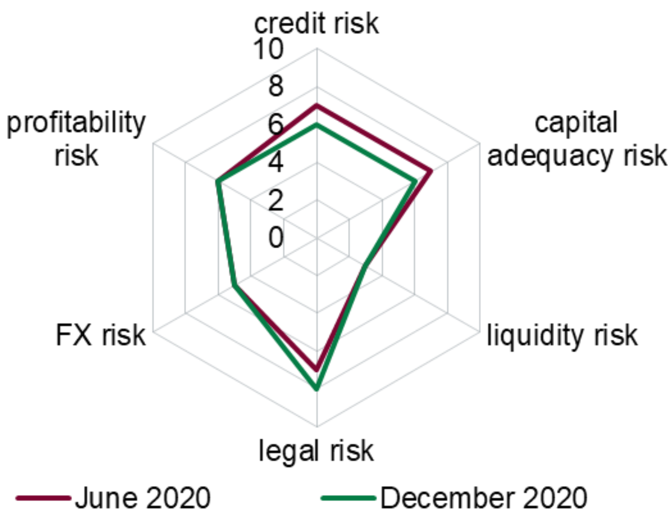
- The banking sector proved to be resilient to COVID crisis. Banks continuously provided services and supported clients through lending.
- Credit risk materialized to a lesser extent than the NBU had expected, thanks to efficient measures taken by banks, including restructuring of loans to borrowers who experienced temporary financial difficulties.
- Banks are well-capitalized and have sufficient capital stocks to absorb losses and increase loan portfolio.
- Real sector is recovering from COVID crisis. Although growth rates are uneven across industries, the segment proved resilient in general. Deterioration of corporate loans quality was not material. Lending is gradually recovering, most intensively for SMEs.
- In Q2, unsecured loan segment saw a noticeable growth in loan past due at a few banks, which made them restructure loans. The NBU perceives higher risks in this segment and confirms its intentions to introduce higher risk weights for such loans.
- The key unfavorable factor for lending recovery is a decline in cost of retail and corporate loans.
- The key risks for profitability is a gradual narrowing of interest rate spread. Rates on loans will fall further, while room for decrease in funding costs is limited.
- Opportunities for banks to invest in foreign currencies has narrowed. That additionally encourages banks to dedollarize their balance sheets.

Financial stress index is consistently low

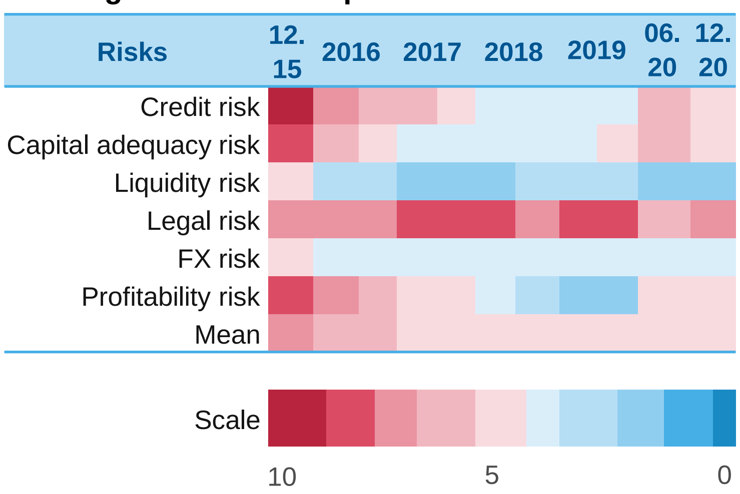
Source: NBU.

- Since December 2020, FSI is calculated based on the new methodology. Updated FSI takes into account the effect of time-varying correlation between subindices.
- Almost all subindices returned back to pre-crisis level; moreover, some of them reached the historical minimum, in particular deposit rate.

Banking sector risk map



Banking sector heat map



Credit risk (-1). The risk materialized to a lesser extent than the NBU had expected, inter alia thanks to flexible loan restructurings and public support for business. However, some credit losses will still be reported in 2021.

Liquidity risk (const). Liquidity stock, propensity to save, and trust to banks are high. However, share of term deposits is falling.

Legal risk (+1). Controversial rulings of courts, cancellation of IMF-supported anti-corruption reforms increased legal risks once again.

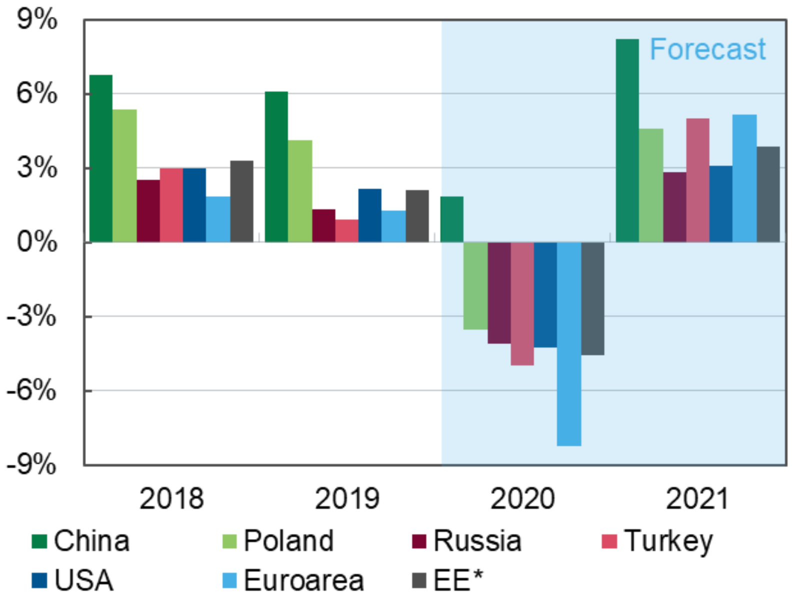
FX risk (const). Share of FX deposits remains high, while room to invest them is limited. On general, banks are resilient to exchange rate fluctuations.

Profitability risk (const). Fee and commission income of banks recovered, interest income did not fall substantially. However, interest rate spread will narrow, provisioning will weigh on profits. Higher operational efficiency of banks may partly offset the risks.

Capital adequacy risk (-1) decreased thanks to recapitalization of a state-owned bank. Banks should prepare for lower profitability and introduction of new capital requirements.

Global economy requires, yet risks are high

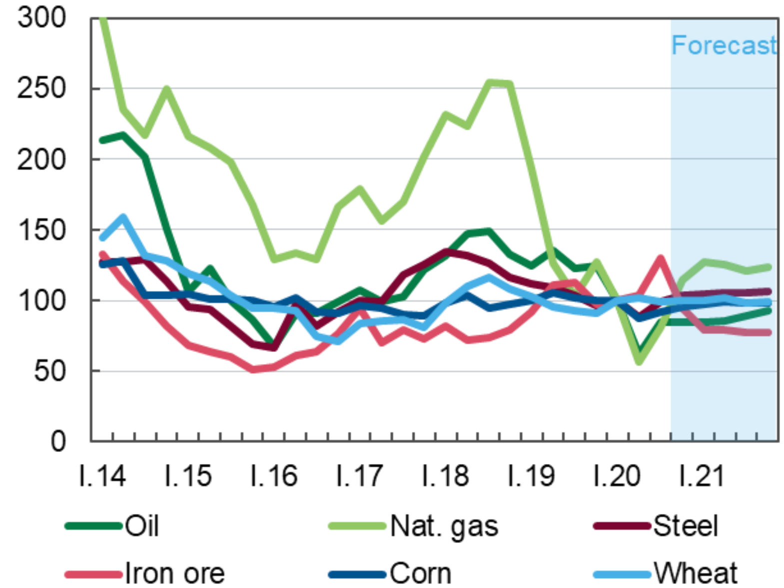
GDP change of Ukraine's major trading partners



* Eastern Europe.

Source: IMF, World Economic Outlook, October 2020.

World commodity prices*, Q1 2020 = 100



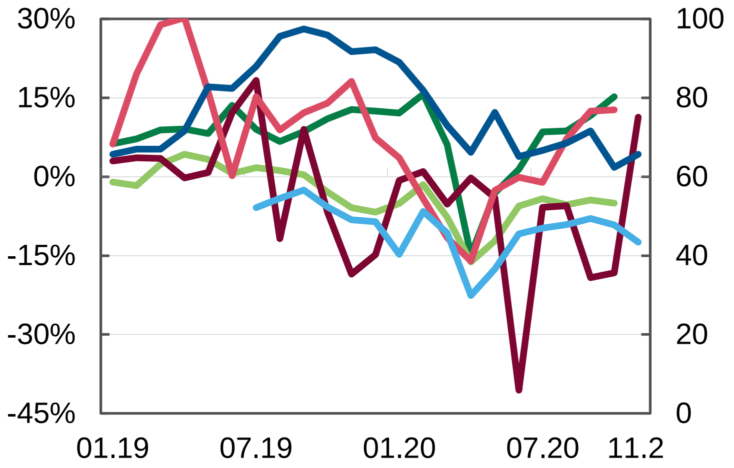
* Brent oil; natural gas from Russia; steel billet, Exp FOB; iron ore – China import, Fines 62% FE; wheat, corn – quarterly average world prices.

Source: NBU, Inflation Report, October 2020.

- GDPs of trading partner countries are recovering thanks to lifting of quarantine restrictions, emergence of vaccines, and massive anti-crisis measures of governments and IFIs.
- Prices on commodities and financial assets are rising to pre-crisis levels.
- Risks of a new wave of pandemics, premature cancellation of incentives (e.g. because of hiking public debt) are high.

The macroeconomic environment is improving

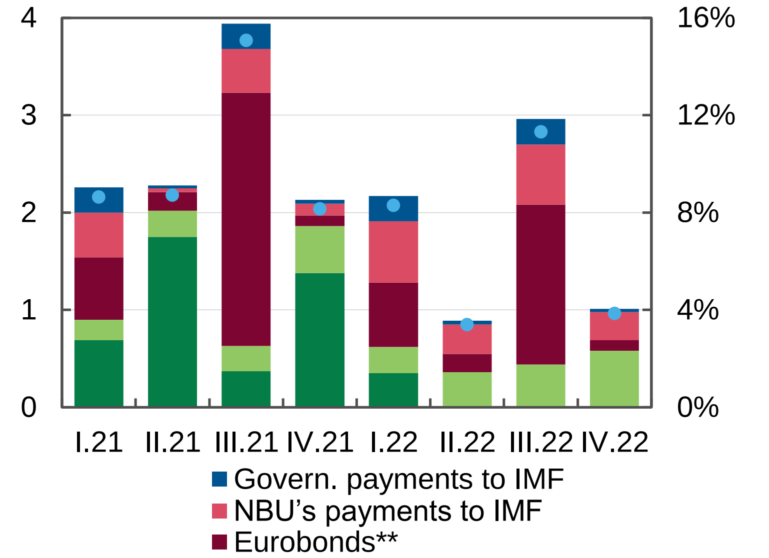
Economic dynamics* and sentiments



*Calculated on the basis of the relevant indices, current month to the same period of the last year ,%; ** CCI - Consumer Confidence Index (calculated by Info Sapiens), BAEI - Business Activity Expectations Index (calculated by the NBU. The value below 50 points signals the predominance of pessimistic business expectations).

Source: SSSU, NBU, Info Sapiens.

Public and publicly guaranteed FX debt repayments, USD billion equiv.*



* Including interests, ** including USD 1 billion–worth of Eurobonds guaranteed by the USA - repayment in the third quarter of 2021, *** forecasted payments in the corresponding quarter to the volume of gross international reserves of Ukraine as of 01.12.2020.

Source: NBU calculations.

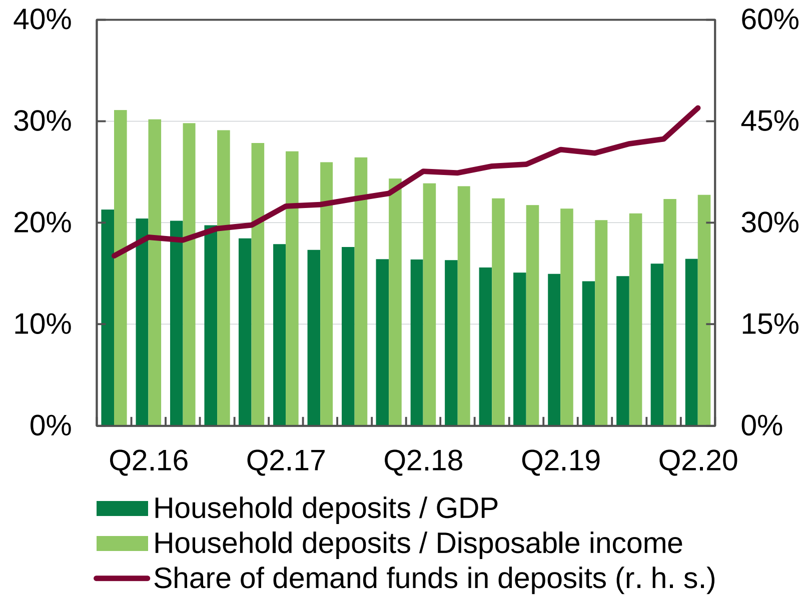
- The economy is recovering fairly quickly from the consequences of spring restrictions, thanks to the stability of domestic demand and favorable external conditions.
- The ability to finance the 2021 budget deficit will depend on access to IFI loans and external private capital markets.
- Payments on foreign currency debt in 2021-2022 will exceed 17 billion dollars.

Real incomes are recovering and household deposits are growing

Change in the main components of household incomes and expenditures

Source: SSSU, NBU estimates.

Household deposits

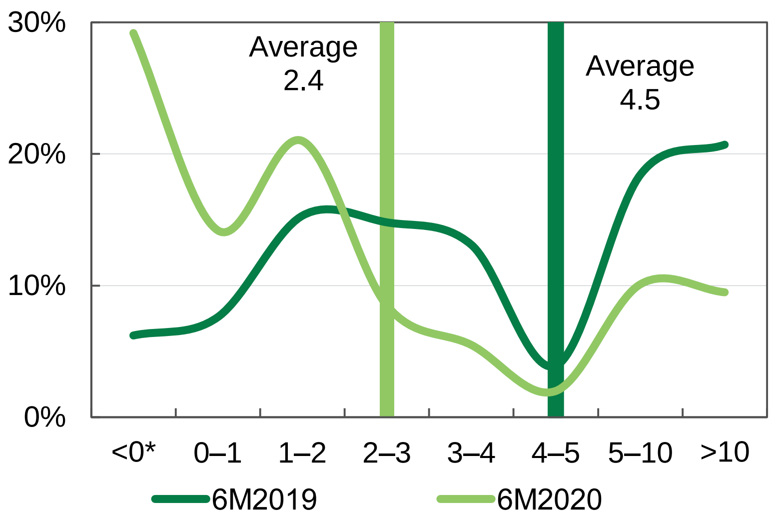


Source: SSSU, NBU estimates.

- The pandemic and deteriorating consumer sentiment have limited consumption and increased the propensity to save for the majority of the population.
- In autumn, real wages rose, in part due to higher minimum wages.
- Deposits at banks grow mainly on current accounts. Demand for loans is gradually recovering.

Corporate portfolios proved to be resilient to crisis

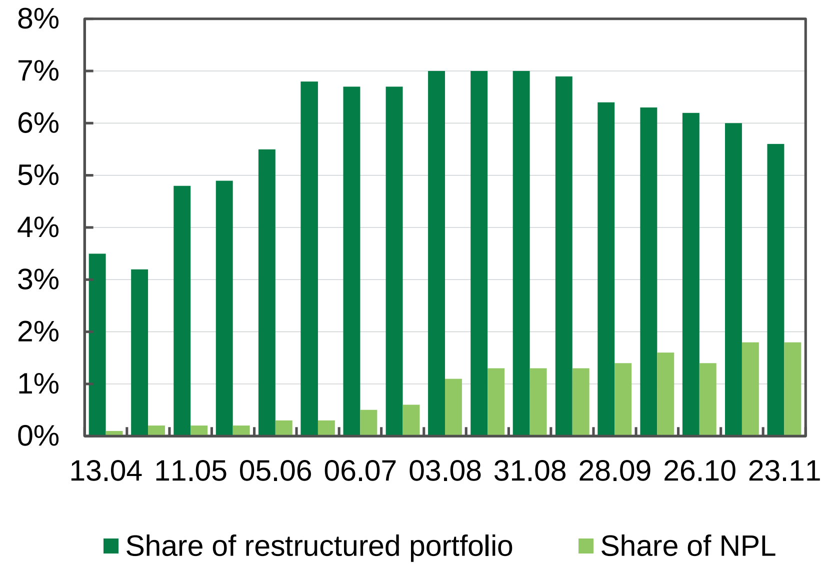
Breakdown of EBITDA to interest expenses for borrowers with performing loans



* Share of borrowers' loans with negative EBITDA. Average value weighted by loan amounts as of 1 July 2020.
Calculated based on standalone financial statements of borrowers.

Source: NBU.

Shares of performing corporate loans as of 1 March 2020, that were restructured and recognized as non-performing since the beginning of the crisis

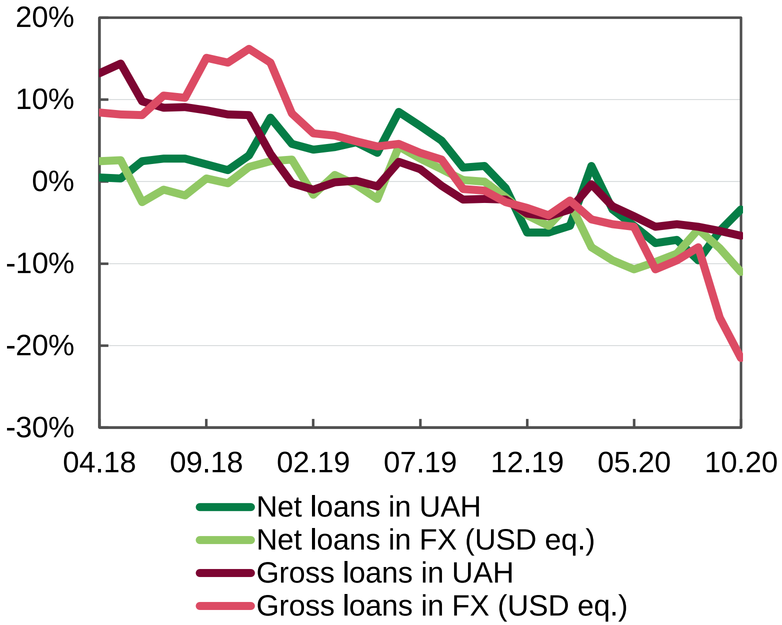


Source: survey of the 22 largest banks, NBU estimates.

- 40% of borrowers with performing loans showed an unsatisfactory EBITDA-to-interest-expenses ratios in 1H2020, which caused a temporary shortage of liquidity.
- Timely restructurings and small exposure to the most vulnerable sectors in the banks' portfolios ensured a relatively smooth passage through recent crisis.
- Further deterioration of the portfolios' quality is possible, but it is already clear that the losses will not be significant.

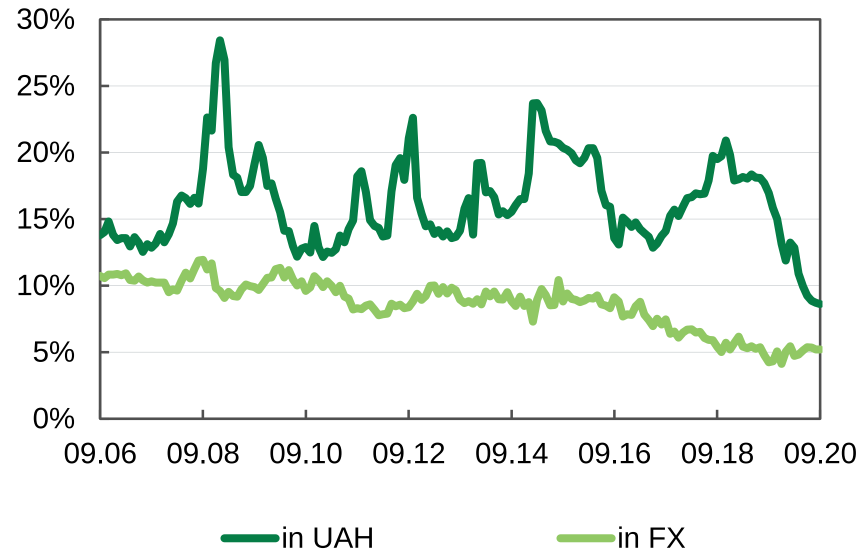
Corporate portfolio has shown the first signs of recovery

Gross and net corporate loans, yoy



In solvent banks as of 1 November 2020.
Source: NBU.

Interest rates on new loans to non-financial corporations (excl. overdrafts)

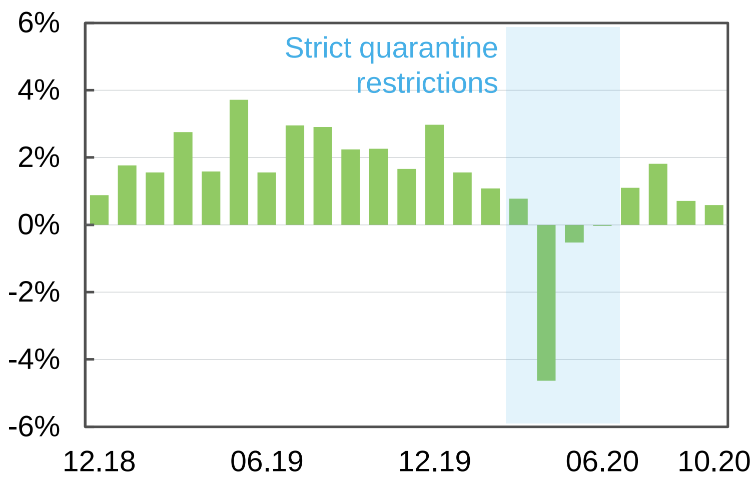


Source: NBU.

- The portfolio has been declining year-on-year; however, since September, there were signs of recovery as the hryvnia portfolio has begun to grow.
- At the same time, lending to SMEs is growing rapidly.
- The cost of the hryvnia borrowing has reached an all-time minimum. FX interest rates also remain low.

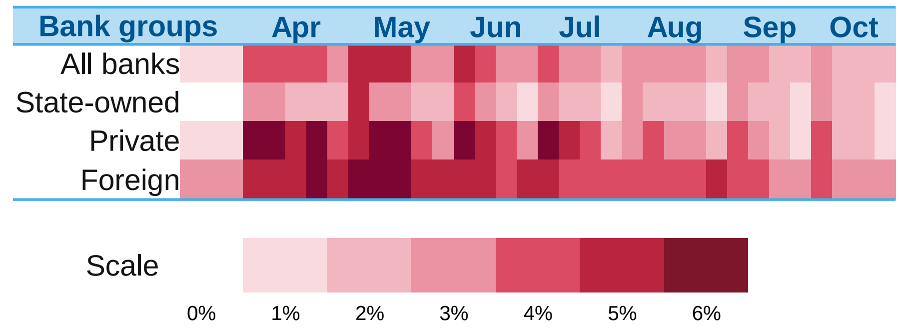
Consumer lending growth is slower than it was before the crisis

Change in net hryvnia consumer loans, m-o-m



Source: NBU.

Change in fraction of overdue hryvnia loans to households comparing to 1 March 2020

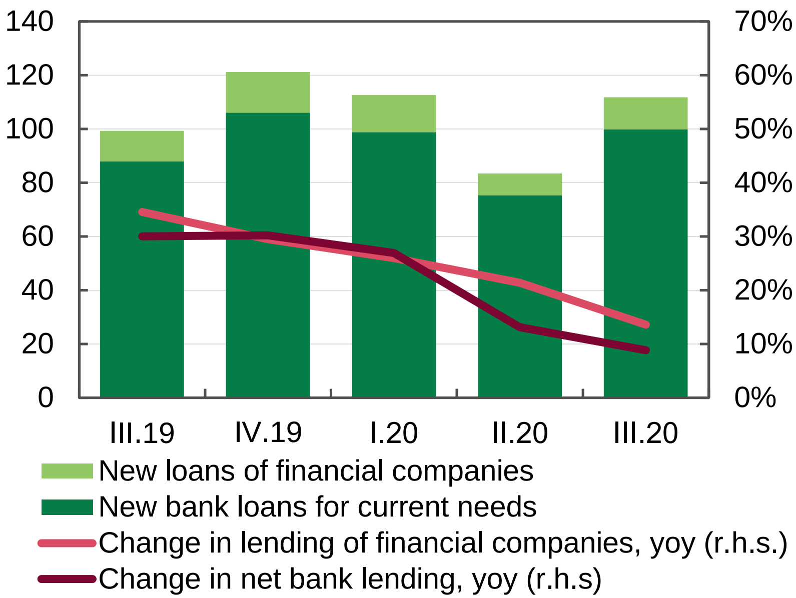


Source: banks data, calculations of the NBU.

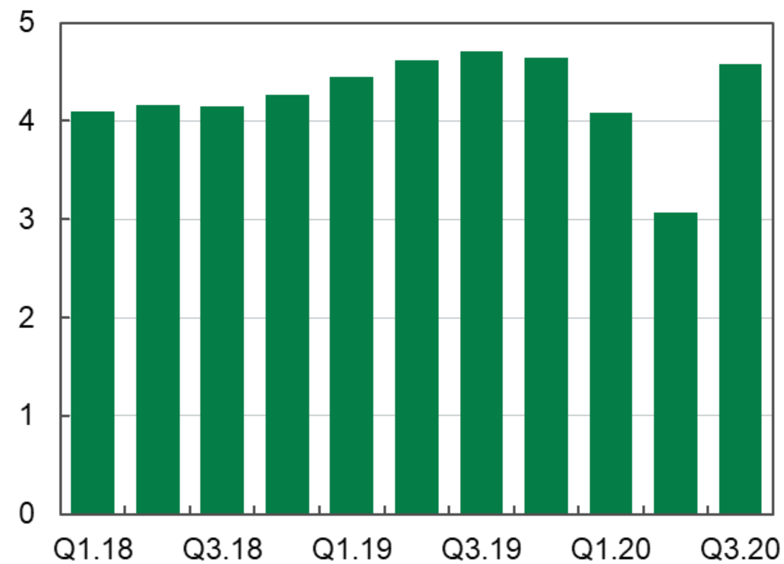
- Consumer lending is growing but slower than before the crisis.
- Overdue peak has passed, but part of the credit risk will be recognized only in the beginning of 2021.
- Two stage implementation of higher risk weights in 2021 will help to decrease segment’s risks.

Migration of retail lending to non-banking segment did not occur

Retail lending, UAH billions



Pawnshop lending, UAH billions

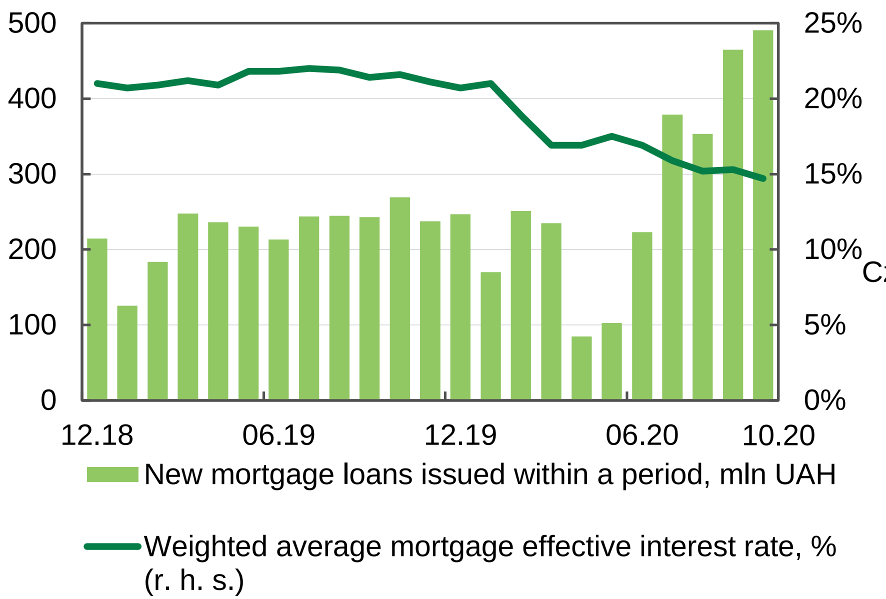


Source: NBU.

- Consumer lending in banking and non-banking segments grew at rates close to 30% prior to 2020.
- During the crisis, lending in both segments slowed down, clients' migration between segments was nearly non-existent.
- Finance companies and pawnshops almost regained volumes of new lending in the third quarter.

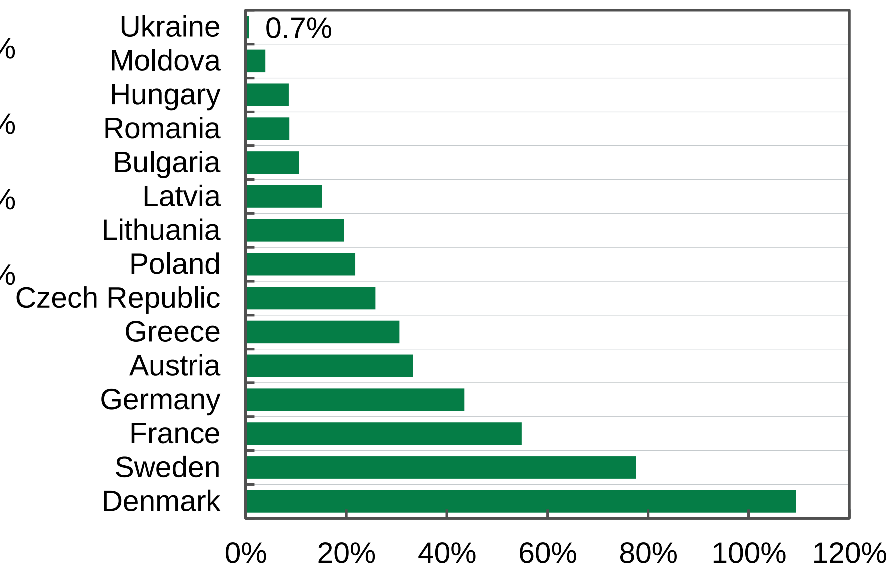
Mortgage lending is rebounding, but from an extremely low base

New housing loans and the cost of mortgage



Source: banks' data.

Mortgage portfolio to GDP* ratio in 2020 by countries



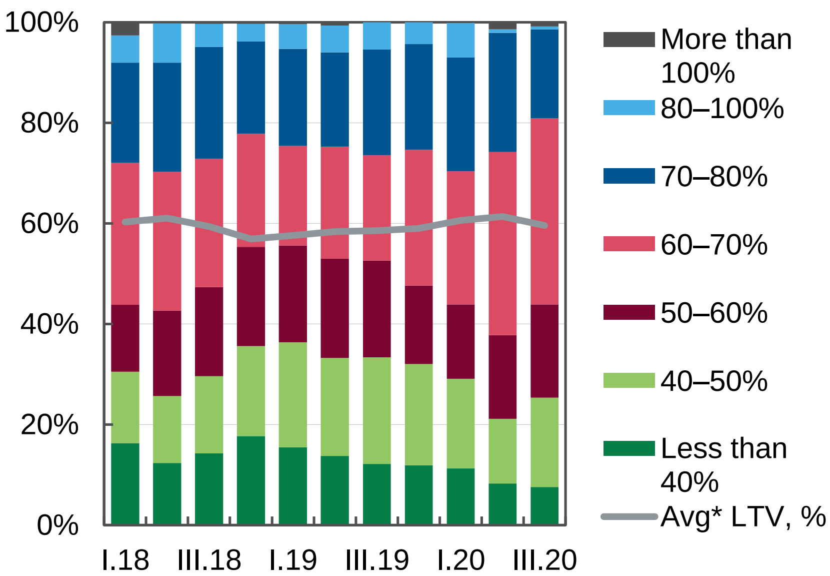
*GDP forecast for 2020 – an estimate by the IMF in «World Economic Outlook» as of October.

Source: ECB, IMF, National bank of Moldova, banks' data.

- In the first ten months of 2020, effective rate for the new mortgage loans fell by almost 7 p. p.
- The amount of new mortgage lending is rising, but from a very low level: a ratio of mortgage portfolio to GDP is abnormally low.
- Almost 90% of new mortgages are issued for the purchase of housing on the secondary market.

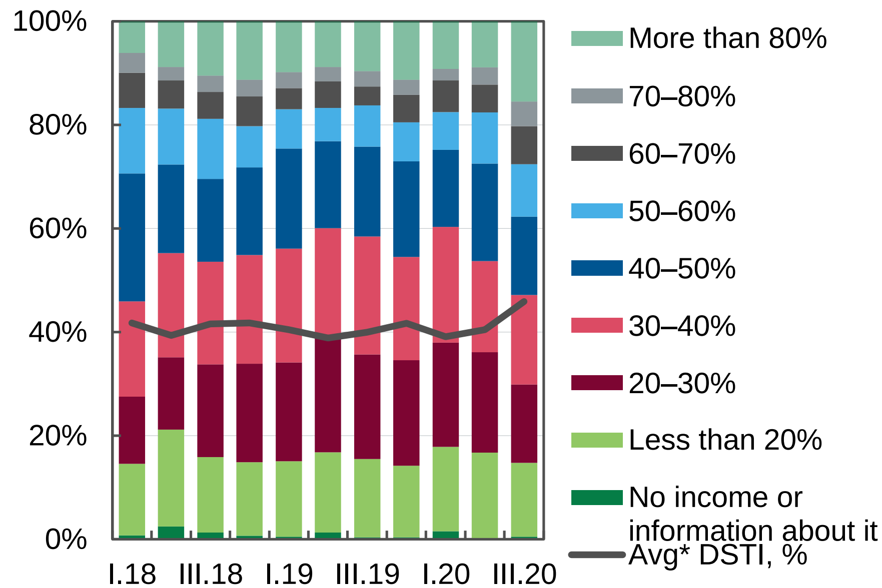
Debt burden has risen, but lending standards are still conservative

Loan distribution by LTV



*Weighted by the volume of loans issued
Source: banks' data.

Loan distribution by DSTI at origination

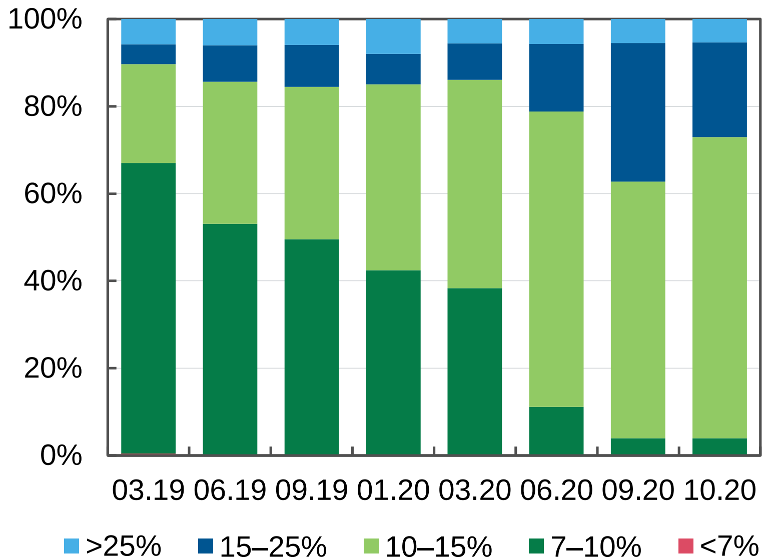


*Weighted by the volume of loans issued
Source: banks' data.

- In the third quarter of 2020 the Loan-to-value ratio was quite low at 59.6%.
- However, the Debt-service-to-income ratio has risen over a year and now stands quite high at 45.9%.

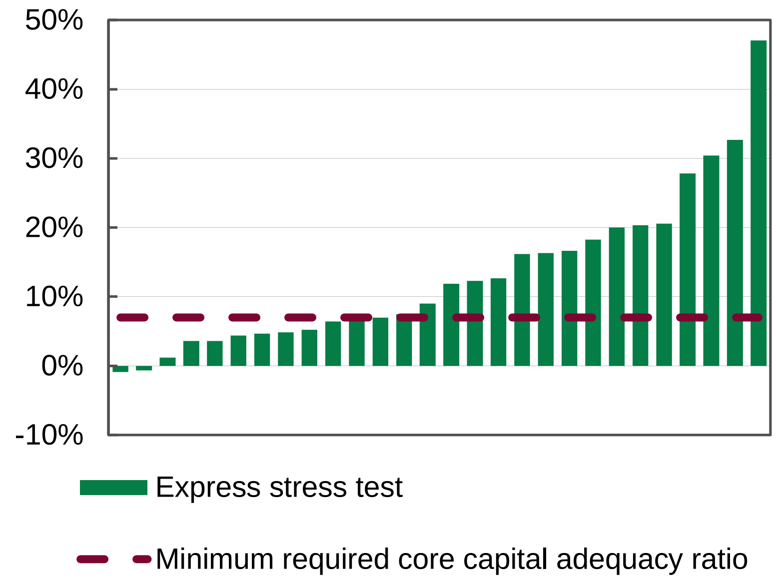
Risks to banks' capital weakened

Core capital adequacy distribution by assets' share



Source: NBU.

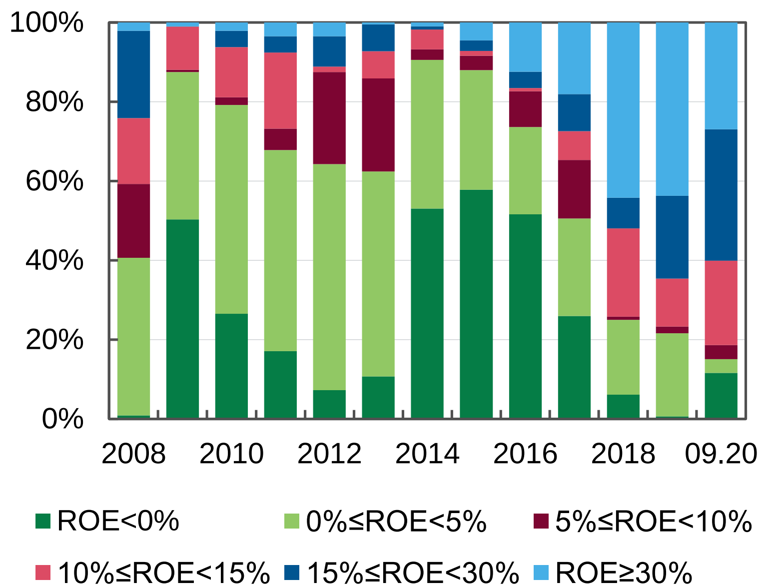
Core capital adequacy ratio for individual banks over one-year horizon: based on express stress test



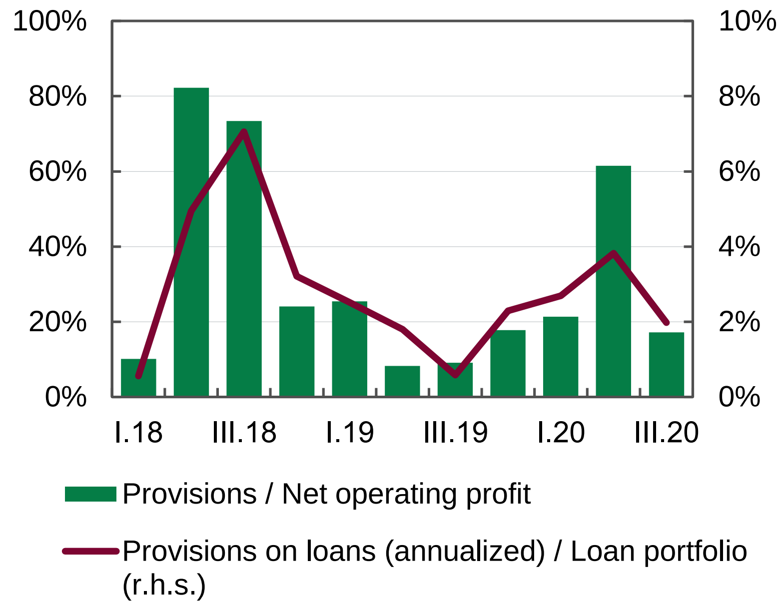
- As a result of lower credit risk and moderate decrease in revenue during the crisis, negative impact on banks' capital was lower than expected.
- Recapitalization of a large state-owned bank significantly decreased capital risks.
- From now on, banks have to manage capital with regard to new regulations and profitability risks.

Impact of the COVID Crisis on profitability is still moderate

Breakdown of banking sector assets by ROE of banks



The ratios of loan loss provisions and loan portfolio or net operating profit

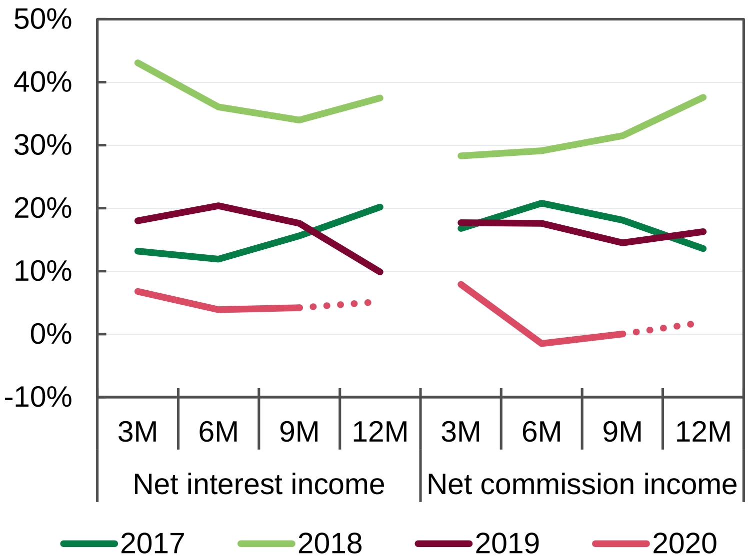


Source: NBU

- The sector's profits fell by less than a quarter. However, it was higher than for the whole of 2018. Banks accounting for 60% of the sector's assets operated with ROE of more than 15%.
- Provisions more than doubled, but a third of them were made by Privatbank against legal risks in Q2. It will be feasible to estimate the full scale of credit risk losses in early 2021.

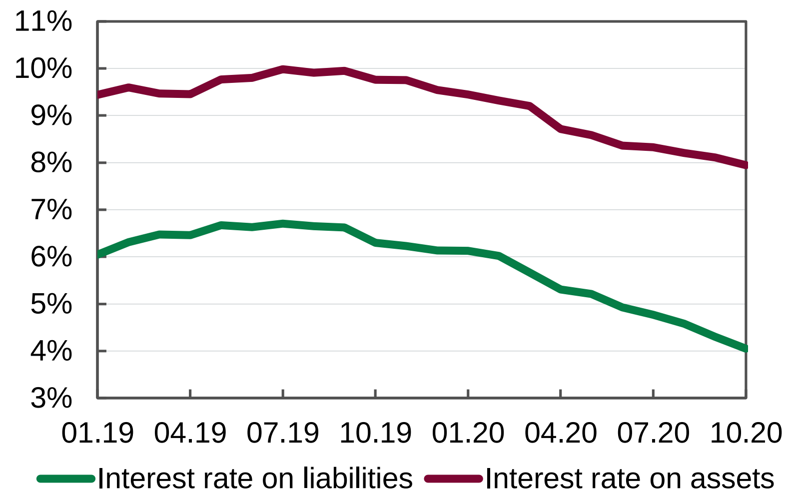
Operating income proved resilient to the crisis

Change in net interest and net commission income, yoy



* In 2020, annual data - for 10 months.
Source: NBU

Interest rate on assets and liabilities, % per annum *

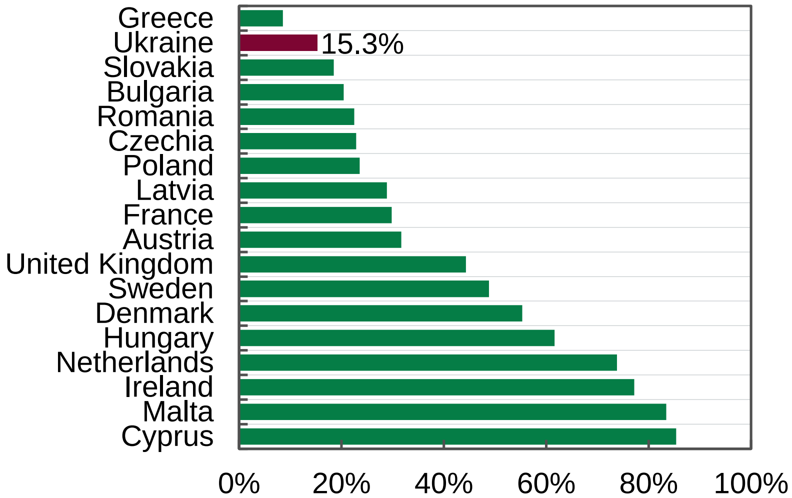


* Three-month moving average. The following segments are taken onto account: retail, businesses, banks, the NBU (including certificates of deposit), authorities (including T-bills); IFIs funds and subordinated debt.

- Net interest income increased moderately yoy.
- Net fee and commission income decreased in the second quarter, but recovered in the third quarter, in particular due to the transition to the online services format.
- The interest spread will gradually narrow. Loans will become cheaper, while room to cut deposit rates is limited.

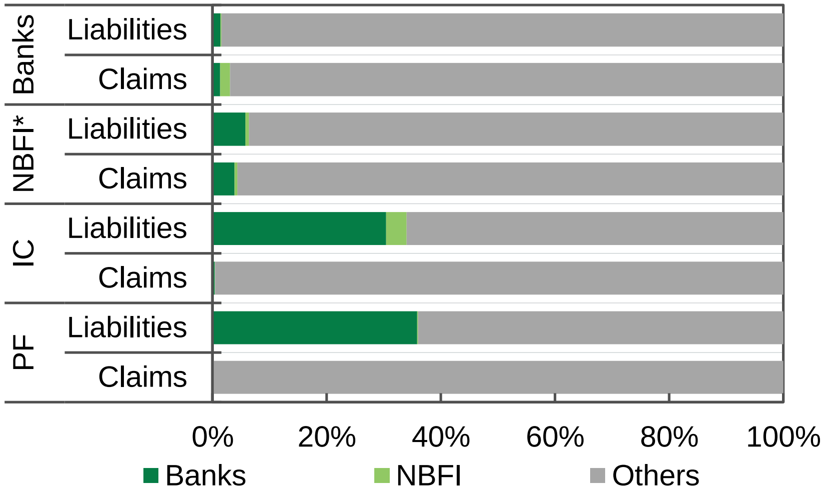
Non-banking financial sector does not carry systemic risks

Share of non-banking financial sector in European countries as of 1 July 2020



Source: Eurostat, NBU.

Exposures between banking and non-banking sector in Ukraine



* All non-banking financial institutions. PF – non-government pension funds, IC - insurers.

Source: NBU.

- Macroprudential policy strategy was updated due to transition of some Non-banking financial institutions (NBFI) under the NBU regulation.
- NBFIs hold minor share in Ukrainian financial sector's assets, significantly lower than in European countries, exposures between NBFIs and banks are moderate.
- Long term funding, low correlation between risks and macro environment, and diversified operations lower probability of systemic risks development in the segment.