National Bank of Ukraine

Financial Stability Report

19 June 2024

Summary

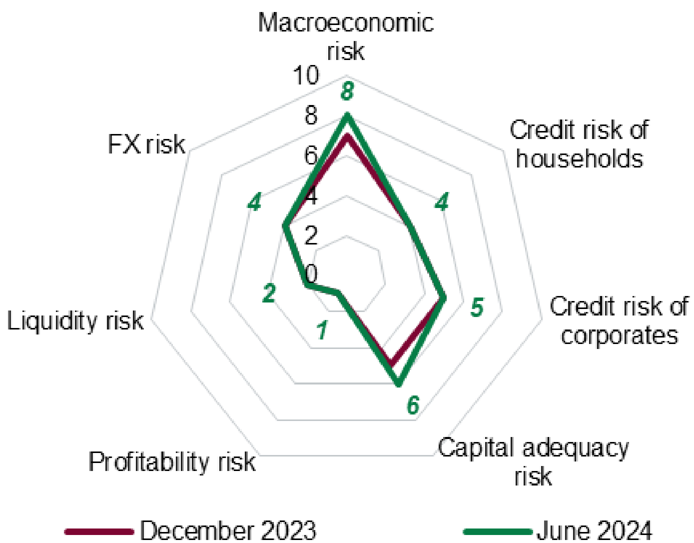
- Banks remain financially resilient, retain clients' trust, increase lending to businesses and households, and become increasingly involved in financing of the state budget.
- Macroeconomic environment remains mostly favorable for the banks, yet there are still risks of insufficient and/or irregular international assistance through next years.
- The banks further ramp up lending to businesses in hryvnia. Loan portfolio to SMEs growth faster, and unsubsidized lending plays an increasingly important role.
- Slow and uneven economic recovery, shortage of power supply, and persistent high war-related risks limit demand for business loans.
- Volume of retail loans is growing fast, with mortgage portfolio expanding the fastest, albeit from a low base.
- Credit risks decline, default rates in both retail and corporate segments are trending down.
- Commercial loan rates decline on, but changes in asset composition supports income. Sharp changes in profitability are unlikely to occur in coming years.
- Sustained profitability facilitates steady build-up of bank capital. This enables the NBU to further implement its regulatory requirements in line with EU standards.
- By the end of this year, the banks will have to cover in full credit, market, and operational risks in line with European standards.
- NBU survey shows that Ukrainian banks are yet at early stages of climate risk management.

Financial stress index indicates the presence of stress in the sector

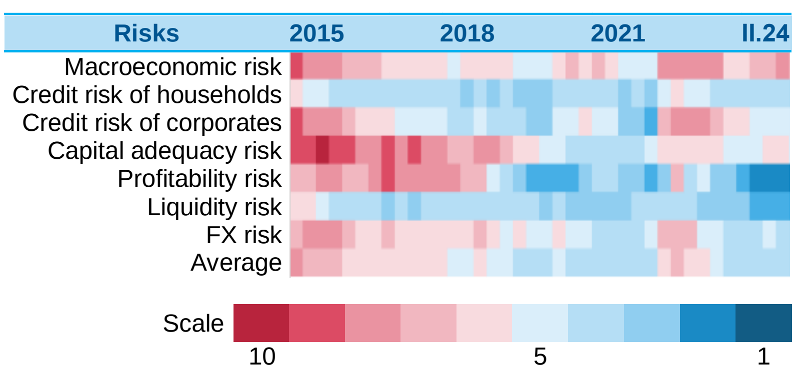
Source: NBU.

- FSI remained moderately high during the first half of the year, indicating continued stress in the financial sector as a whole.
- The government debt subindex has the largest contribution to the FSI: the growth of yields on Eurobonds was partly offset by the decrease in the price of domestic borrowing.
- The foreign currency subindex has been growing since the spring due to the gradual devaluation of the hryvnia.
- However, the banking sub-index decreased thanks to the decrease in interbank rates.

Financial sector risk map



Financial sector heatmap



Macroeconomic risk increased (+1). Economic recovery has slowed. Both current account deficit and state debt increased. The state budget deficit and external debt both remain high. Significant international financial assistance mitigate the risk.

Credit risk of households has not changed. The quality of the retail portfolio and banks' expectations regarding it have improved, while the economic expectations of households have somewhat worsened.

Credit risk of corporates remained unchanged. The default rates were declining. Banks are more optimistic about future loan quality. However, companies expect a decline in business activity.

Capital adequacy risk has increased (+1), but the capital remains significant, and the risk is average.

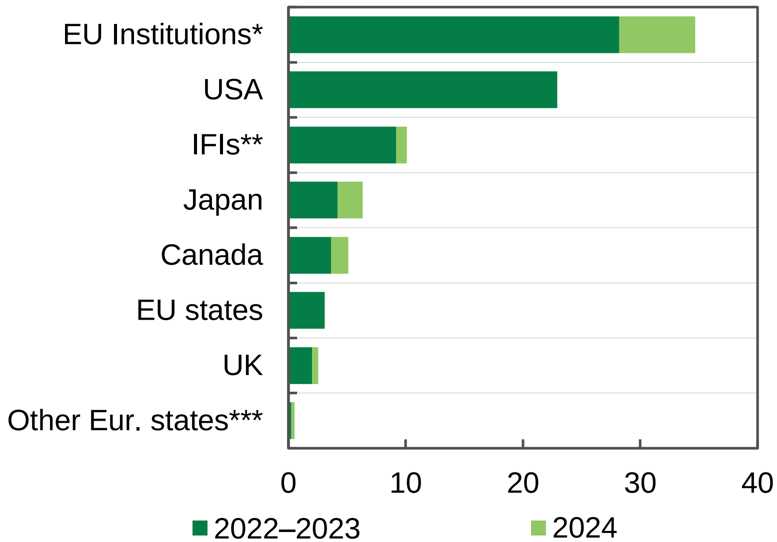
Profitability risk remained unchanged due to high interest income, low provisions and high operating efficiency of banks.

Liquidity risk has not changed. Client deposits continue to grow. The LCR is significantly higher than the requirements.

FX risk has not changed. The volatility of the dollar exchange rate has increased slightly. However, large international reserves provide comfort in the market.

International assistance underpins macrostability

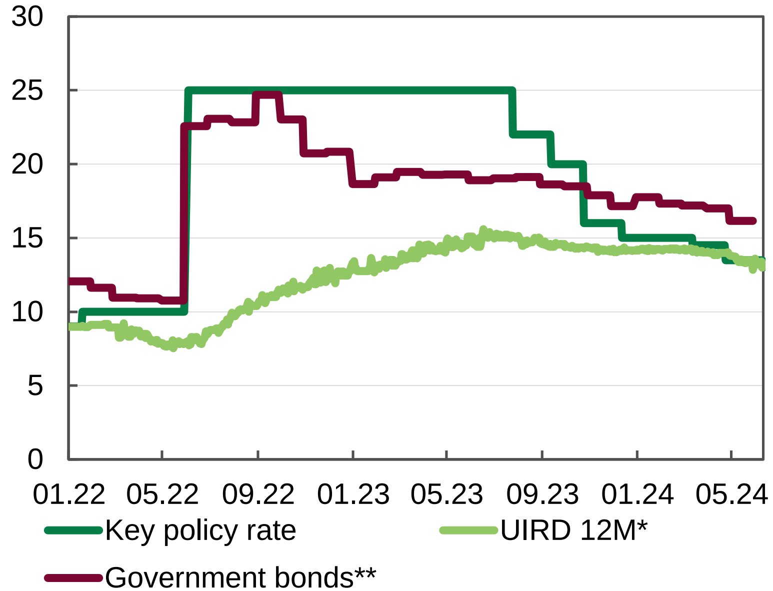
External financing of the State budget as of 28 May 2024, USD billions



* Including EIB. ** IMF and World Bank. *** Norway, Switzerland, Iceland, and Albania.

Source: Ministry of Finance of Ukraine.

Government bonds yield, key policy rate, and UIRD index, %



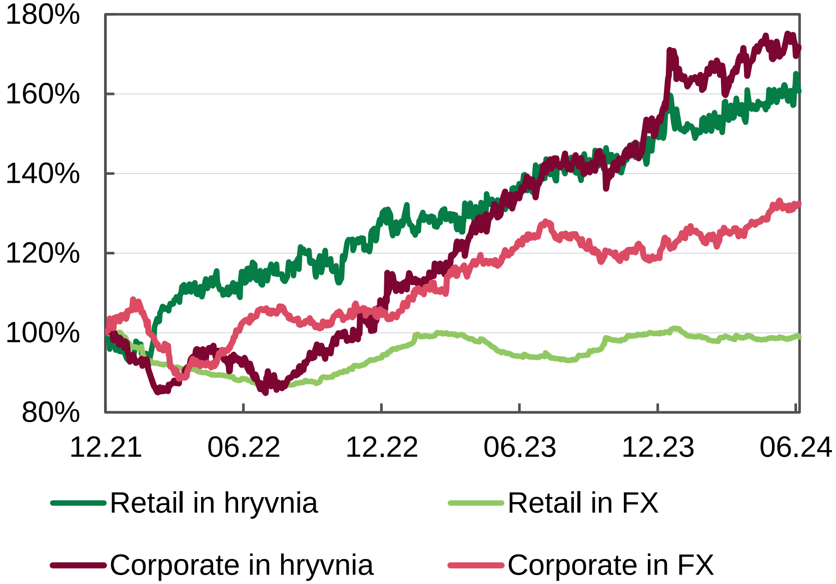
* Ukrainian Index of Retail Deposit Rates. ** Average weighted yield of government bonds denominated in hryvnia, placed on the primary market.

Source: Ministry of Finance, Thomson Reuters, NBU.

- Approval of financial assistance packages by partners ensures coverage of budgetary needs and maintenance of comfortable level of international reserves in 2024.
- Persistent high security risks increase the need for sufficient support in the future. G7 agreement on providing Ukraine around USD 50 billion in assistance reduces uncertainty around future financing.
- Steep decline in inflation and control over situation on FX market allowed NBU to proceed faster with interest rate cut – the policy rate was cut to 13% in June.

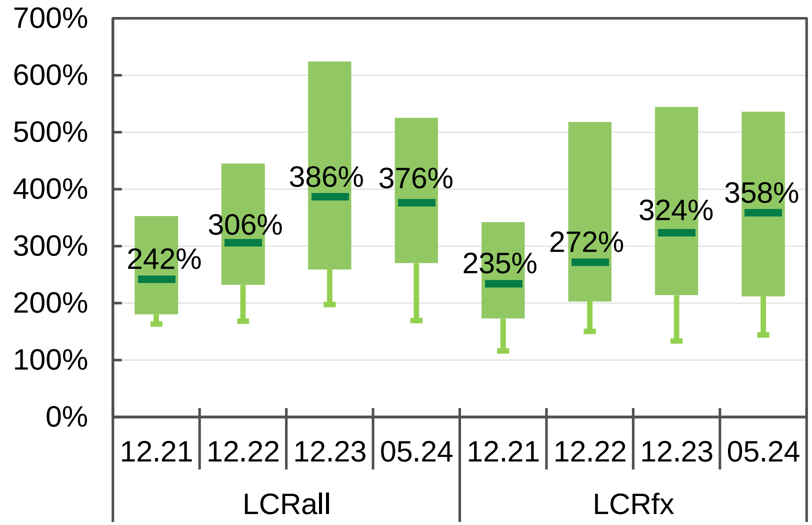
Banks maintain high liquidity

Household and business deposits, 1 January 2022 = 100%



Source: NBU

Liquidity coverage ratios in all currencies (LCRall) and FX (LCRfx)



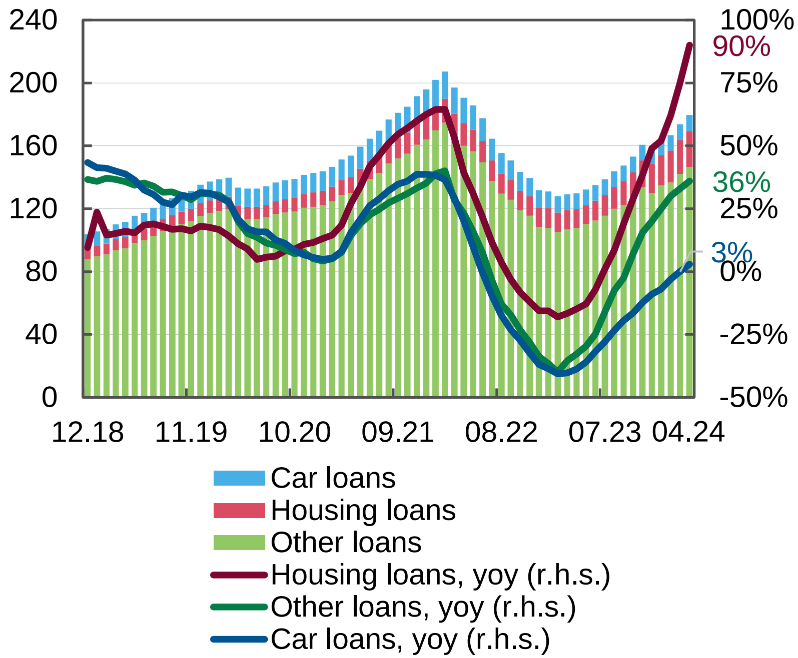
Upper and lower edges of the green rectangles represent the first and the third quartiles of the indicator distribution across the banks for the date. Dashes inside the rectangle show the median. Lower dashes outside the rectangle show the minimum. Standard value 100%.

Source: NBU.

- Clients' deposits, both from households and businesses, grow on and provide almost all of banks' funding. Thus, the banks do not need much of funding from other sources.
- The share of high-quality liquid assets in total sector assets is close to 42%.
- Almost a third of hryvnia retail deposits rest are term deposits. Propensity to save on term hryvnia deposits stays high.
- Number and average size of deposits are rising, larger deposits grow faster.

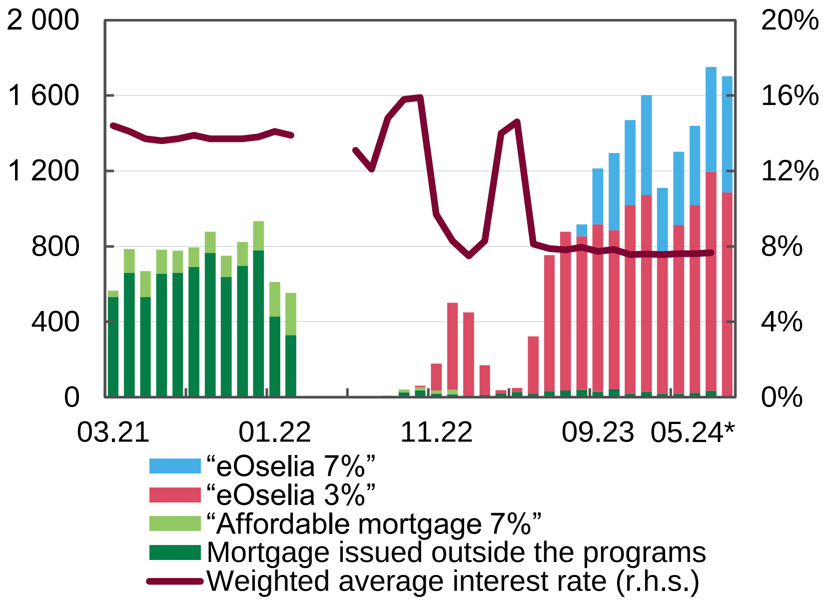
The retail loan portfolio is recovering quickly

Net hryvnia loans to households, UAH billions



Source: NBU.

New mortgage lending, UAH millions

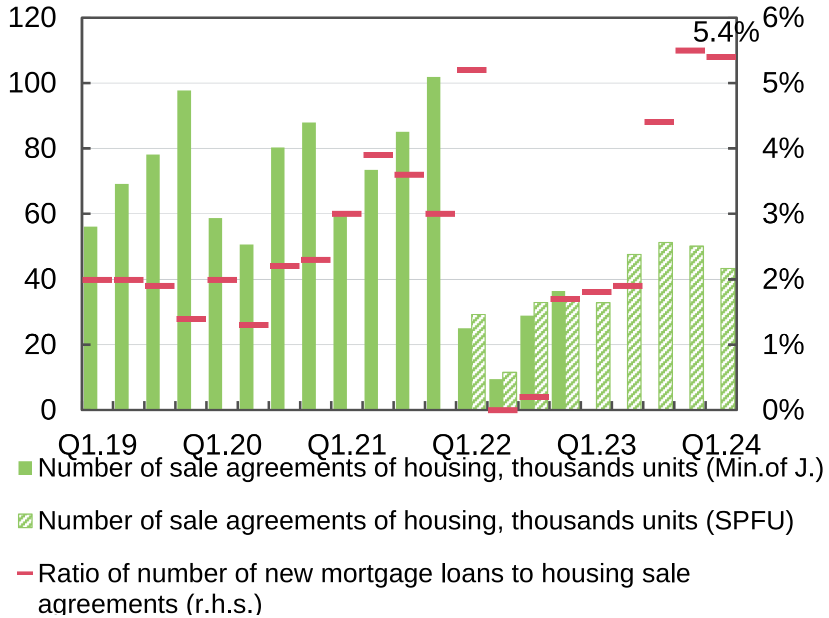


"eOselia 7%" - mortgage loans for the broad categories.
* In May data on mortgages issued outside the program are unavailable.
Source: banks' data, BDF, UFHC.

- The retail loan portfolio is recovering rapidly thanks to the consumer demand.
- The biggest share of the portfolio, as before, is made up of unsecured loans, and mortgages are growing the fastest thanks to the "eOselya" program.
- Mortgage lending standards have been eased, although this risk is offset by the moderate debt burden of clients.
- The low margin under the program does not attract a wider range of banks. At the same time, an increasing number of banks are considering relaunch of their own mortgage products.

Demand for housing is weak, but increasing

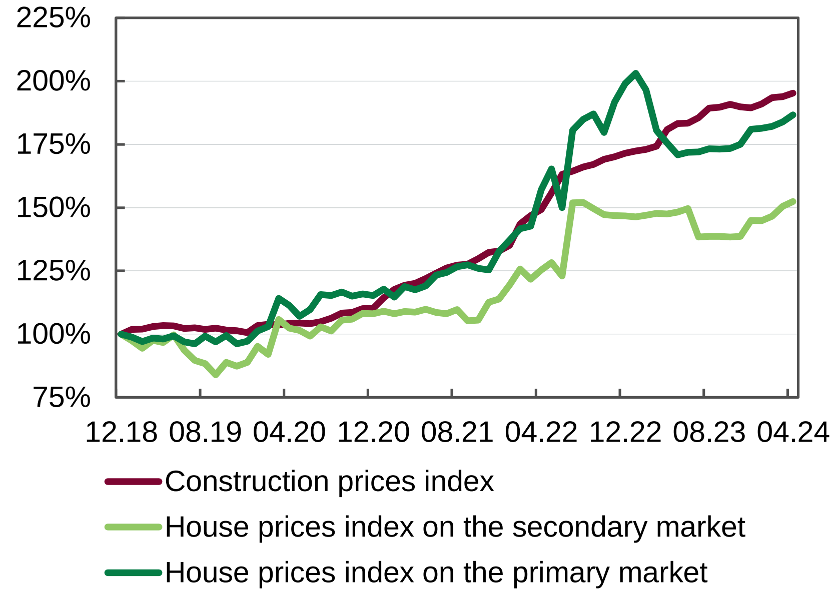
Housing market activity



SPFU data – transactions data certified by notaries, resulted in the personal income tax payment obligation.

Source: Ministry of Justice, State Property Fund of Ukraine, banks' data.

Construction and house prices index in hryvnia, 12.2018 = 100%

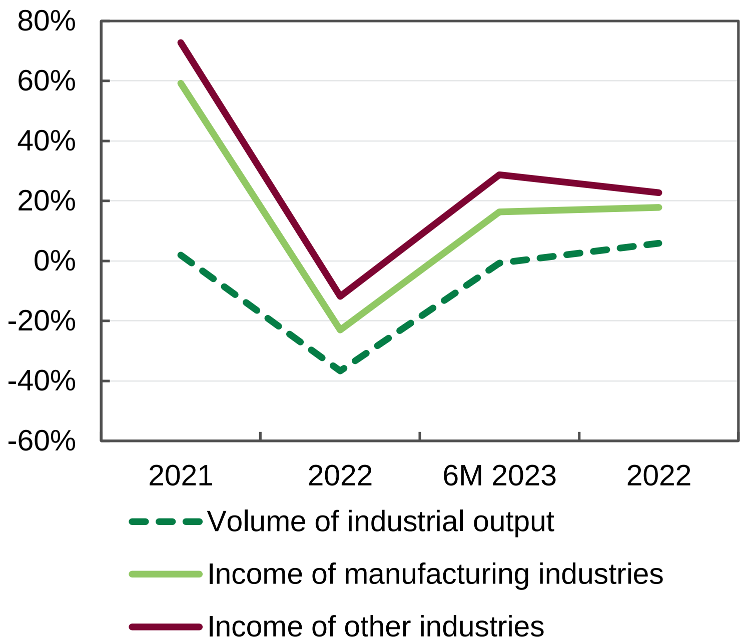


Source: SSCU, real estate agencies, NBU estimates.

- Demand on the housing market is slightly increasing, but is still much lower than before the full-scale invasion, while secondary market housing draws an increasing interest.
- Housing supply is replenished weakly due to the lack of funding and high risks, so the post-war demand recovery can cause a supply deficit.
- Mortgage plays an increasingly important role on the market, supporting prices in the segments with more active lending.

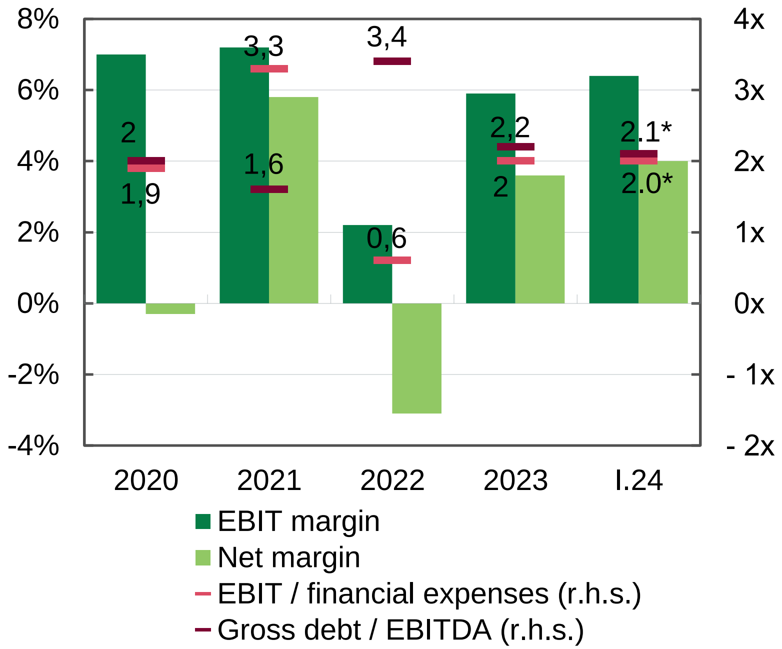
Demand for corporate loans is weak despite the recovery of incomes

Change in production volumes and income of companies, yoy



Source: SSSU, open data portal.

Profitability and debt burden



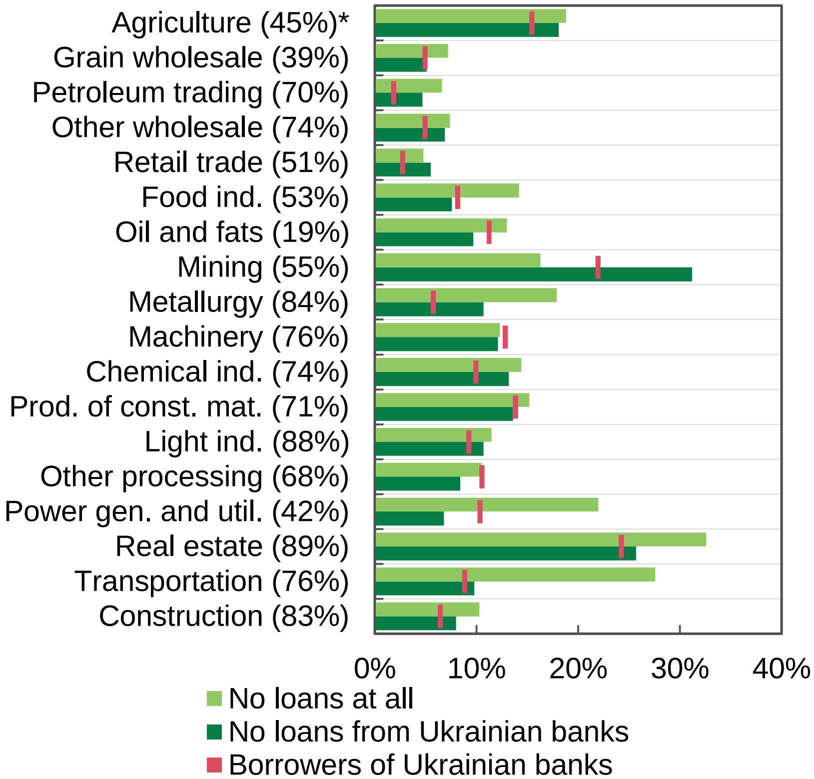
* Calculated for 12 months ending March 2024.

Source: NBU estimates, open data portal.

- The growth of incomes of real sector companies is proportionate to the change in nominal GDP, mostly thanks to the increase in the output in a number of industries.
- Profitability of enterprises is satisfactory, although it is still lower than before the full-scale war.
- Intensification of hostilities, shortages of power supply and qualified personnel are likely to restrain further recovery of the real sector and suppress credit demand.

Low credit demand restrains lending

Average EBIT margin of operationally profitable companies in 2023 by the fact of presence of debt



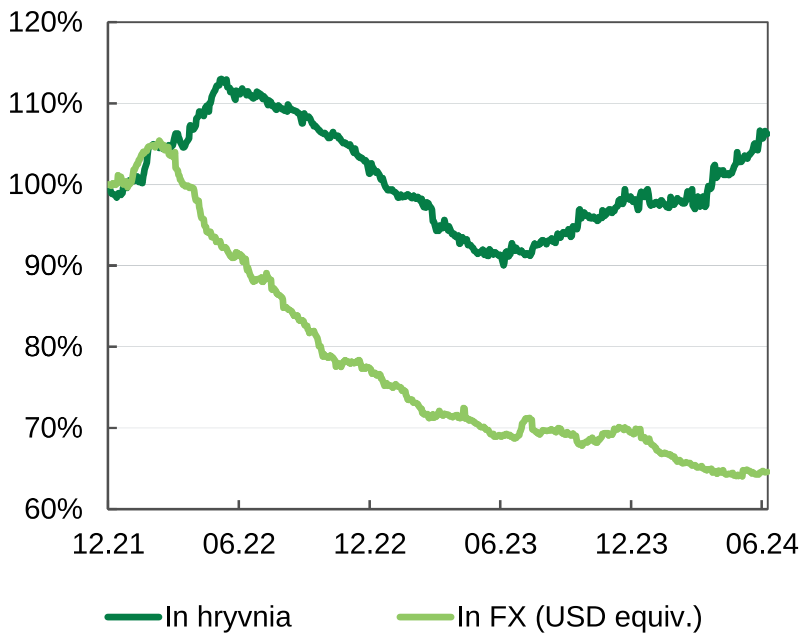
* The share of EBIT of companies that do not have loans in Ukrainian banks is indicated in parentheses. A company that owes more than UAH 2 millions as of 1 January 2024 is considered a borrower of Ukrainian banks.

Source: Open data portal, NBU estimates.

- Many companies do not take bank loans, although they have high operating profitability, and therefore they are desirable clients for banks.
- Half of them are financed from alternative sources, in particular through external borrowings, including intra-group ones.
- Companies with high revenues and profits often have sufficient liquidity to finance their working capital and investments without taking loans.

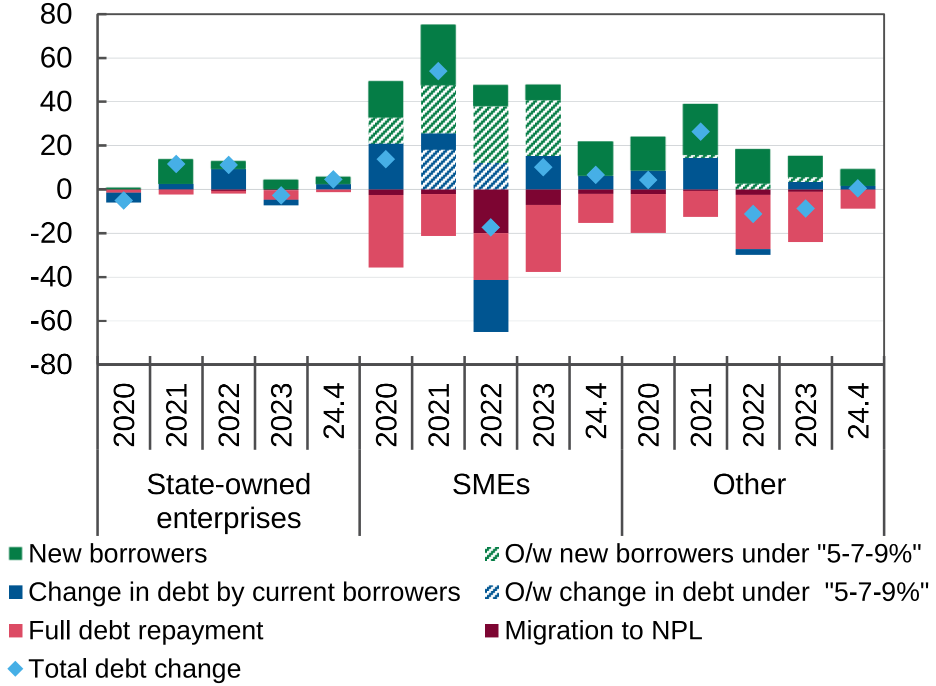
Banks build up loan portfolios, but the demand is weak

Net corporate loans, Dec. 2021 = 100%



Source: NBU.

Change in gross corporate performing loans in hryvnia, UAH billions

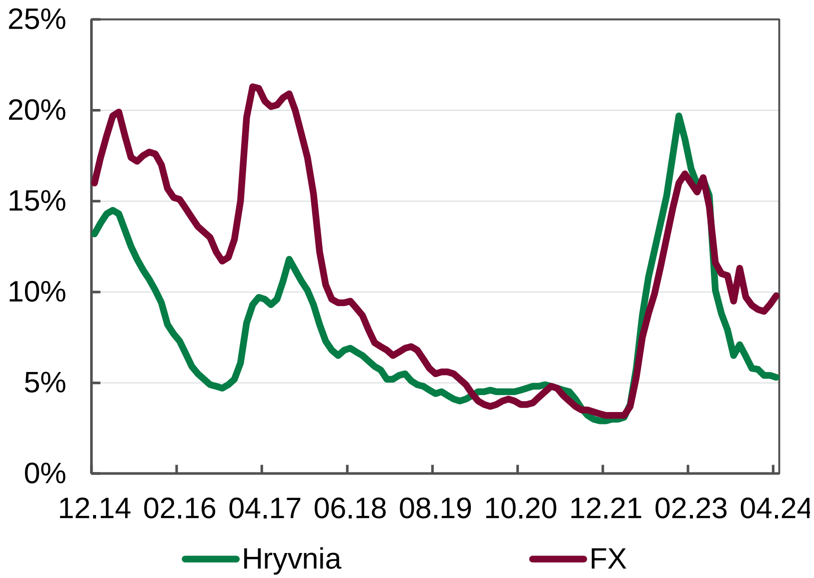


Source: NBU.

- Net hryvnia loans to business increased by 12% yoy, in line with banks' plans.
- SMEs remain the major driver of the portfolio growth, with loans to this segment growing much faster than to the rest. The role of unsubsidized lending is on the rise.
- Despite the positive lending trends of the last year, it is too early to claim that the banks restored this function in full. Lending Development Strategy reflects a comprehensive view over this problem and ways to mitigate impediments for lending.

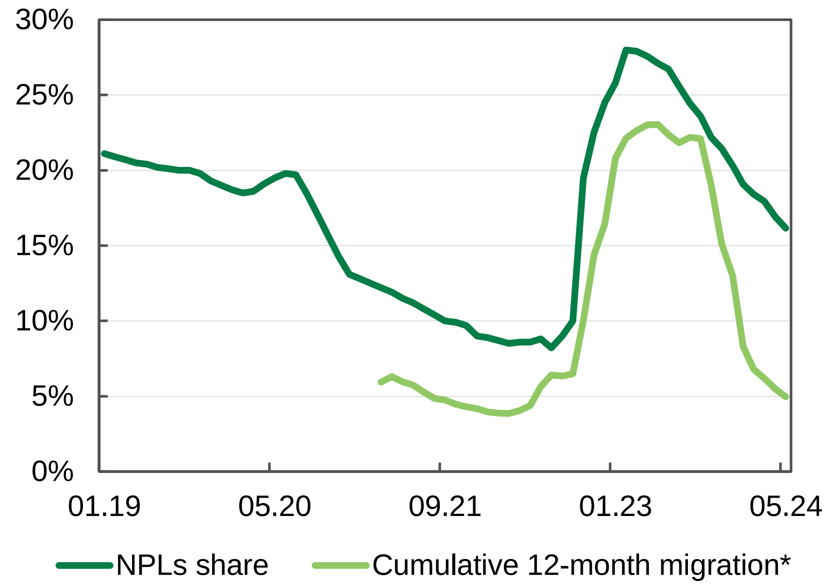
Credit risk has eased, provisioning is prudent

Default rate of borrowers over the 12-month, smoothed data



Source: NBU.

Share of hryvnia retail NPLs and migration of performing retail loans



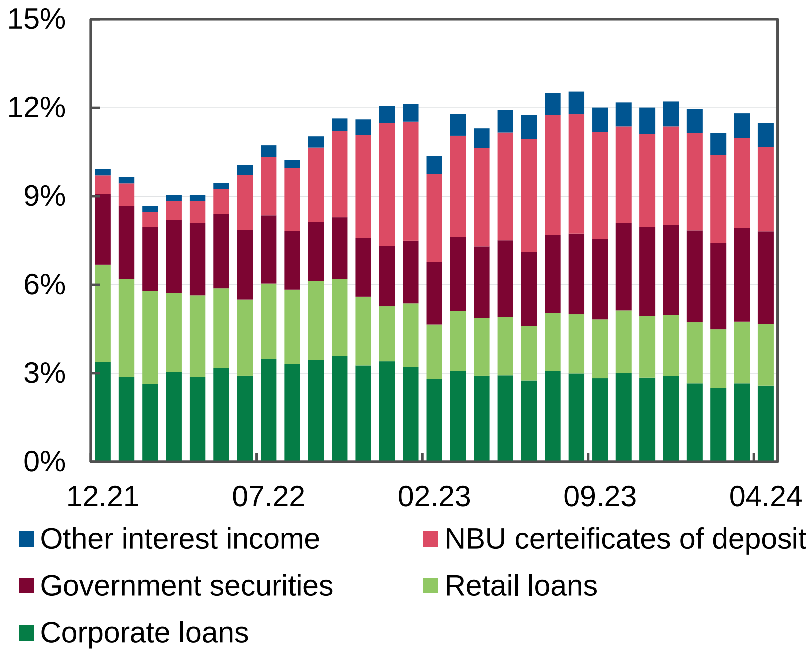
* Cumulative migration to the third under IFRS 9, % of loans at the first and second stages

Source: NBU.

- Default rates in both and corporate portfolios declines and approaches pre-war levels. The banks do not need additional provisioning for loans.
- The banks are resolving retail NPLs faster, by writing-off or selling them. Resolution of corporate NPLs is more complicated.
- During the full-scale war, the banks more often combined loan prolongation with grace periods for interest repayment and also second restructurings.
- However, NPL recovery is not a systemic phenomenon.

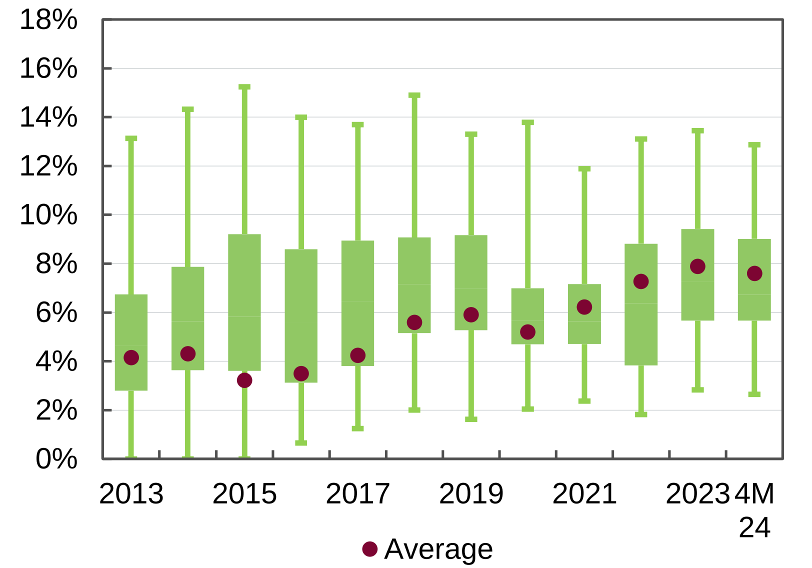
The sector is profitable thanks to persistent high return on assets

Components of interest income, % of net assets



Source: NBU.

Banks’ net interest margin



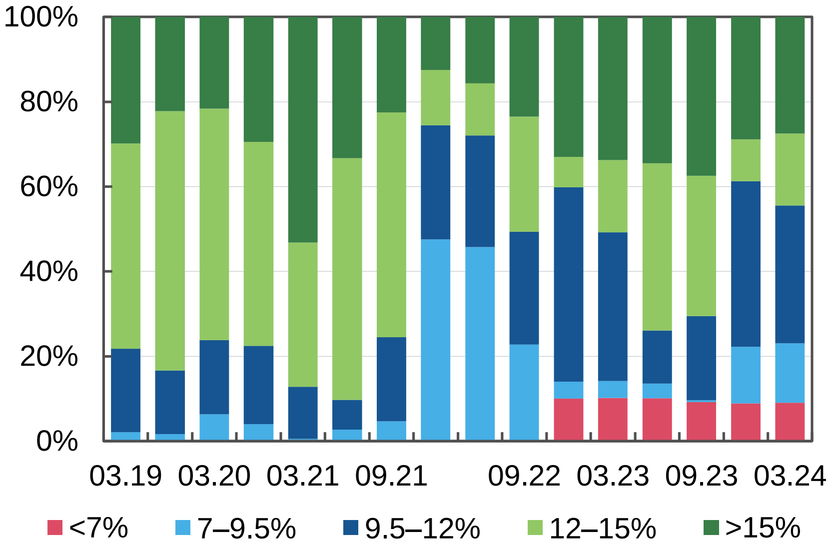
Upper and lower edges of the rectangles show the first and the third quartiles of the indicator distribution across the banks for the date. Upper and lower dashes outside the rectangle show the 5th and 95th percentiles..

Source: NBU.

- Ukrainian banks maintain profitability and efficiency thanks to net interest margin that remains wide.
- Return on assets and cost of liabilities change slower than markets rate decline. The banks lock in yields by investing in longer-term instruments.
- There is a potential for further decline in return on assets, but decelerating pace of decline of market interest rates will ease risks to banks’ profitability.

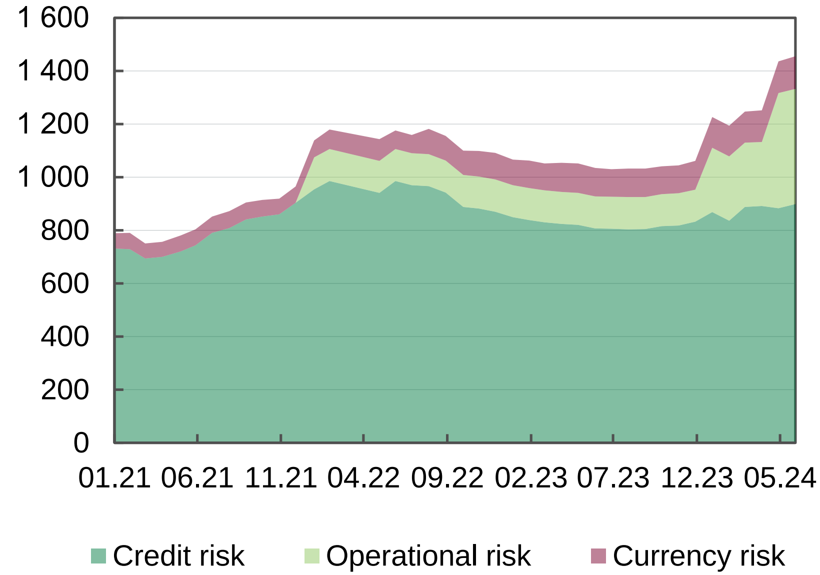
Banks' capital covers an increasingly wide scope of risks

Distribution of core capital adequacy ratio by banks' share of total assets



Source: NBU.

Risk-weighted assets of banks, UAH billions

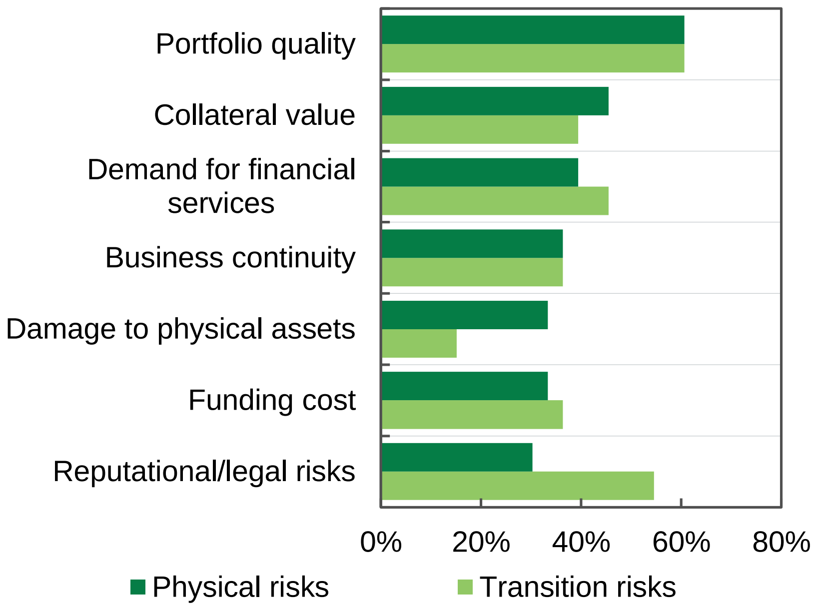


Source: NBU.

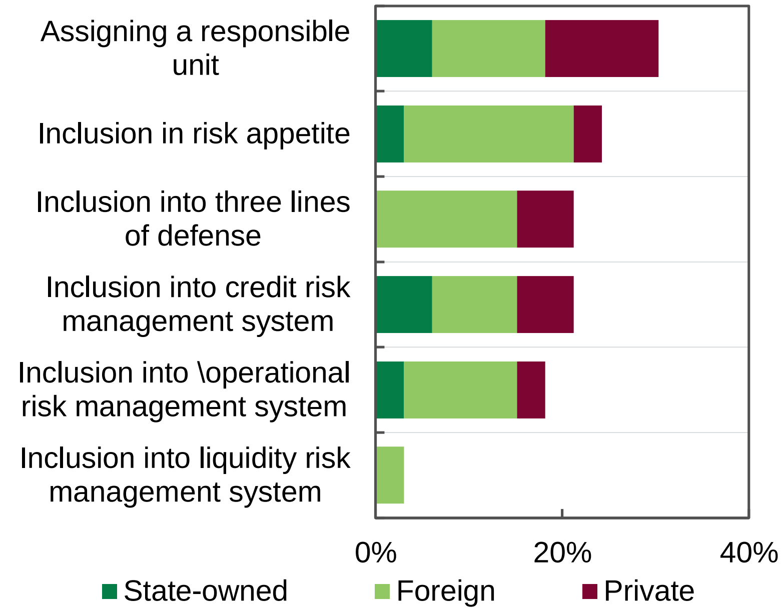
- The banks build up capital and enhance resilience to potential adverse developments. That paves the way for implementation of new capital requirements in line with those in the EU.
- From August, the banks will have to cover with capital all major risks – credit, operational, and market one, while capital will be calculated under the new structure.
- Transitional provisions for introduction of new requirements will enhance banks' ability to lend.
- In 2025, bank resilience assessment including an adverse scenario will help to chose the optimal schedule for further regulatory changes.

Banks are only starting to manage climate risks

Share of surveyed banks that noted the impact of climate risks on the specific aspects of their activities



Share of surveyed banks that reported inclusion of climate risks into their risk management system



Source: banks' survey.

- NBU polled 33 banks about their approaches to climate risk management. Almost three quarters of respondents noted that climate change has impact on their activity.
- However, just a third of polled banks have advanced in managing of these risks, integrated them into risk management system, primarily as a part of credit an operational risks.
- Integration of climate risks into credit risk assessment remains weak: the risks do not affect loan terms or parameters of credit risk assessment.

Recommendations of the National Bank

Recommendations to financial institutions

- For banks – to adjust to new rules of capital adequacy calculation and NPL management.
- For non-bank financial services providers – to comply with regulator's requirements to solvency and reporting, to submit information to credit register.

Recommendations to public authorities

- To keep the pace of reforms in lines with agreements with the EU, IMF, and other donors and partners.
- To adopt draft law on payment services market reg. # 11043.
- To implement the Lending Development Strategy.
- To focus further state lending support programs in order to encourage expansion of non-subsidized lending.

NBU's priorities

- To conduct resilience assessment of the banking sector next year and to continue implementation of EU regulatory standards.
- To work on establishment of framework of war risk insurance.