National Bank of Ukraine

Financial Stability Report

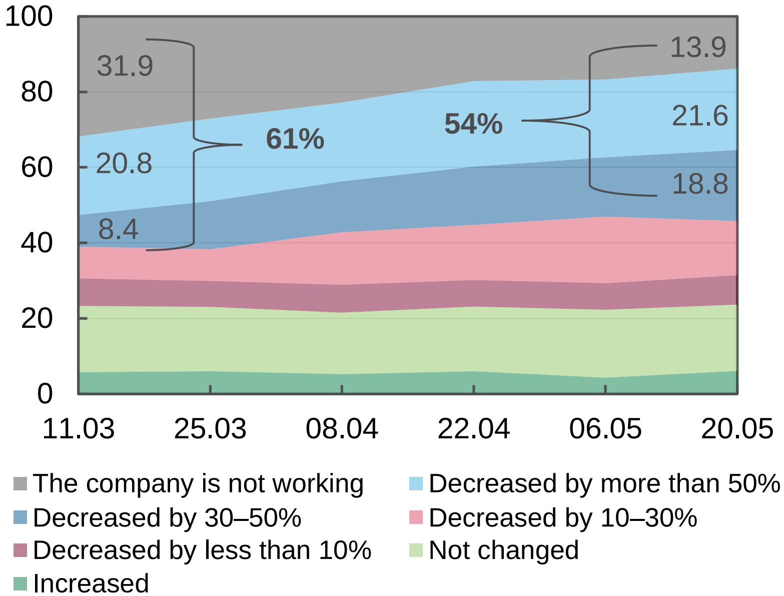
21 June 2022

Summary

- The full-scale war caused materialization of threats to macroeconomic and financial stability.
- Despite the shock, the banking system continues to operate, remains highly liquid, and has high resilience margin. Banks kept the trust of their clients.
- The real sector is gradually recovering from the first shock of the war. However, a significant part of enterprises could not resume operation, and thus will have issues with debt servicing.
- Corporate lending growth has been driven exclusively by government support. Retail lending declined, mortgage lending came to a halt.
- The banks coped with operational challenges, but posted record-high losses because of operational risk events.
- Credit risks will increase, loan portfolio losses may exceed 20%.
- In February, banks' capital significantly exceeded the minimum requirements. Therefore banks are able to absorb such credit losses. After the war, the banks will have enough time to recover their solvency in full.
- Additional capital for covering credit risks was ensured by higher risk weights for unsecured consumer loans, which the NBU will cancel from end-July.
- Nonbank financial institutions dealt with operational risks less successfully. However, there are market players in each segment that continue to provide quality services continuously.

War caused a deep economic crisis

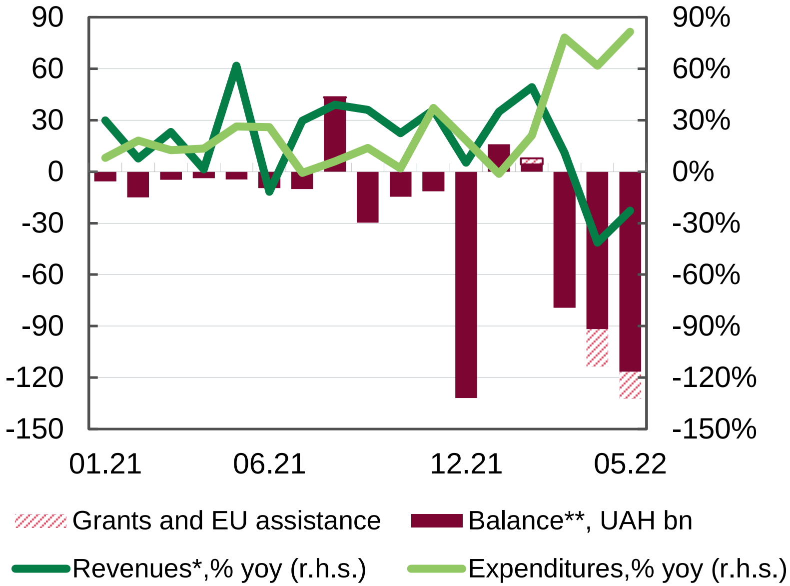
Production capacity load of Ukrainian companies in March–May 2022*



* Compared to the period prior to the full-scale war.

Source: NBU surveys.

State budget parameters in 2021-2022



* Revenue dynamics - excluding grants and EU assistance programs.

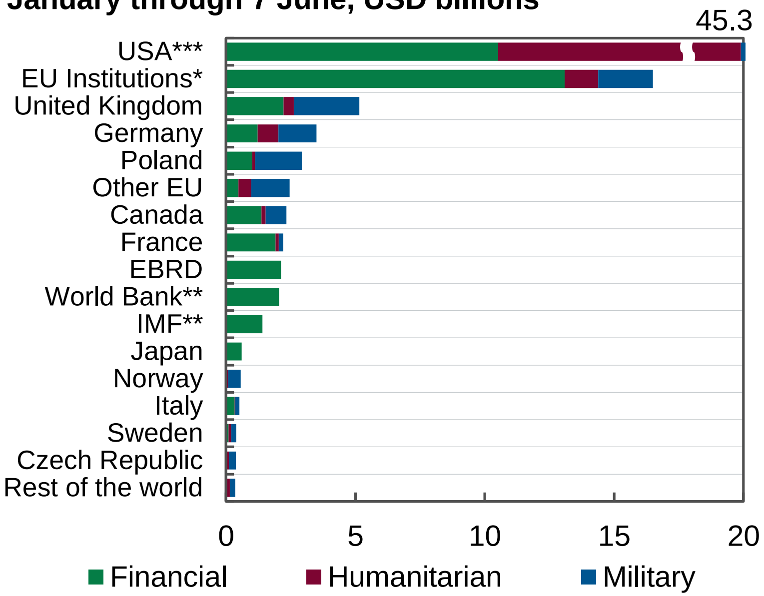
** Negative readings point at deficit, positive – at surplus.

Source: State Treasury Service of Ukraine, Ministry of Finance of Ukraine, openbudget.gov.ua, NBU calculations..

- Ukrainian GDP may fall by more than a third, while inflation accelerates.
- Rising expenditures and falling revenues of the state budget provoked a significant deficit, which the NBU partially finances through purchase of government bonds.
- The NBU fixed exchange rate and sells substantial amounts of foreign currency to balance the FX market.

Global support helps Ukraine to withstand in war

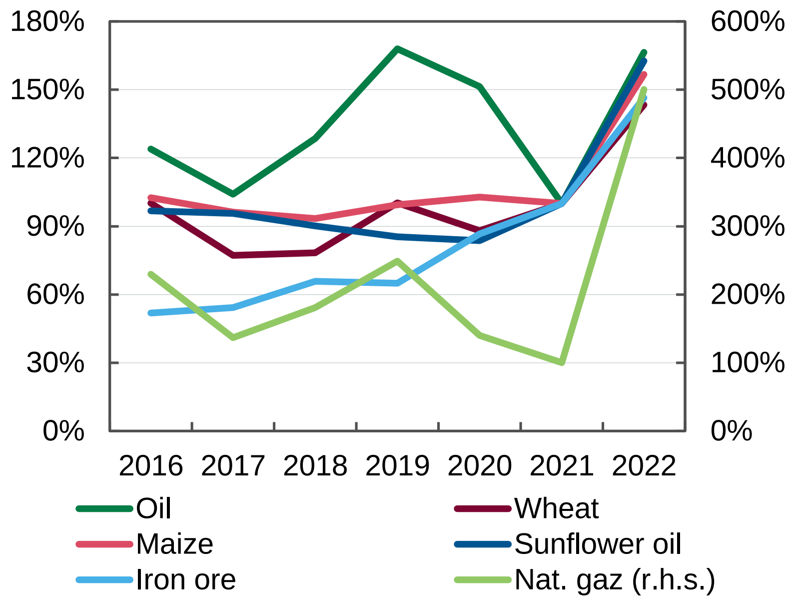
Official committed assistance for Ukraine, late January through 7 June, USD billions



* Commitments of the European Commission, EU Council, EIB and European Peace Facility; ** Assistance from individual countries through multi-donor is excluded from the IFI assistance; ***Including 10.5 bln of financial, 9.4 bln of humanitarian, and 24.5 bln of military assistance.

Source: Kiel Institute for the World Economy (Germany).

Global commodity prices*, 2021 = 100%*



* Crude oil, Brent; russian natural gas; China import Iron Ore Fines 62% FE; sunflower oil, maize, wheat - international prices.

Source: IMF, World Economic Outlook, April 2022.

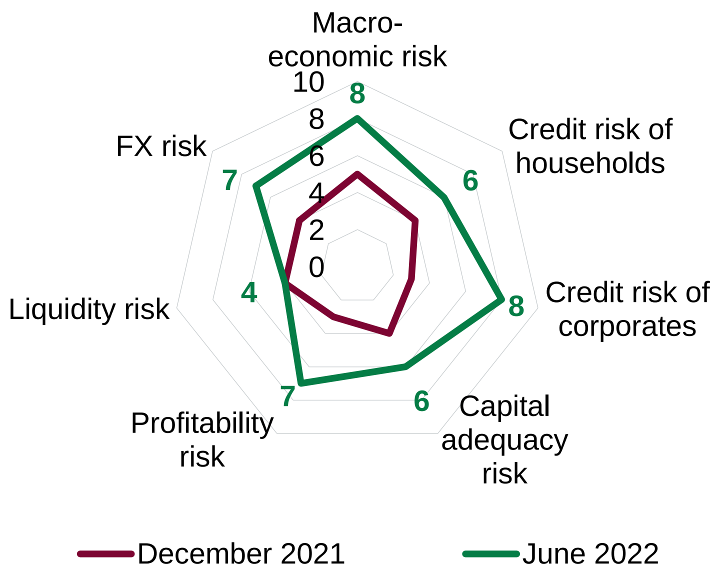
- Financial assistance from partner countries allows to finance public budget deficit and support international reserves while external financial markets are inaccessible for Ukraine.
- Rising prices for essential commodities is a key war-related risk for Ukraine and global financial system.
- Ukraine moved closer to the EU. A plan to rebuild Ukraine is under development.

Financial Stress Index is over its peak, yet it is still high

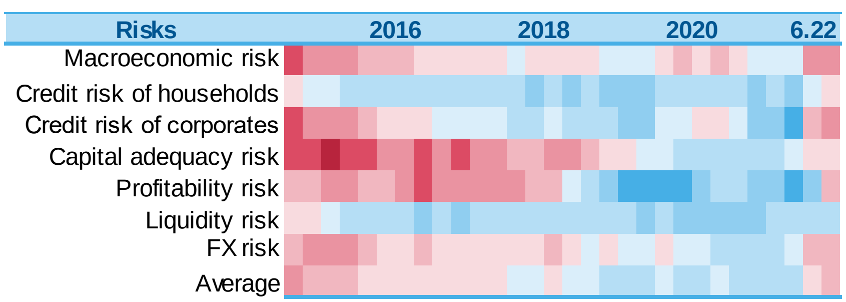
Source: NBU.

- After a hike, the index gradually subsides: readings of almost all of components has improved.
- FX subindex stays high because of considerable NBU interventions and exchange rate volatility on FX cash market.

Financial sector risk map



Financial sector heatmap



Macroeconomic risk has risen (+3) because of deep economic slump and widening public budget deficit.

Credit risk of households has grown (+2). Banks expect deterioration of portfolio quality, NPL ratio was increased.

Credit risk of corporates has hiked (+5) because of sharp rise in expected credit losses and worsening estimations of loan portfolio quality.

Capital risk has increased (+2). For now, capital adequacy ratio is well above minimum requirements, but capital risks intensify going forward.

Profitability risk has risen (+4) because of losses caused by higher provisioning. Fee and commission income fell, only interest margins did not change.

Liquidity risk has not changed. The stock of liquid assets remained significant, but banks expect further increase of the risk.

FX risk has increased (+3) due to significant FX market imbalances and worsening depreciation expectations. Fixed exchange rate, moderate balance dollarization, and balanced FX position limit this risk.

MACRO LEVEL

Full-scale russian invasion into Ukraine caused:

- a plummet in economic activity and household incomes
- a surge in public budget deficit
- critical dependence of Ukrainian economy on international assistance

NBU

NBU contained risks for financial by:

- fixing exchange rate and imposing currency restrictions
- supporting bank liquidity
- introducing timely regulatory easing

BANKS

Banks were resilient by the onset of the war:

- well-capitalized, liquid
- with well-arranged operations
- with prepared contingency plans

- successfully coped with operational challenges – banks did not suspend their work
- liquidity was not an issue: depositors' trust kept the banks from bank runs
- lending continues thanks to government support programs
- credit risk is the key challenge for profitability and capital: banks may lose over 20% of their loan portfolio; however, many of them have capital to absorb these losses
- banks should adjust their business models to current conditions in order to recover after the crisis.

The NBU will give banks with viable business models enough time to restore their capital

NONBANKS

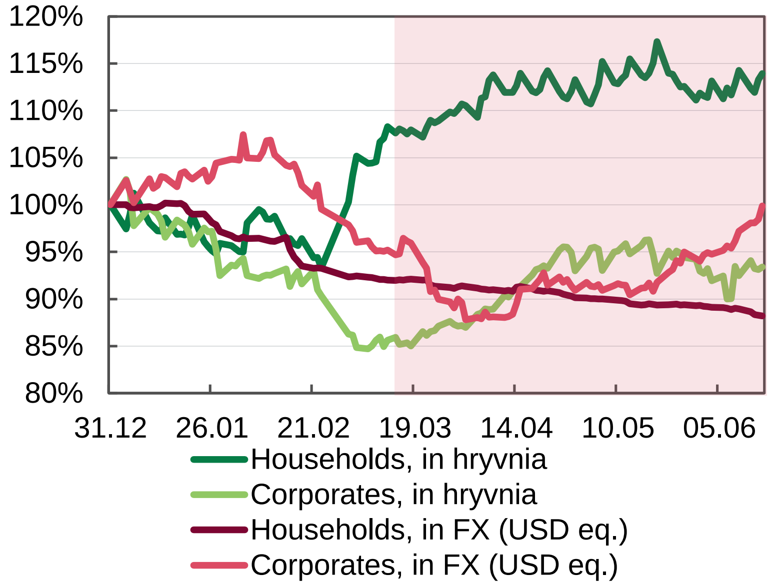
Many nonbank financial institutions were hit hard by COVID crisis and only started to recover:

- the sector remains weak because of previous crises
- operational challenges proved to be too hard for some institutions and they seize to operate
- liquidity and solvency risks increase
- there are resilient financial institutions in each segment that continue to provide quality services.

In order to recover, the financial institutions should mobilize their own resources

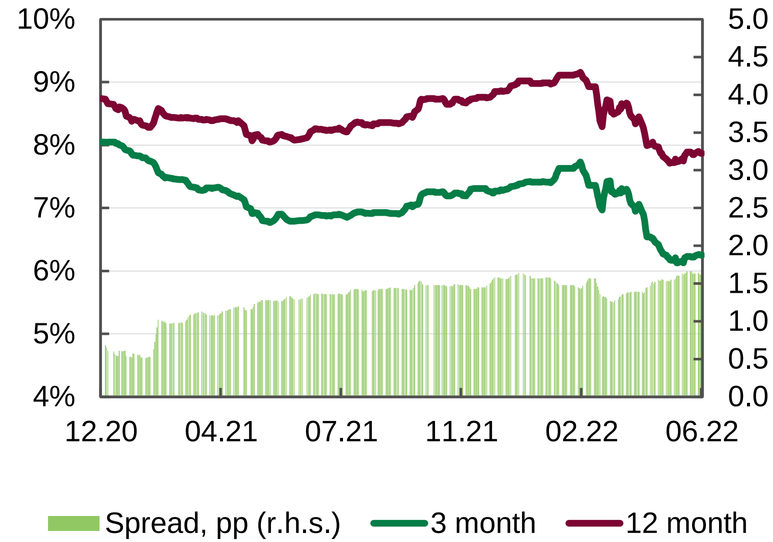
Banking system remains highly liquid

Client deposits, 2021=100%



Source: NBU.

Ukrainian Index of Retail Deposit Rates in the hryvnia, % per annum

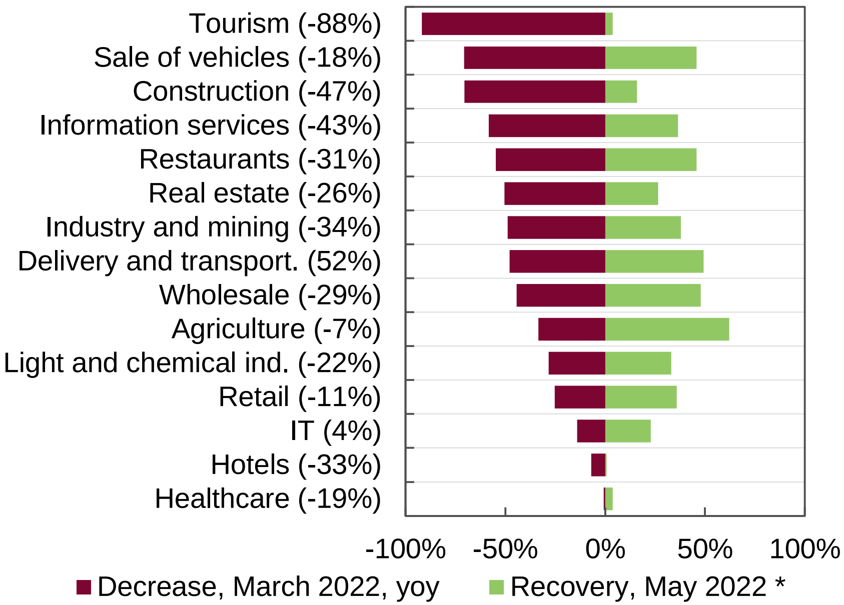


Source: Based on data of “Thomson Reuters”, 5-day moving average.

- Banks kept the trust of depositors. In the early weeks of the full-scale invasion, hryvnia funding of banks surged, change of banks by retail depositors was virtually non-existent.
- Currently, funding is not growing, and its term structure deteriorates.
- In order to boost attractiveness of term hryvnia savings, banks have to raise deposit rates.

Real sector gradually recovers from the initial shock of war

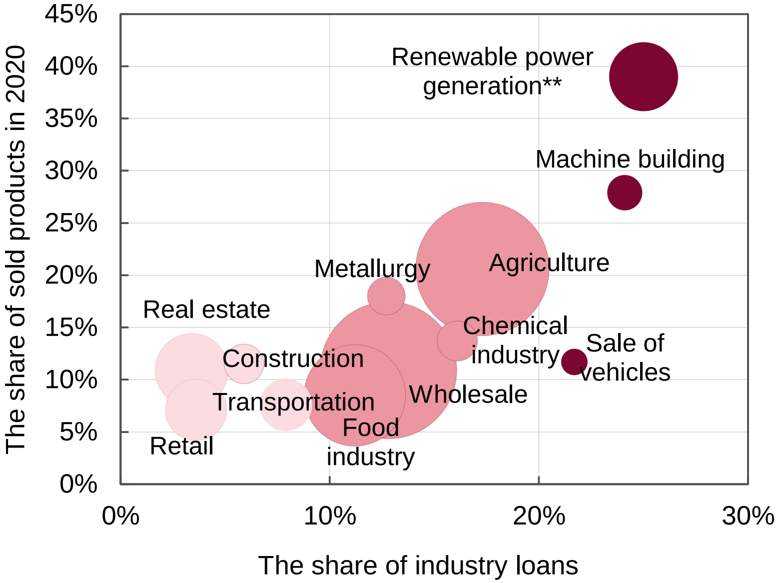
Change in the volume of outward payments of PrivatBank corporate clients



* Calculated as the difference between the growth rates of May and March yoy. The brackets indicate the change in the number of outgoing payments of companies in May 2022.

Source: PrivatBank, NBU estimates.

Corporate performing loans as of 1 June 2022 and sold products in the zone of active hostilities*

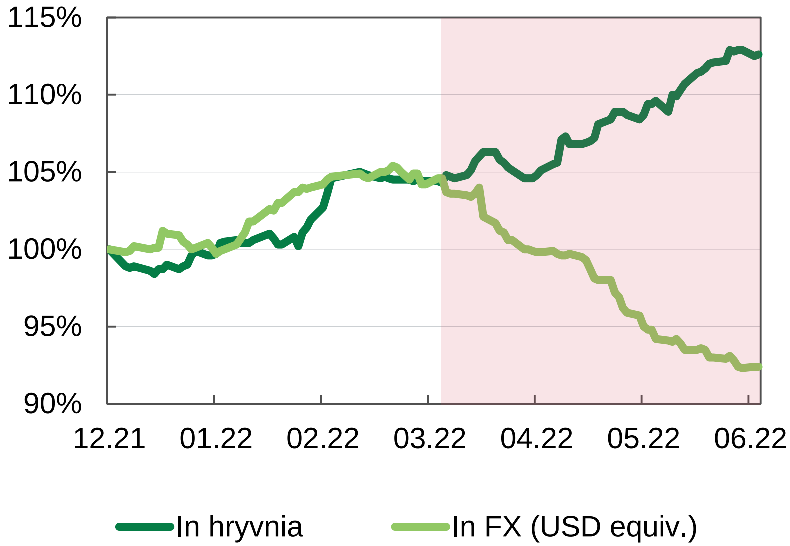


At banks that were solvent as of 10 June 2022. The size of the circle is the volume of performing loans. * Zone of active hostilities: Donetsk, Luhansk, Kharkiv, Zaporizhia, Mykolaiv, Kherson regions. ** The share of the installed electric capacity of renewable power producers at the end of 2021 in the zone of active hostilities.
Source: NBU, SSSU, NCSREU, NBU estimates.

- Key factors behind the decline of economic activity are disrupted logistics and loss of markets.
- Production capacities of industries that make up a considerable proportion of loan portfolio are located in areas suffering from hostilities.

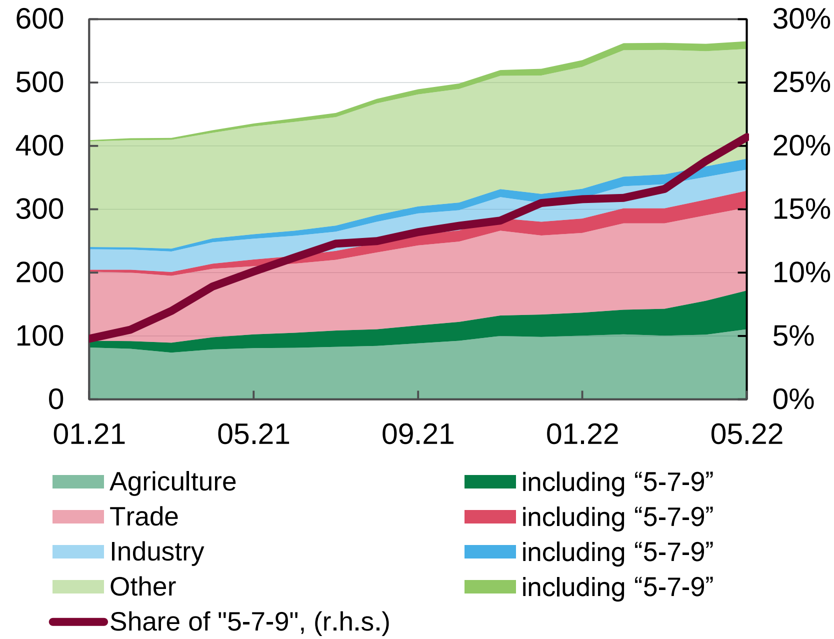
Corporate lending is growing thanks to government support

Net corporate loans, 12.2021 = 100%



Source: NBU.

Performing loans of corporate borrowers and loans under the State program "Affordable loans 5-7-9%" in terms of economic sectors, UAH billions

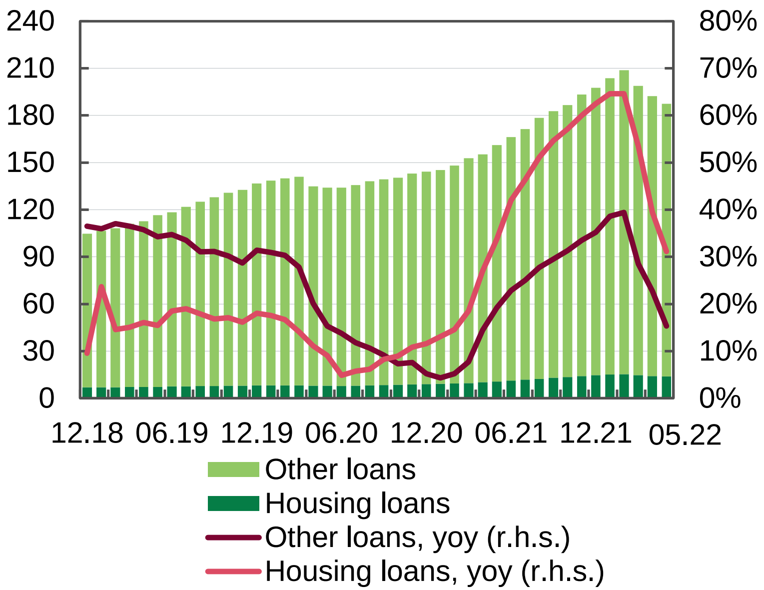


Source: NBU.

- Demand of enterprises for loans has shrank and banks’ risk appetite declined.
- Clients’ access to finance is ensured thanks to state programs for lending support.
- Since the onset of the full-scale war, net hryvnia corporate loans rose by around 8%, while FX ones declined.

Retail portfolio has been shrinking since the onset of the war

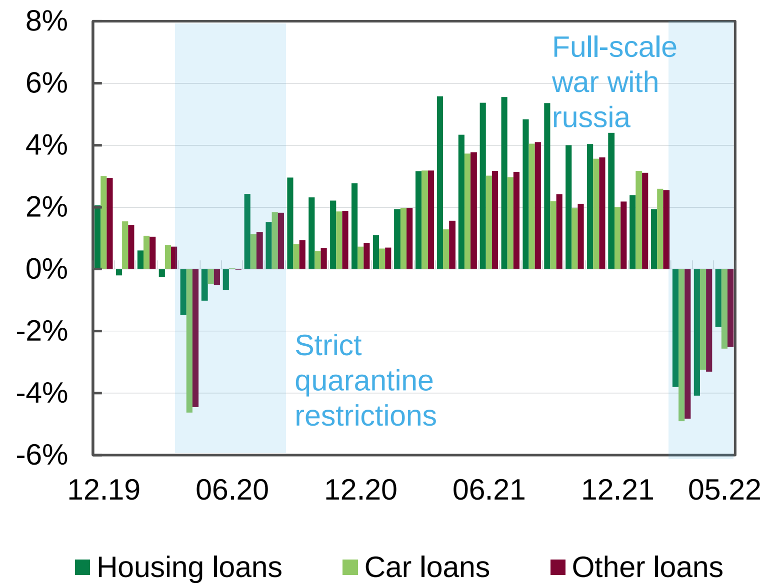
Net retail loans in hryvnia, UAH billions



At banks solvent as of 10 June 2022.

Source: NBU.

Change in net loans, mom

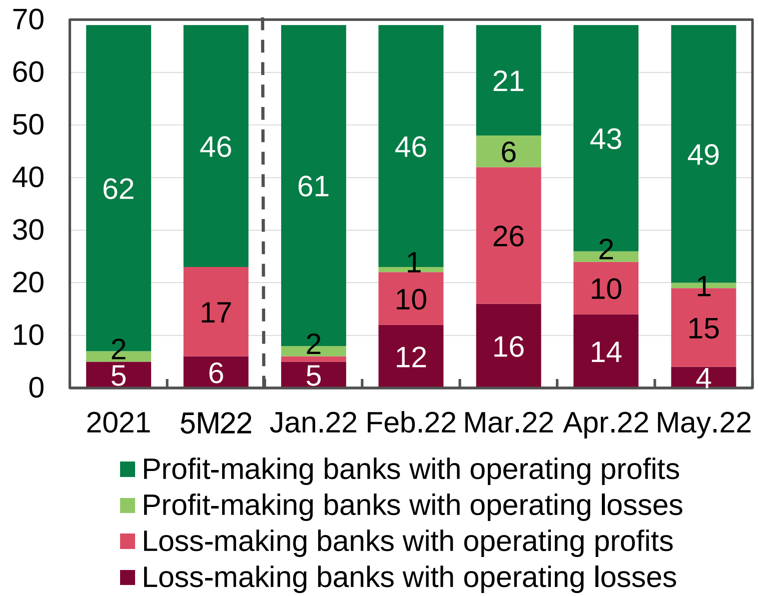


Source: NBU.

- Sharp fall in consumer demand, uncertain prospects of real estate market, and a drop in incomes of certain household groups diminished demand for loans.
- From March through May, net retail loan portfolio shrank by around 10%. Mortgage lending has virtually come to a halt.
- The NBU decreased risk weights on unsecured consumer loans from 150% to 100%. This instrument had performed its countercyclical function.

Sector suffered losses for the first time since 2017 due to credit risk

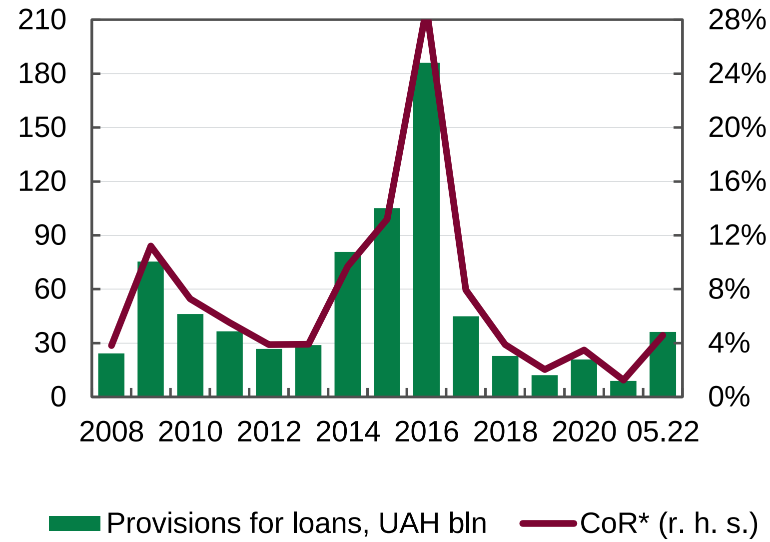
Loss or profit by number of banks *



* For banks solvent as of 1 June 2022.

Source: NBU.

Provisions and Cost of Risk



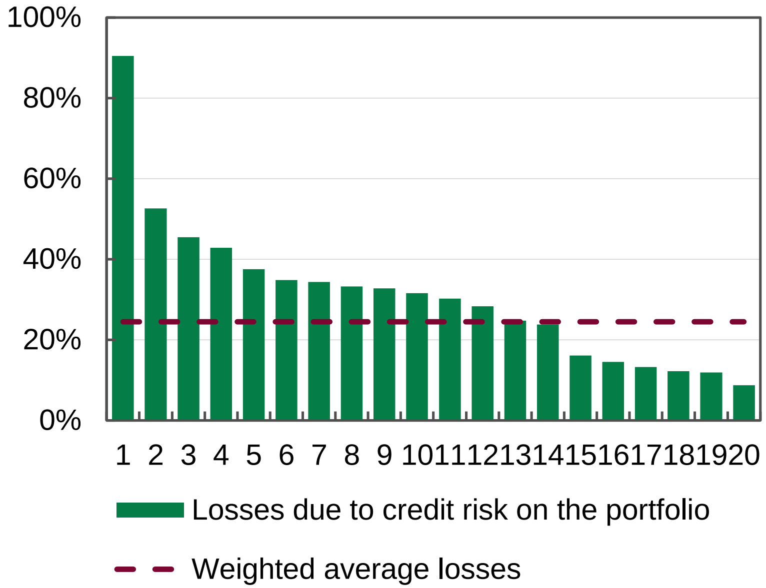
* Ratio of provisions for loans in respective period to net loan portfolio.

Source: NBU.

- Bank provisions for credit losses almost quadrupled yoy, CoR = 4.6%.However, this is just a beginning of portfolio quality recognition.
- Bank losses due to credit risk under current macroeconomic conditions may exceed 20% of portfolio value.

Banks have sufficient capital to cover substantial credit losses

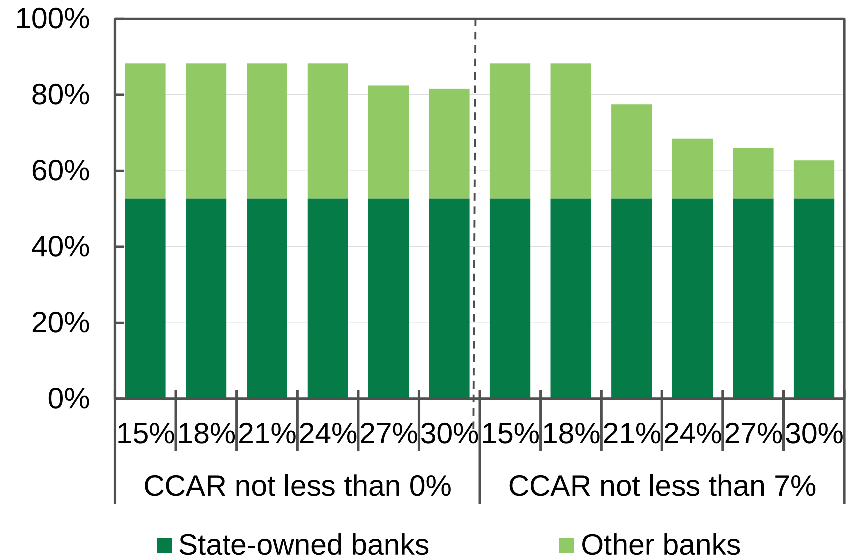
Losses due to credit losses that banks may cover with core capital (including profits from past years)



Horizontal axis shows notional numbers of banks.

Source: NBU.

Share of assets of banks that have respective core capital adequacy ratio (CCAR) under different losses from credit risk



Source: NBU.

- The NBU held a reverse stress test of credit risk under following assumptions: administrative costs rise by 20%, fee and commission income falls by 15%, and interest incomes depend o credit losses of their portfolios.
- On average, banks are capable of covering a loss of 24.5% of performing loan portfolio with core capital and profits of past years.

NBU will set a schedule for banks’ capital recovery

Time

Stage 1
deep economic crisis

- Capital declines, portfolio quality deteriorates
- Regulatory easing: the NBU does not impose corrective measures to banks for capital losses

Stage 2
stabilization of economic situation

- The NBU holds an asset quality review and bank viability study
- Terms for capital recovery are set
- Banks submit capitalization and / or restructuring plans

Stage 3
post-war economic recovery

- Banks implement capitalization and / or restructuring plans
- Banks gradually rebuild capital in line with plans validated by the NBU

Stage 4
stable economic growth

- The NBU re-imposes pre-war requirements
- The NBU further harmonizes its regulatory requirements with the EU acquis

Recommendations for financial institutions, authorities, and NBU plans

Recommendations for financial institutions:

- To recognize credit risks in timely manner and to restructure loans as needed.
- To adjust business models and action plans to crisis environment.
- Nonbank financial institutions should relaunch timely reporting.

Recommendations for public authorities:

- To expand government programs for lending support.
- To bring terms of issue of domestic government debt securities closer to market costs of hryvnia funding.
- To resolve the issue of lost housing and potentially nonperforming mortgages.

NBU plans:

- Going forward, the NBU will respond to developments in a flexible way and adjust regulatory approaches in order to promote financial stability.