National Bank of Ukraine

Financial Stability Report
June 2021

22 June 2021

Summary

- Economy is recovering from the crisis, driven primarily by strong private domestic demand and favorable terms on external markets.
- Financial stress index points at a low level of stress in the financial sector.
- Most of the companies weather through the COVID crisis without significant losses. Only enterprises in a few segments face serious issues.
- Banks are profitable and well capitalized, they have adjusted to work under quarantine. That allows them to step up lending in both retail and corporate segments.
- Last year, banks actively invested in government debt securities. Thus, they financed a notable proportion of budget deficit then access to external financing was limited. However, investing in government debt did not limit or discourage banks from lending into economy.
- In crisis-hit 2020, bank provisioning for loan losses doubled. However, provisioning remained moderate on general.
- Maturity composition of banks' liabilities has changed a lot over the last year and a half: the share of demand deposits rose. However, funding remains stable overall.
- The effect from falling funding cost for interest margin has almost exhausted. Going forward, loan rates are to decline, interest margin of banks is likely to narrow.
- The sector remains profitable, key income components are surging. The banks channel a material proportion of their income to build up capital.
- Persistence of high bank profitability as a source of capital allows the NBU to proceed with introduction of regulatory changes. That includes capital requirement to cover operational risks as well as setting a schedule for building up capital buffers.

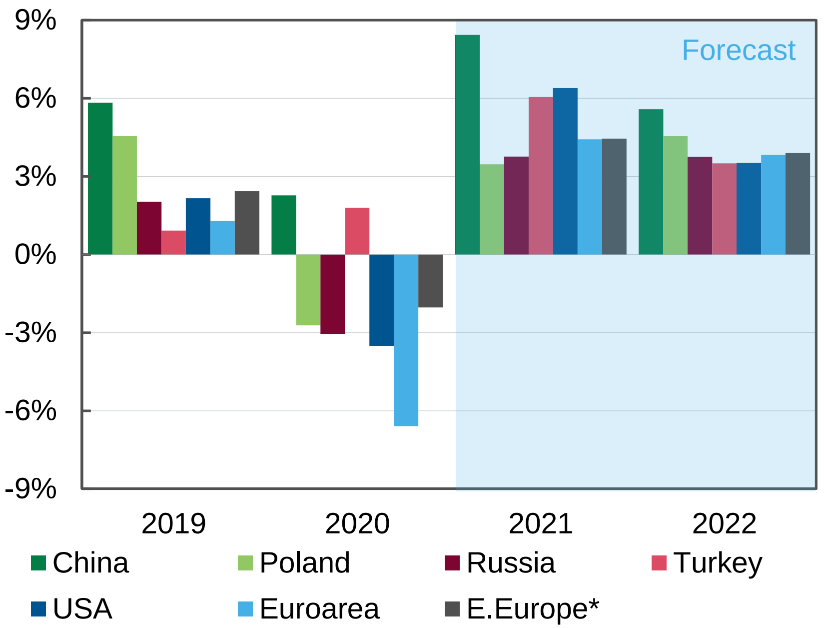
Readings of the Financial Stress Index are low, yet volatile

Source: NBU.

- The Financial Stress Index remains low.
- Volatility in March and April 2021 was provoked by rising risk-free rates in US dollars and heightened threat of Russian army invasion. Subindices of public and corporate securities reacted the most.
- Stress of the banking sector subindex is around historical lows.

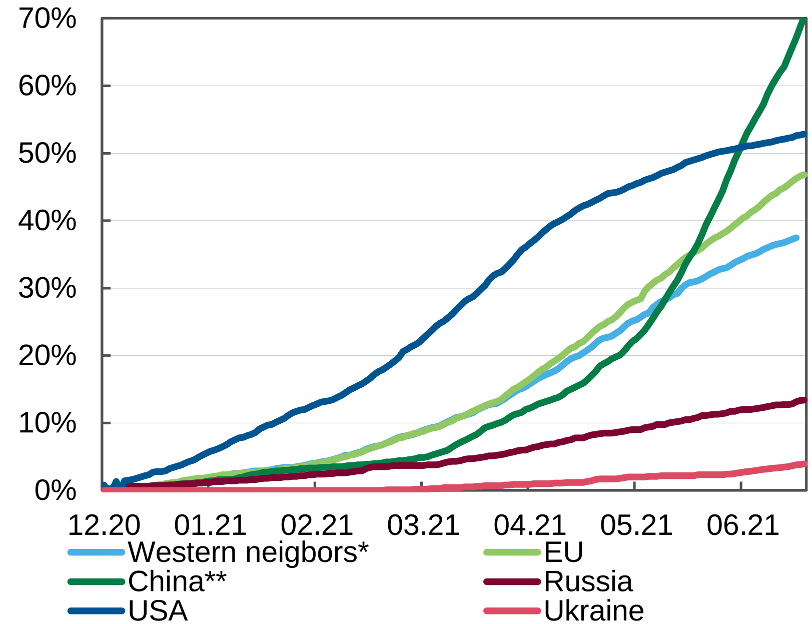
GDPs of major partners and commodity prices rise, but risks are high

Change in GDP of major trading partners of Ukraine



* Eastern Europe includes Belarus, Ukraine, Moldova.
Source: World Bank, Global Economic Prospects, June 2021.

Vaccinated people, % of population

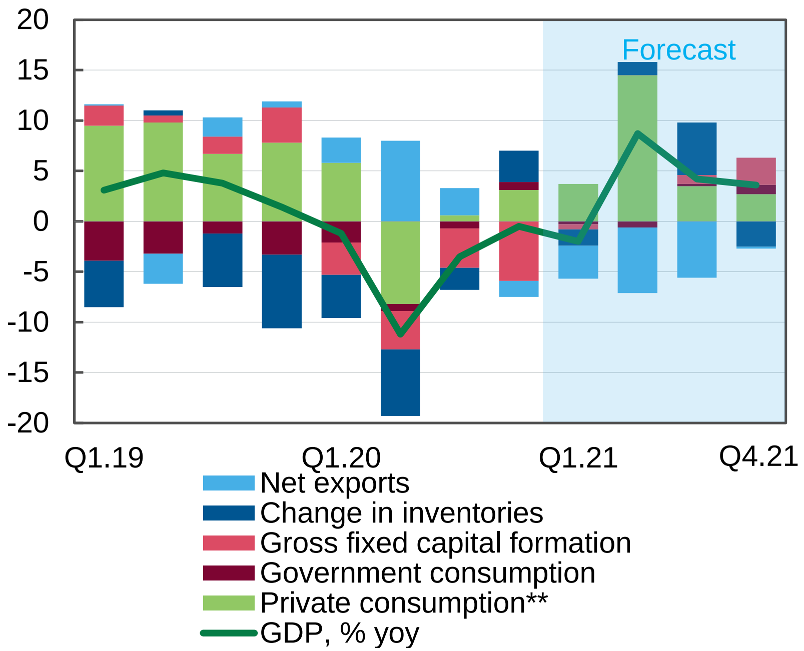


* Western neighbors include Bulgaria, Czech Republic, Hungary, Lithuania, Poland, Romania, Slovakia; their data weighted for population size.
** Number of vaccination per 100 of population.
Source: Our World in Data.

- GDPs of major trading partners of Ukraine are rising. However, the growth is uneven, largely due to different vaccination rates.
- Commodity prices have soared, in particular prices for Ukrainian exports.
- COVID remains the key challenge. Rising risk-free interest rates in advanced countries pose risks for new borrowings.

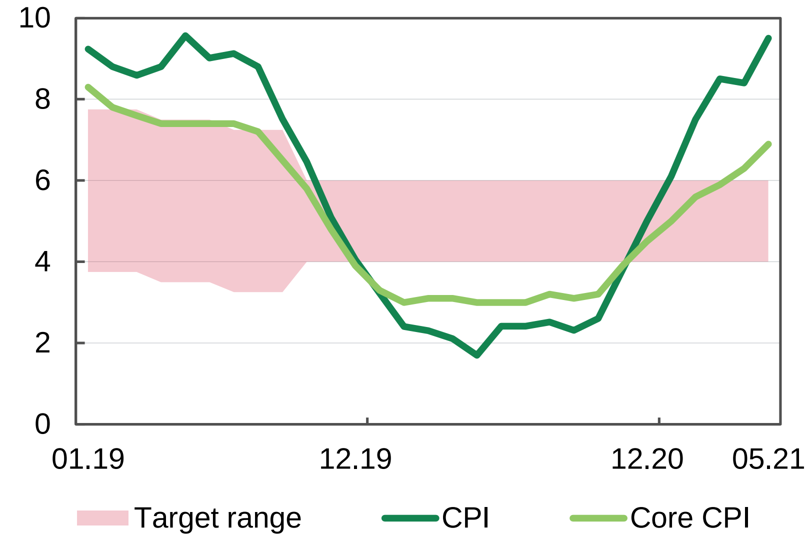
Economic recovery is slower than expected

Contributions to annual GDP growth by final use, pp



* Forecast for the Q2-Q4 from April 2021 (will be updated in July).
** Including non-profit organizations serving households.
Source: State Statistics Service of Ukraine (SSSU), NBU calculations.

Consumer price index and NBU's target range

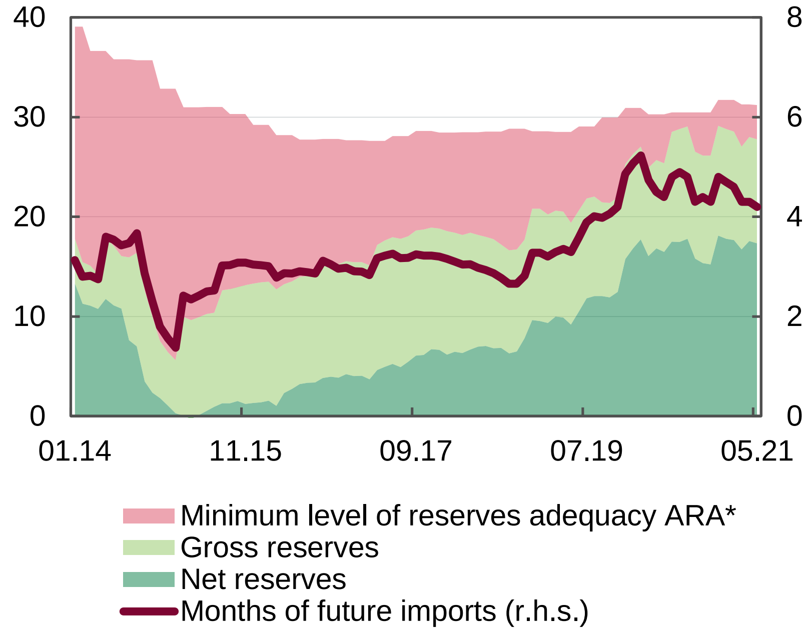


Source: SSSU.

- According to preliminary estimation, GDP dropped by 2% in Q1 yoy.
- Early this year, inflation exceeded target range of 5±1% and accelerated further. In NBU estimations, inflation is to return into the range only in 2022.
- NBU's monetary policy remains accommodative in spite of policy rate hikes early this year.

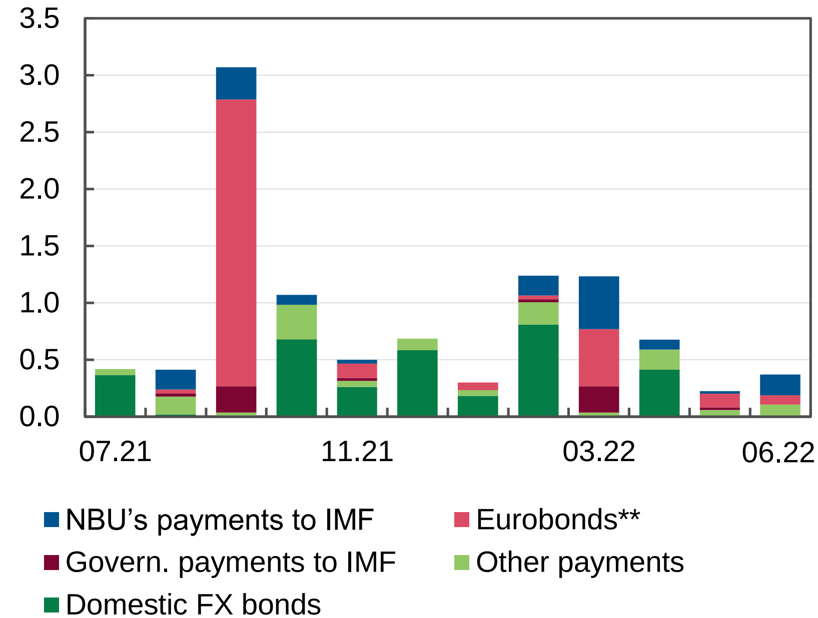
Ukraine needs cooperation with the IMF to mitigate economic risks

International reserves, USD billions



* The minimum level of ARA reserve adequacy according to the IMF methodology.
Source: NBU.

Public and publicly guaranteed FX debt repayments, USD billions equivalent*

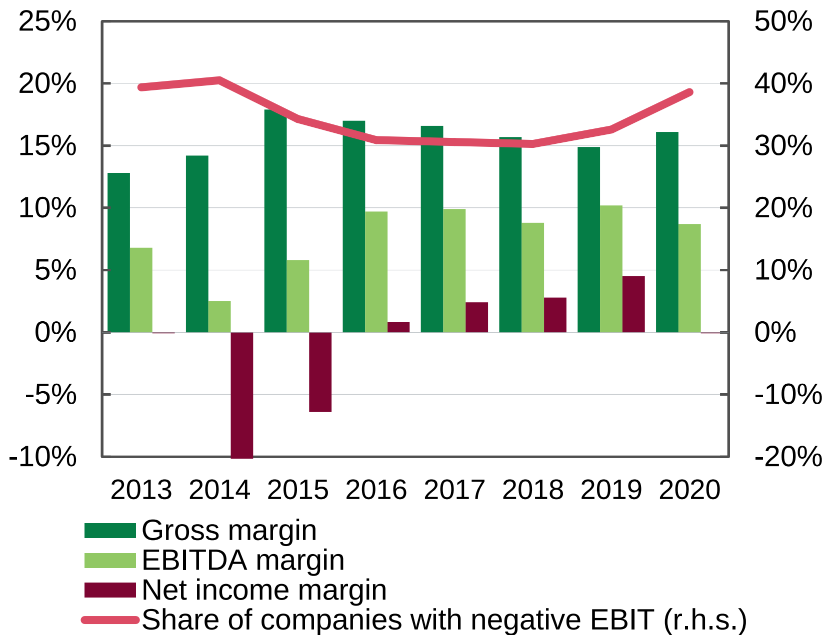


* Including interests. ** including Eurobonds for 1 billion dollars guaranteed by the USA - repayment in September 2021.
Source NBU calculations.

- International reserves are at relatively comfortable level, close to minimum level of reserve adequacy according to IMF composite indicator.
- Cooperation with the IMF will ensure mitigation of threats to financial stability. Given current Ukraine's credit ratings, absence of regular access to official international financing poses risks.

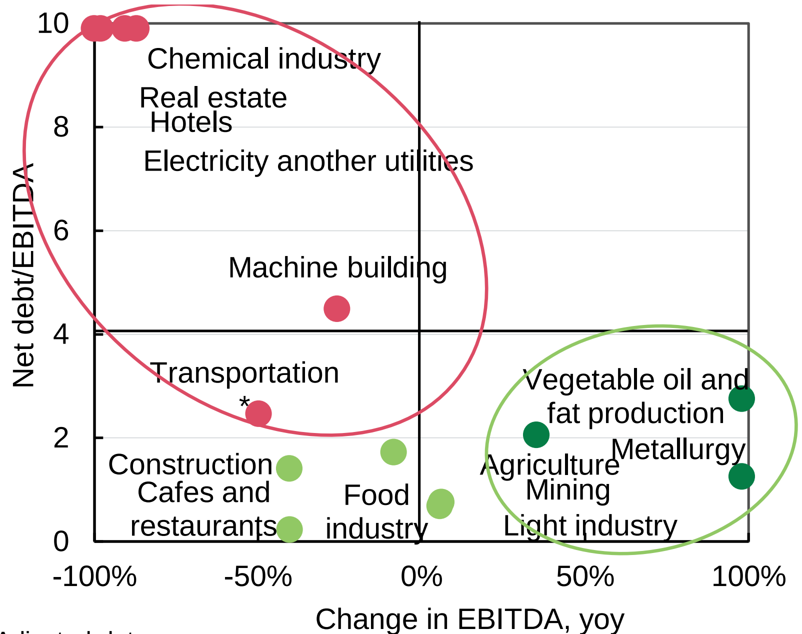
Real sector: uneven and gradual recovery continues

Real sector profitability and share of companies with operating losses



Source: SSSU, data.gov.ua, NBU calculations.

Debt burden in 2020 and EBITDA change from 2019 to 2020, by industries

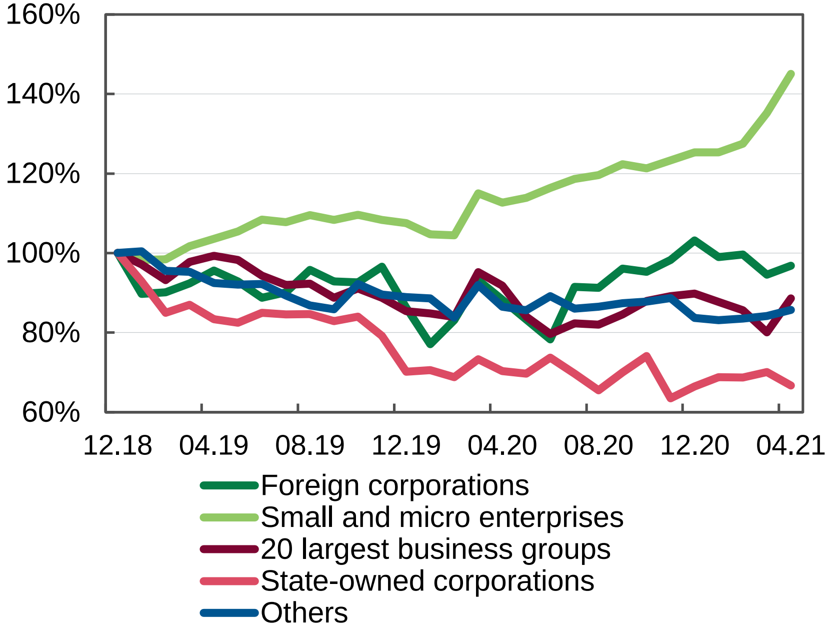


Adjusted data.
* Excluding pipeline transportation.
Source: data.gov.ua, NBU calculations..

- Real sector weathers through this crisis in a better shape than it did it during previous ones. A large proportion of enterprises are financially stable and profitable.
- Most of the industries keep acceptable debt burden despite the crisis. Aggregate Debt/EBITDA is acceptable in spite of increase to 2.7x.
- Service industries that suffered the most from the COVID crisis may face lasting structural problems.

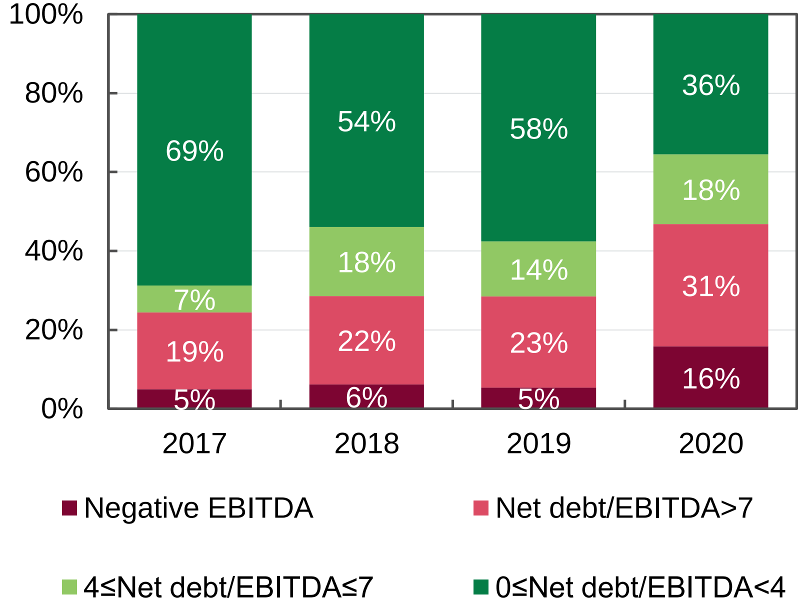
Corporate portfolio – cautiously positive assessment

Net corporate loans by groups of non-financial corporations, December 2018 = 100%



In solvent banks as of 1 May 2021.
Source: NBU.

Breakdown of corporate borrowers* by debt load

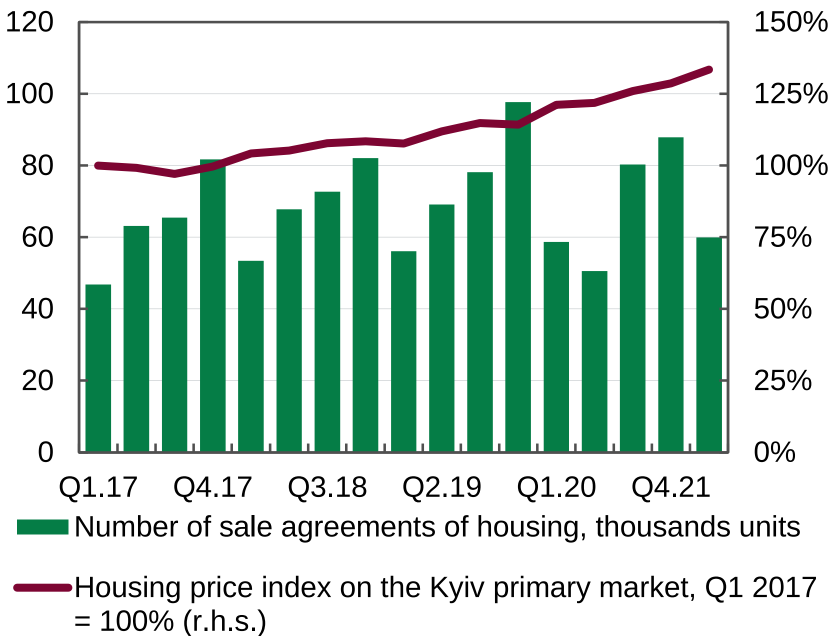


* Performing loans as of 1 January 2021 with outstanding amount of more than UAH 2 million..
Source: NBU, data.gov.ua, NBU estimates..

- Volume of corporate lending increases moderately but steadily.
- Lending to small and medium enterprises remains a driver of corporate portfolio growth.
- Financial indicators of borrowers deteriorated in 2020. However, it does not cause serious concerns for majority of borrowers.

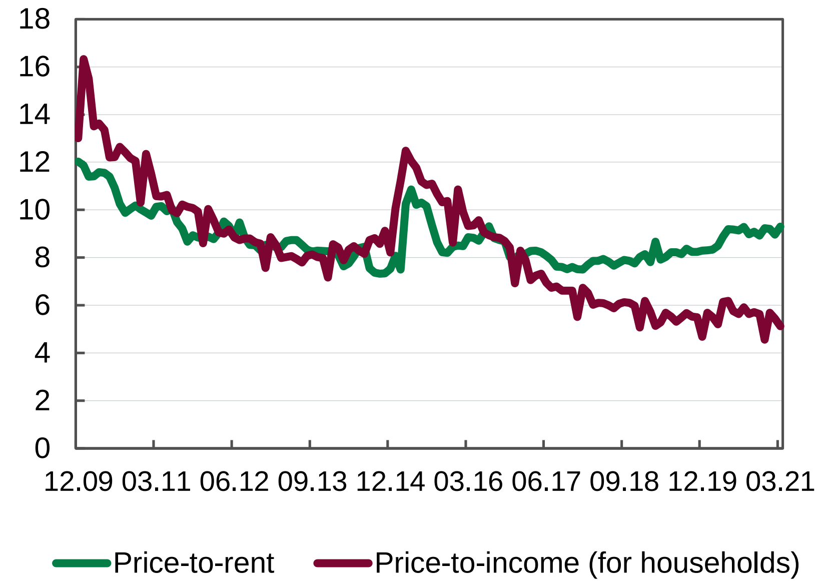
Housing price goes up, but it remains relatively affordable

Housing market activity



Source: Ministry of Justice, real estate agencies, SSSU.

Price-to-income and price-to-rent ratios of the primary real estate market of Kyiv

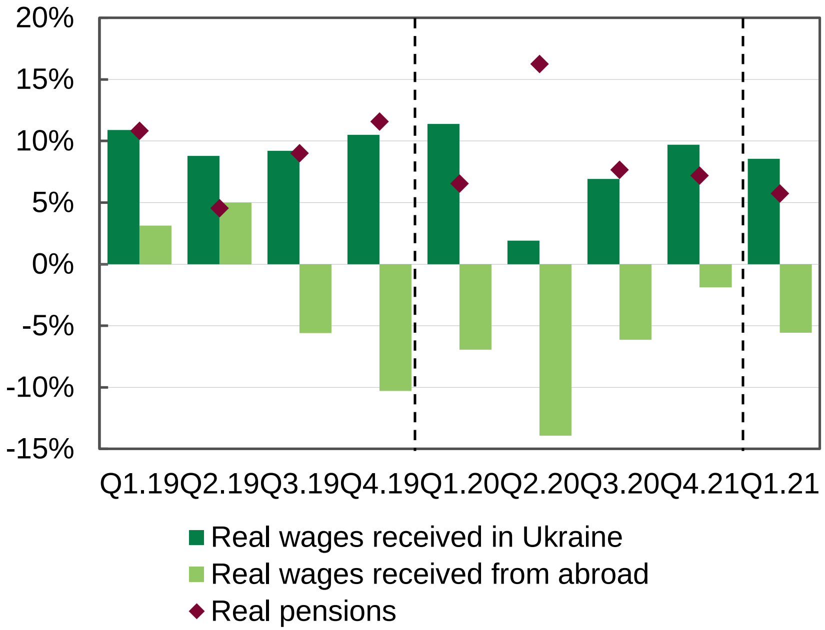


Source: SSSU, real estate agencies, NBU estimates.

- Housing price is on the rise: in April, prices on both primary and secondary market of Kyiv went up by more than 10% yoy.
- Housing remains affordable in relative terms, as prices and incomes of households increase at commensurate rates.

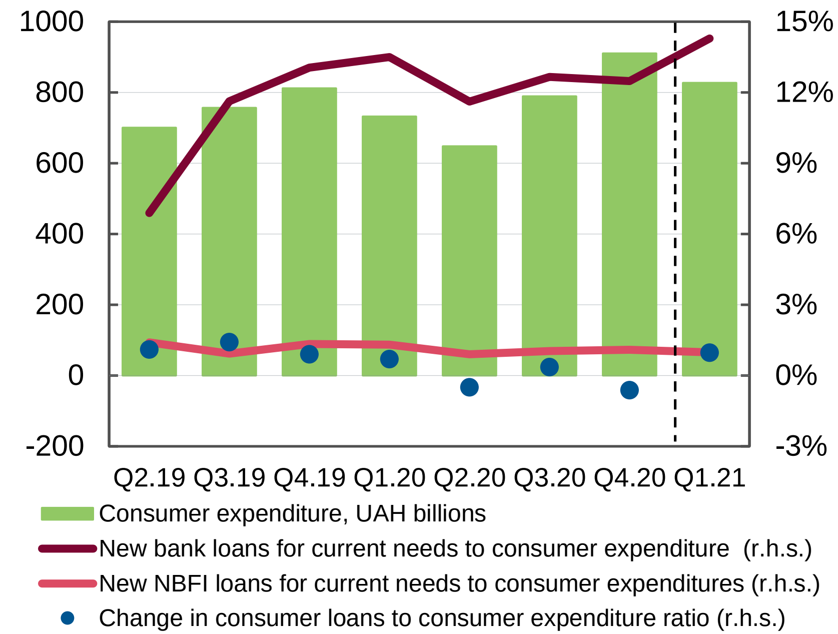
Households: real incomes and consumption rise

Change in real wages and pensions, yoy



Source: SSSU, NBU calculations.

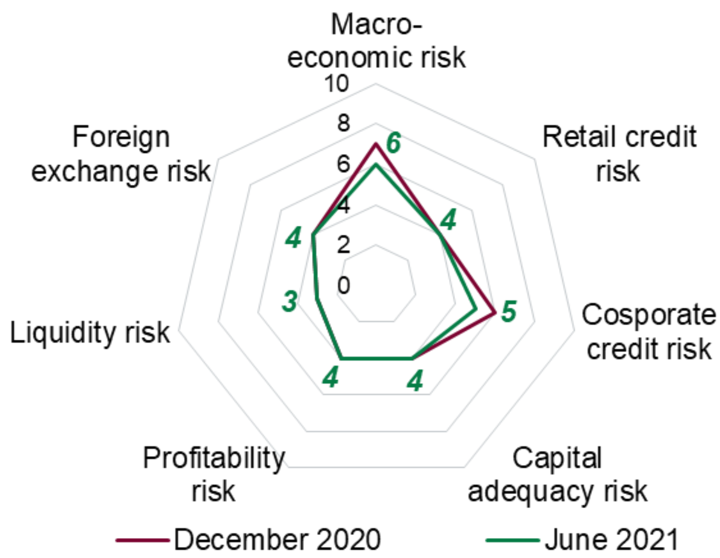
Impact of consumer lending on household consumption



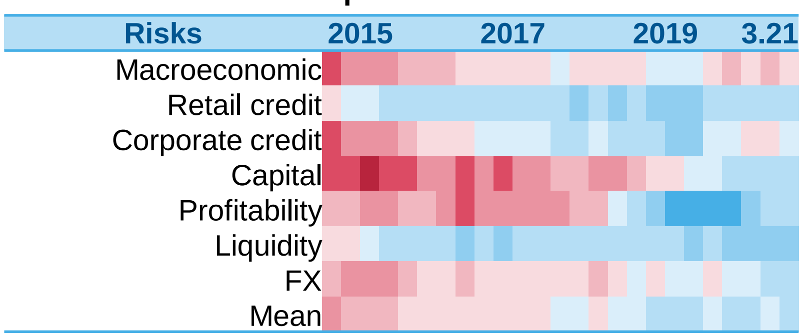
Source: SSSU, NBU calculations.

- In the first four months of 2021, average real wage increased by 11.3% yoy.
- Consumer sentiment recovered to pre-crisis levels, thus promoting consumption and credit demand.
- Total debt burden on households trends further down thanks to an increase in nominal income that outpaces lending growth.

Financial sector risk map



Financial sector heat map



Macroeconomic risk has declined (-1) and returned to a pre-crisis level, thanks to positive GDP forecast and drop in value of 5-year CDS for sovereign securities.

Credit risk of households is flat: moderate since H2 2020. Expectations on retail loan quality improved.

Credit risk of corporate sector has fallen (-1). Market sentiments are improving, yet deteriorating financial results of enterprises reflect an impact of previous crisis.

Capital risk is unchanged. High capital adequacy ratios push it upwards, while low leverage ratio puts downward pressure on it.

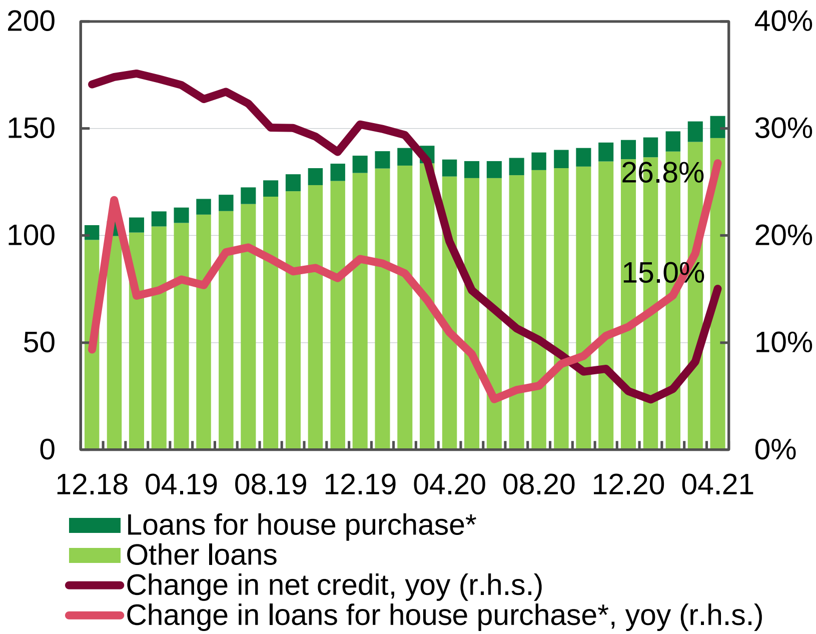
Profitability risk is constant. Operating efficiency of banks has deteriorated, but profitability indicators stay high.

Liquidity risk has not changed and remains the lowest one, promoted by a surge in household deposits.

FX risk is unchanged. Thanks to low exchange rate volatility, sufficient international reserves and upbeat expectations, FX risk remains moderate.

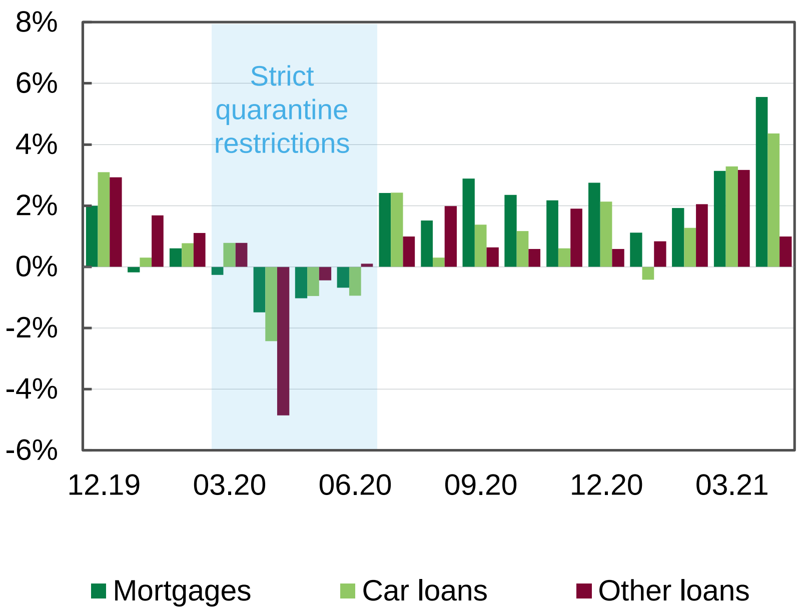
Retail portfolio growth accelerates

Net hryvnia retail loans, UAH billions



At banks that were solvent on 1 May 2021.
* Loans for real estate purchase or reconstruction.
Source: NBU.

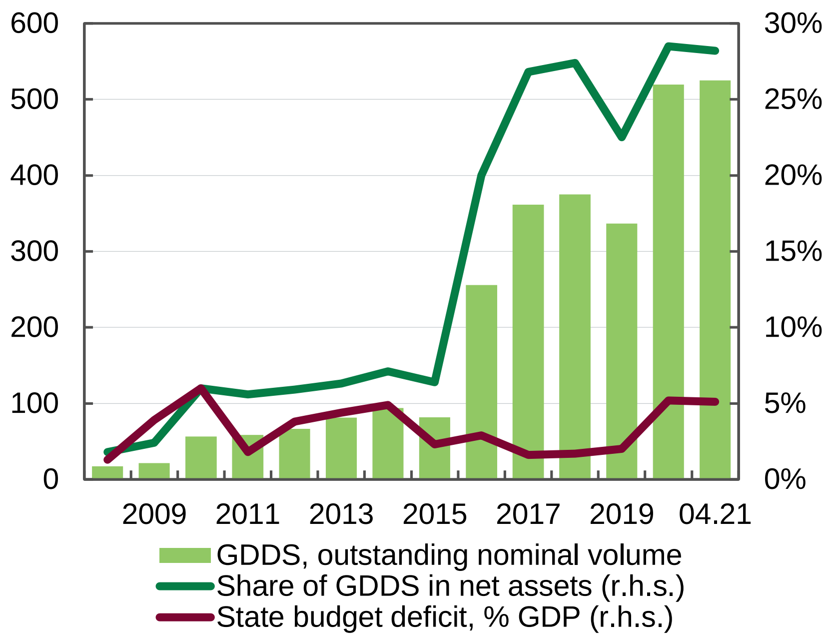
Change in net retail credit, mom



- The year-on-year growth of retail loan portfolio has accelerated notably to 15% (to 27% for mortgage segment).
- The rates of growth in the portfolio are steady and depend only marginally on waves of quarantine restrictions.

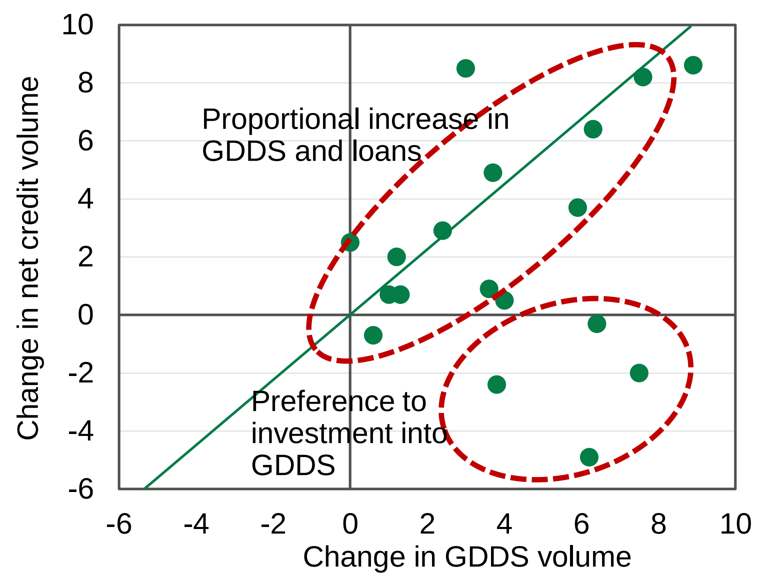
Government debt security in banks’ portfolios increased underpinned by NBU refinancing

Government domestic debt securities (GDDS) in terms of nominal volume, their share in net assets, and State budget deficit



At banks that were solvent on 1 May 2021.
Source: NBU

Change in volume of Government domestic debt securities (GDDS)* and net loans at Top-20 banks, yoy, UAH billions**

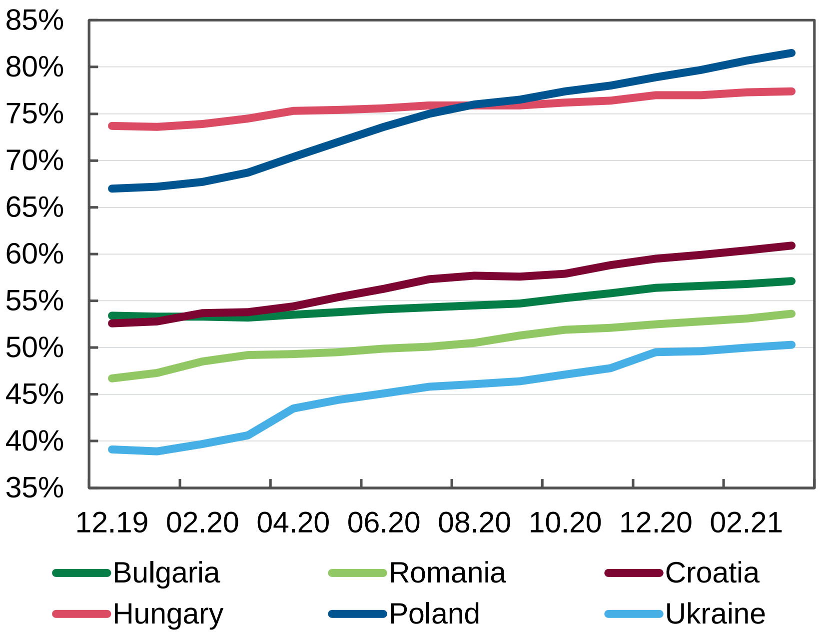


* Excluding GDDS issued to recapitalize state-owned banks. Excluding two largest state-owned banks. ** In all currencies, exchange rate fixed as for 1 January 2020.
Source: NBU.

- Like most other countries, Ukraine expanded budget deficit while fighting COVID.
- The banks were the major investors in GDDS in 2020. Three factors were at play: free liquidity, moderate demand for loans, and rising yields of GDDS
- Bank demand for GDDS was underpinned by NBU refinancing, which became longer.
- Banks investment in GDDS did not squeeze out lending.

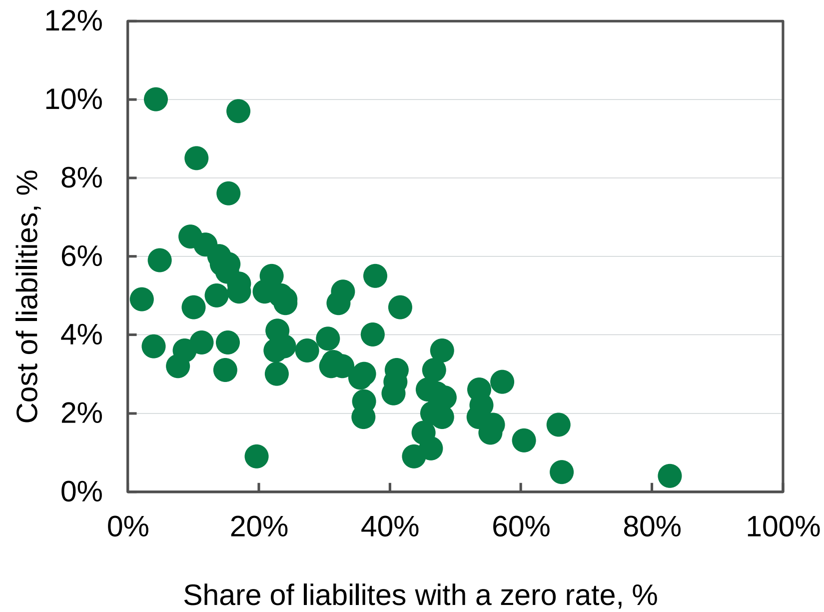
Short-term stable funding is a reality for long

Share of demand deposits in retail deposits



Source: NBU, ECB, the central banks.

Cost of liabilities and share of zero-rate liabilities by banks as of 1 May 2021



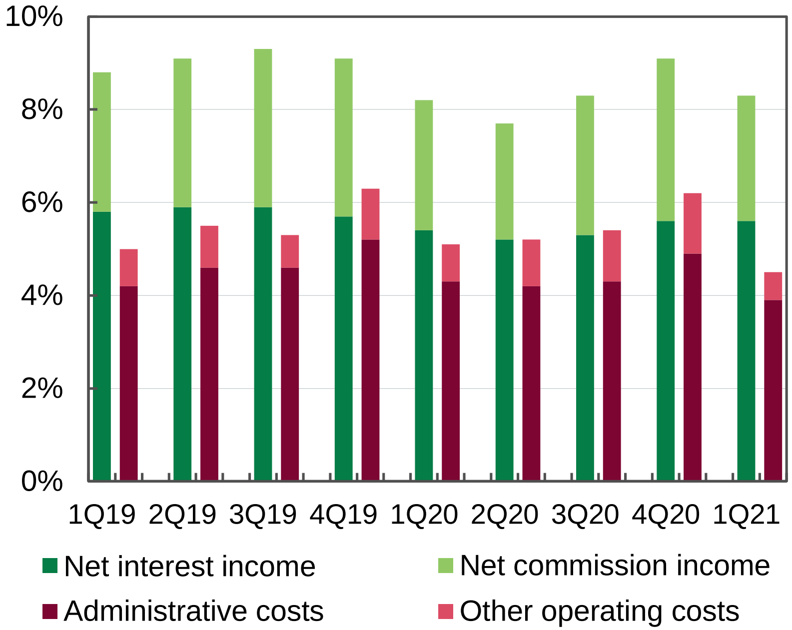
Source: NBU.

- Share of retail demand deposits increased, but is still below those observed in most of peer countries.
- The drivers are lower interest rates on term deposits and a wish of households to have an unrestrained access to their savings during the pandemics.

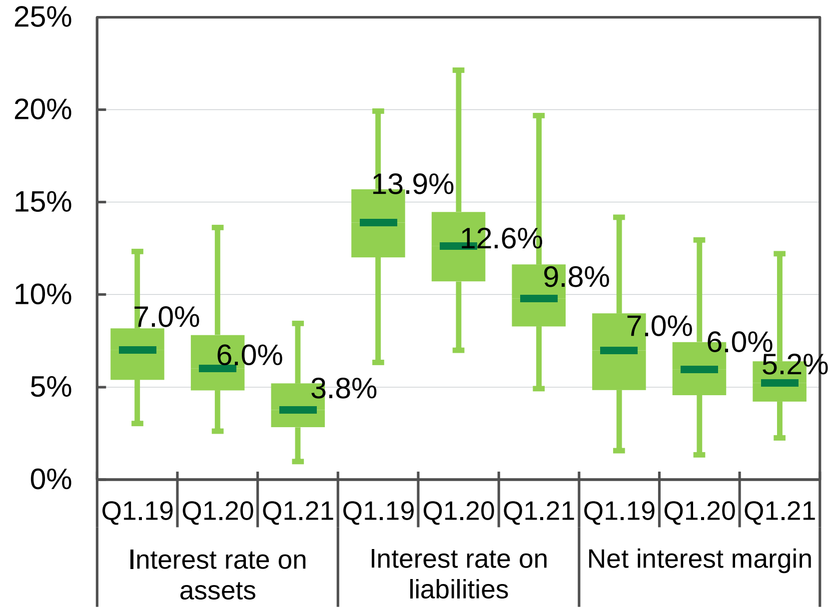
National Bank of Ukraine

Risks to profitability arise only in a few clusters

Ratios of operating income and operating costs to net assets



Cost of assets and liabilities and net interest margin*

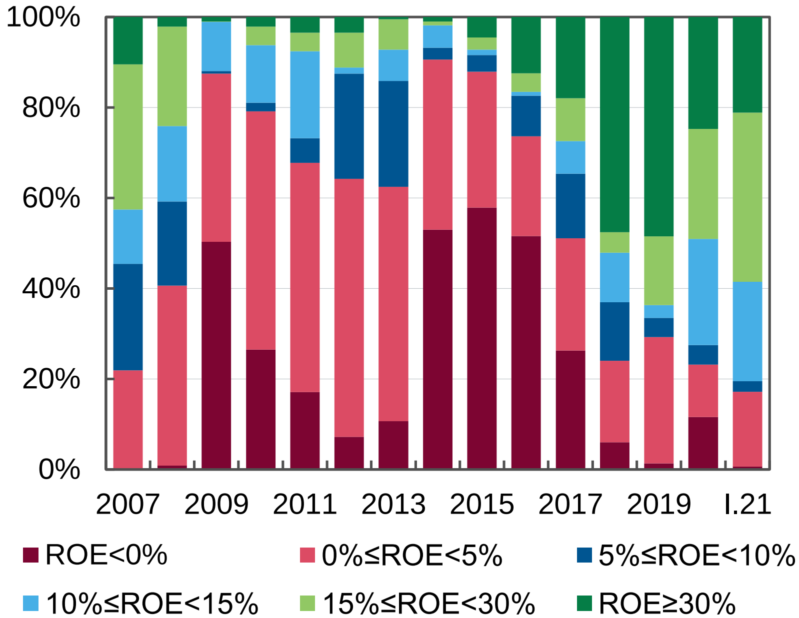


* Upper and lower edges of the green rectangles represent the first and the third quartiles of the indicator distribution across the banks for the date. The dashes inside the rectangle shows the mean. Upper and lower dashes outside the rectangle show 5th and 95th percentiles.
Source: NBU.

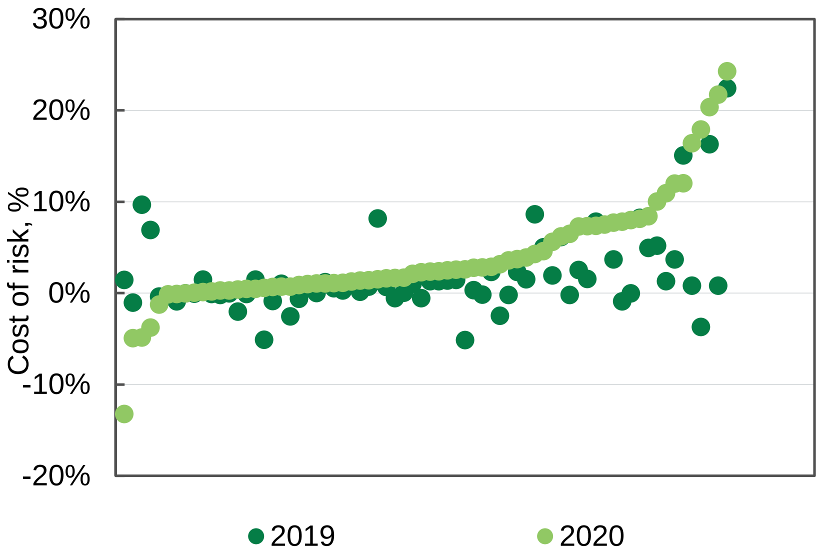
- In the first 4 months of 2021, the combined net interest and fee and commission income increased by 20% yoy. Their ratio to assets exceeds 8% annualized.
- In spite of certain contraction, sector's net interest margin made 5.7% (5.2% median). Banks with expensive funding focused on corporate lending are at risk.
- Net fee and commission income is to grow in the long run.

The sector generates profits in the aftermath of the crisis, provisioning is moderate

Distribution of banks by ROE, %



Cost of Risk* by banks

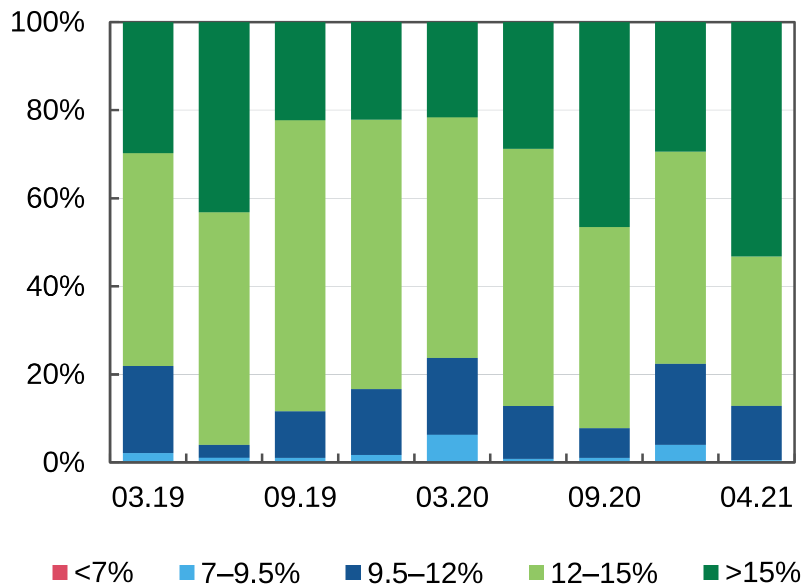


* Ratio of annual loan loss provisioning to net loan portfolio.
Source: NBU.

- In January-April 2021, 26 banks accounting for almost two thirds of the sector's assets operated with ROE of over 15%.
- Last year, total cost of risk almost doubled to 3.4%. In the first 4 months of 2021 it was1.9%.

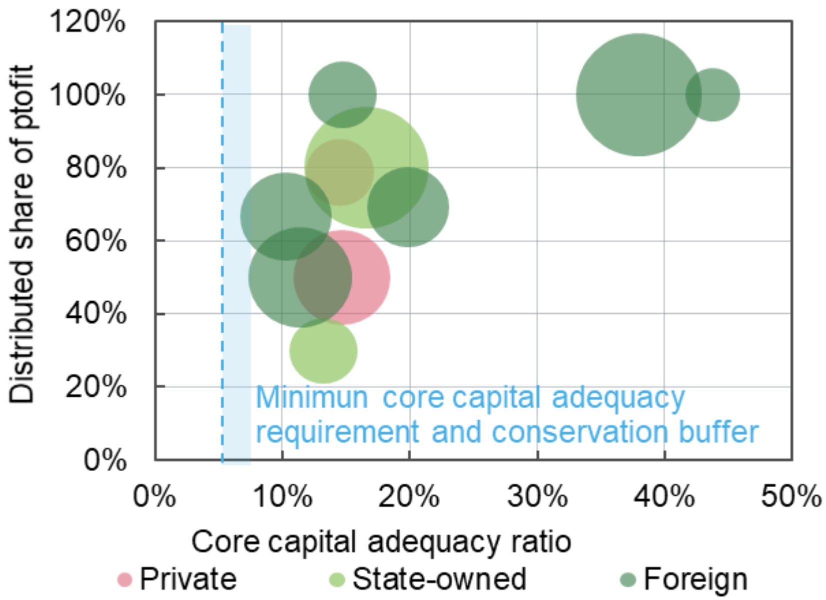
Banks maintain capital above minimum requirements

Change of core capital adequacy ratio distribution by banks' assets



Source: NBU.

Share of 2020 profits in 2020, distributed as dividends and core capital adequacy ratio



Size of a circle reflects ROE size.

Source: NBU.

- For several years running, banking sector capital has been significantly above minimum requirements.
- All banks that distributed profits, retained capital above minimum regulatory requirements even in the aftermath of the distribution.

Recommendations to financial institutions

To banks

- Make further effort in cutting NPL portfolios.
- Update recovery plans.
- Prepare for introduction of new capital requirements.
- Redouble efforts on FX mortgages restructuring.
- Implement relevant recommendations from previous Reports.

To non-bank financial institutions

- Ensure a transparent ownership structure.
- Ensure timely reporting.
- Comply with solvency requirements.

Recommendations to state authorities and NBU plans

Recommendations to state authorities

- Ensure meeting all conditions for cooperation with international donors.
- Pass legislation aimed to promote financial sector development:
  - amendments to the *Law On Banks and Banking*
  - *On Financial Services and Financial Companies*, *On Issuance*, and *On Credit Unions*
  - on enhanced bank resolution mechanisms
  - on payment services.
- Ensure preconditions for agricultural land turnover and banking lending secured with farmable land.
- Resolve DGF solvency issue.
- Enhance regulation and ensure transparency of primary real estate market.
- Implement court reform and reestablish trust to the judicial system.

NBU plans

- Wind up extraordinary long-term liquidity support measures.
- Enhance capital requirements in line with international standards.
- Complete stress-testing of banks, publish them at the end of the year.
- Finalize requirements on market risk calculations by banks.