National Bank of Ukraine

Non-bank Financial Sector Review

October 2020

Quarantine restrictions and the coronavirus crisis have had mixed impact on the performance of non-bank financial institutions. Credit unions were hit hardest as their activity sharply weakened in spring and they incurred losses due to deteriorating asset quality. Due to credit unions' funding sources and competitive advantages being limited, many of them will require significant time and effort to recover. Finance companies and pawnshops have also confronted the problem of decreased lending. Only factoring transactions continued to grow. The insurance market was least affected by the crisis: its main performance indicators did not worsen, changing largely due to several companies opting to exit the market. Meanwhile, 30 June 2020 marked the end of the transition period for insurance companies to meet solvency requirements. Around a third of them failed to attain the required targets despite the long transition period. Therefore, selected insurers that lack high-quality assets have to take appropriate measures, including increasing their capital.

Sector Structure and Penetration

The non-bank financial sector, which comprises insurance companies, credit unions, finance companies, and pawnshops, is much smaller than the banking sector in terms of assets. Apart from the aforementioned financial institutions, financial services are also provided by legal-entity lessors that do not have financial institution status. The share of assets held by non-bank financial institutions (NBFIs) relative to the financial sector's total assets has been growing steadily in recent years and dropped only in Q2 2020. NBFI assets have dropped by 10.9% since the start of the year. The number of insurance companies, credit unions, and pawnshops has been decreasing gradually, mainly due to voluntary surrender and revocation of licenses. Institutions whose licenses had been revoked before were also excluded from the state register of finance companies. The penetration of non-bank financial services is moderate. Insurance premiums, including life insurance, make up a mere 1.4% of GDP, and the share of life insurance is the lowest among European countries.

Insurance Companies

As of 1 July 2020, 215 insurance companies operated in the market, of which 20 offered life insurance. With the number of companies in this segment declining, insurers' assets contracted. At the same time, gross insurance premiums of currently operating companies rose by 4.4% compared to H1 2019. This growth rate was somewhat smaller than in previous periods. Insurance claims paid increased as well. The ratio of claims paid, which is calculated by dividing claims paid by premiums collected, grew from 25% in Q4 2019 to more than 30% in Q2 2020. This increase was mostly technical, as the companies that exited the market had mostly engaged in reinsurance and had low ratios of claims paid.

The structure of insurance premiums has been relatively stable in recent years. Motor vehicle insurance (comprehensive coverage and compulsory third party liability insurance) accounted for the largest share of insurance premiums or 36%. Life insurance, voluntary health insurance, and accident insurance generated 28% of total premiums. Substantial premiums were collected for property insurance, fire insurance, and insurance against financial risks.

In Q2 2020, the loss ratio of non-life insurance was 26%. This ratio declined somewhat during the lockdown compared to the start of the year. It was higher for compulsory types of insurance, reaching 37%. The ratio surged in Q1 2020 due to the building of loss provisions after a Ukraine International Airlines plane crashed in Iran in January 2020. Premiums for compulsory third party liability insurance of motor vehicle owners accounted for 68% of total compulsory insurance premiums. For voluntary insurance, the loss ratio was 23%.

The operational efficiency of non-life insurers has been low since the end of 2019. Claim settlements, provisioning, and other expenses related to insurance activities exceeded premiums by 23–25%. In Q2, despite the imposition of the quarantine, industry metrics improved slightly on lower loss ratios.

Despite the deteriorating operational efficiency of some insurers, the industry's financial performance remained acceptable, with the return on assets totaling 1.7%. Overall, insurers' current performance indicators, which were reported after some market players closed their business, better reflect market conditions than the indicators observed in previous periods.

The transition period for insurance companies to fully comply with solvency requirements ended on 30 June 2020. It uncovered problems at some insurance companies, as those were in breach of the regulator's requirements. In particular, 57 insurers failed to fully comply with solvency requirements. The main reason was their low asset quality. In a positive development since the start of the year, accounts receivable fell as a share of eligible assets. On top of it, the share of cash and balances with the Motor (Transport) Insurance Bureau of Ukraine (MTIBU) increased. The highest risks are currently related to a large share in the assets of illiquid real estate, the value of which may be overstated.

Credit Unions

The credit union sector has been developing slowly, with asset growth weak and the number of market players declining. Among credit union members, 23% are active, meaning that they use services provided by credit unions. It is hard for credit unions to compete with other lenders, as the provision of auxiliary financial services is limited by law. Their loan interest rates are lower than those of other non-bank creditors but are close to bank interest rates. The situation deteriorated during the crisis. At the beginning of the quarantine, credit unions faced a temporary ban on serving customers at their branches. Although the same ban was imposed on other non-bank lenders, they continued to serve their customers online, which was impossible for credit unions.

In addition, the servicing of loans started to deteriorate, with most of these loans secured by a surety only. Not only risky consumer loans became past due, but also loans taken out for business needs, mostly by agricultural businesses.

As a result, in 2020 credit unions started to generate losses due to loan loss provisioning. That said, provisions are still often insufficient as they mostly reflect actual losses, not expected ones. Furthermore, many credit unions do not have enough net interest income to cover their administrative costs. In view of that, credit unions are not able to generate capital internally, and 12 of them are operating in breach of capital adequacy requirements.

Finance Companies

Finance companies have been among the fastest-growing in the sector over recent years. Their number grew by 30% over the past three years. However, one in six registered companies is dormant. Finance companies often serve as links in the cash redistribution chains of groups under joint control. At the same time, classic finance companies engaged in lending are also present in the market, with a large share of their loans issued to households. These loans are largely short-term, but mostly unsecured, thus carrying high risk. Their extremely high interest rate of 1–2% per day cover the major risks. Demand for loans issued by finance companies declined markedly during the quarantine. Finance companies also tightened their lending standards. As a result, their lending decreased compared to H2 2019. However, it has been recovering since the beginning of summer.

Leasing transactions also dropped, by 25% compared to H2 2019. Only the factoring transactions of finance companies have been growing. Most of these transactions are related to purchasing nonperforming loans.

In general, quarantine restrictions had a significant impact on finance companies' operations. In Q1 2020, they reported losses after more than two years of profitability. In H1, finance companies turned profitable again on a cumulative basis.

Pawnshops

Pawnshops have also reduced their lending since the start of 2020. Their loan portfolio remained almost unchanged compared to the end of 2019. The collateral coverage ratio continued to decrease, reaching 112%. However, sales of pledged property account for only 9% of pawnshops' income. Over 87% of their income comes from interest income, which increased year-on-year. Lower expenses helped ensure a rate of return on a par with the previous year's level.

Prospects and Risks

After the acute phase of the economic crisis is over and as the economy starts to recover, insurance companies, finance companies, and pawnshops are expected to step up the provision of their services. Credit unions, hardest hit by the crisis, are likely to recover more slowly.

All NBFIs violating the regulator's requirements must take all necessary measures to improve their standing as soon as possible. This especially concerns insurers, which must bring their asset structure in compliance with relevant requirements, and in some cases even increase their capital in order to meet solvency criteria. Credit unions must identify the reasons behind their operational inefficiency: revise their administrative costs and adjust their borrowing and lending rates if needed. The number of companies may decrease further, primarily due to the voluntary surrender of licenses by dormant companies.

The quality of reports and adherence to reporting deadlines by NBFIs warrant special attention. As of now, 92–95% of institutions (depending on industry segment) have submitted their Q2 reports to the NBU. Over the year, the NBU will work on updating the reporting system, which will also require the engagement of NBFIs.

Sector Structure and Penetration

NBFI assets make up less than 15% of total assets of the financial sector regulated by the NBU. This percentage decreased somewhat in Q2 2020 after a prolonged period of growth. Finance companies have the largest assets, whereas credit unions and pawnshops account for as little as 0.36% of total assets. The number of financial institutions keeps declining gradually.

Figure 1. Financial sector asset structure, UAH billions

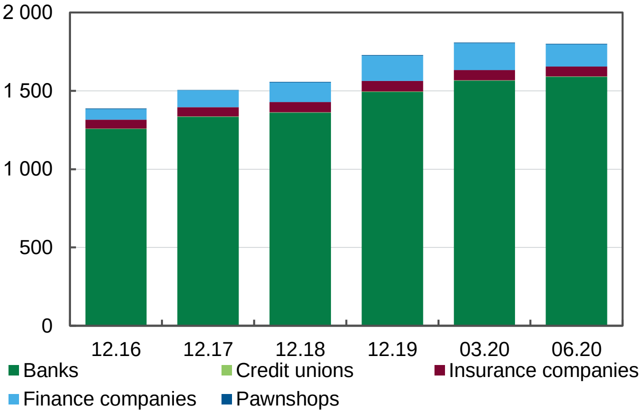
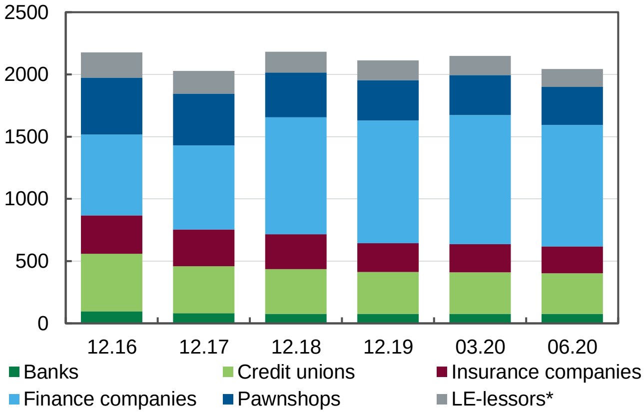


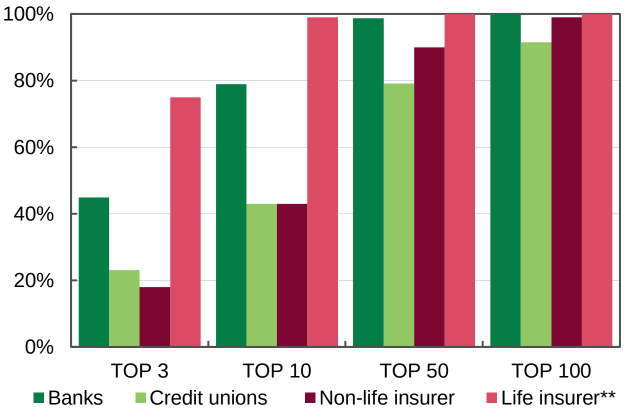
Figure 2. Number of financial service providers



* Legal-entity lessors do not belong to finance companies, but financial leasing services are regulated by the NBU.

The concentration of NBFIs that attract household deposits is moderate. The largest concentration is seen in life insurance, currently offered by 20 companies.

Figure 3. Concentration* of insurance companies and credit unions compared to concentration of banks

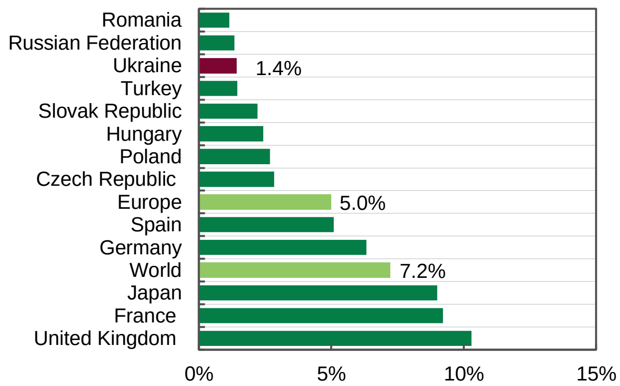


* Concentration was estimated in terms of assets for banks and credit unions, premiums for non-life insurers, and insurance technical provisions for life insurers.

** There are only 20 life insurers.

The level of insurance penetration is low in Ukraine. Life insurance premiums made up only 0.14% of GDP in 2019.

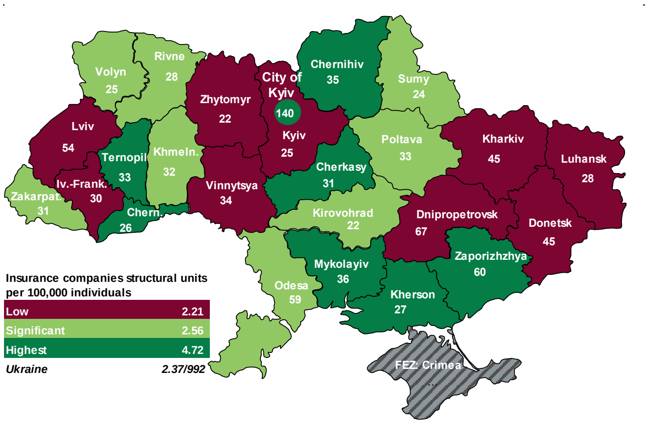
Figure 4. Ratio of insurance premiums (life and non-life) to GDP in 2019



Sources: Swiss Re, Statista.

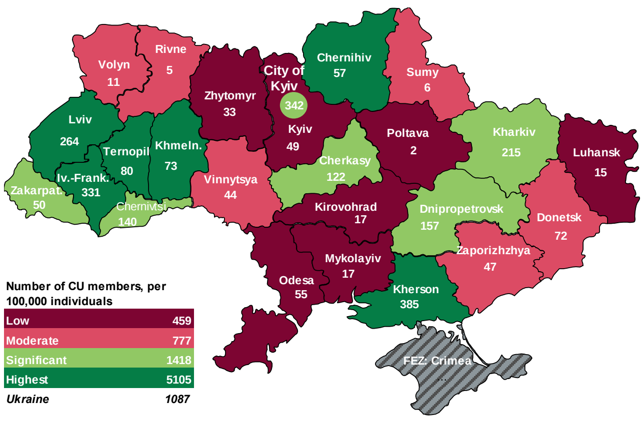
Structural units (branches) of insurance companies are rather evenly distributed across regions.

Figure 5. Number of structural units of insurance companies by region



Credit unions are better represented in remote areas of western provinces (oblasts), where competition from other financial service providers is weak, and in agricultural regions.

Figure 6. Number of members (color scale) and assets (in digits) of credit unions (CU) by region, UAH millions



Insurance Companies

The number of operating insurance companies continues to decrease, primarily through the voluntary surrender of licenses. Exiting the market are mainly companies that do not provide services to households. The asset structure of non-life insurers contains a sizeable portion of illiquid assets, namely long-term investments and accounts receivable.

Figure 7. Number of insurance companies and their assets, UAH billions

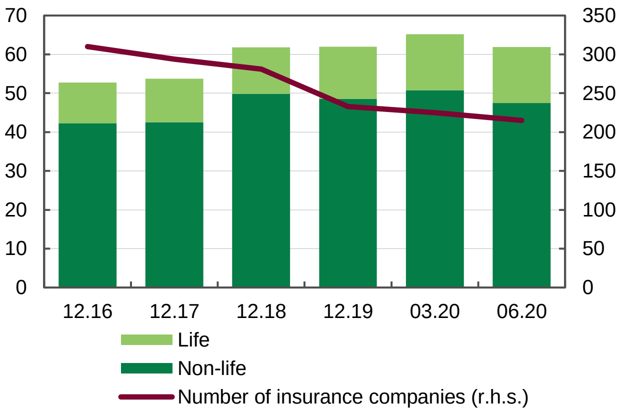
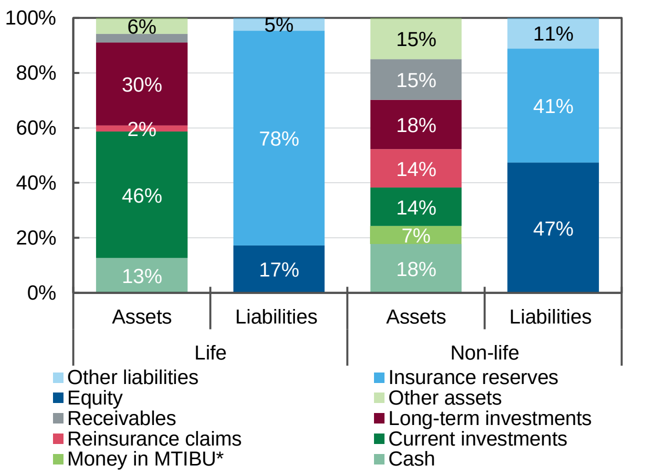


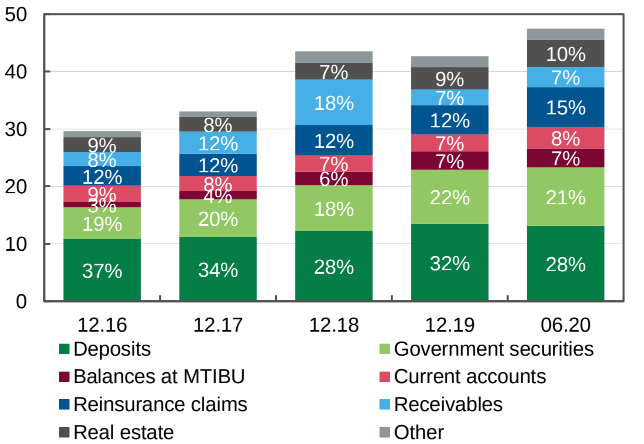
Figure 8. Assets and liabilities of insurance companies as of 1 July 2020



* Motor Transport Insurance Bureau of Ukraine.

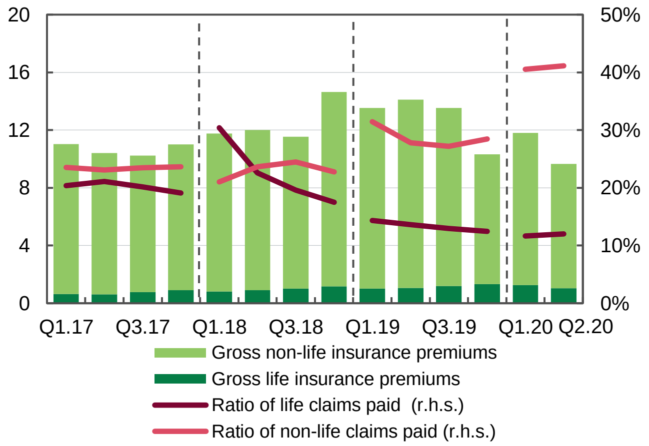
Since the end of 2019, the share of accounts receivable that are eligible to cover insurance provisions of non-life insurers declined, and the share of real estate somewhat increased.

Figure 9. Structure of assets eligible to cover provisions of non-life insurers, UAH billions



Non-life insurers' ratio of claims paid* grew to 41%. For life insurers, it declined to 12% in recent years. Life insurance premiums account for only 11% of gross premiums.

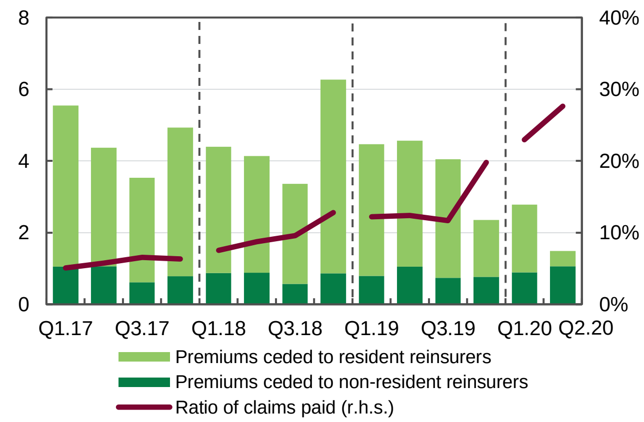
Figure 10. Premiums and ratio of claims paid* by type of insurance, UAH billions



* The ratio of claims paid is the ratio of claim payments to premiums for four quarters preceding the estimate date.

After a number of companies exited the market, internal reinsurance dropped, and the ratio of claims paid* rose.

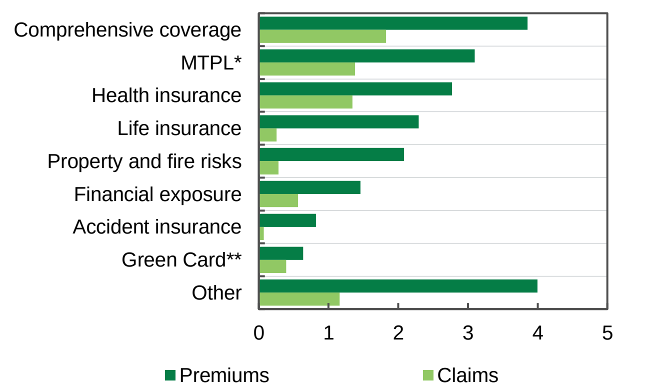
Figure 11. Premiums ceded to reinsurers and ratio of claims paid*, UAH billions



* The ratio of claims paid is the ratio of reinsurance claim payments to premiums for four quarters preceding the estimate date.

Motor vehicle insurance (CASCO and MTPL) accounts for the largest share of gross insurance premiums.

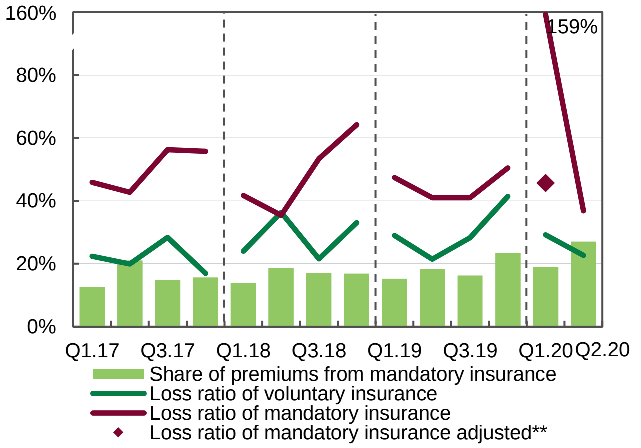
Figure 12. Breakdown of insurance premiums and claim payments by most popular types of insurance, UAH billions



* Compulsory motor third party liability insurance.
** International Motor Insurance Card System.

Compulsory non-life insurance has the highest loss ratio of 37%. The loss ratio of voluntary non-life insurance is 23%. Both indicators declined compared to Q1. The combined ratio of non-life insurers decreased in Q2 because of a decline in the loss ratio, although it remains surprisingly high at 97%.

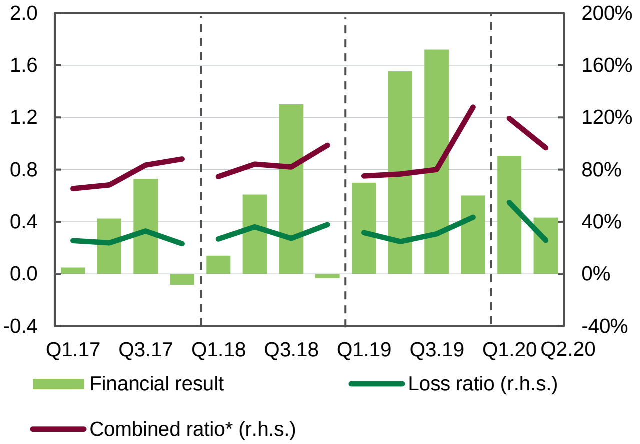
Figure 13. Share of compulsory insurance premiums and loss ratio* of non-life insurance



* The loss ratio is the ratio of claim payments adjusted for the change in loss provisions and loss settlements to premiums adjusted for unearned premium reserves.

** Excluding provisions for losses caused by the crash of the Ukraine International Airlines plane in Iran in January 2020.

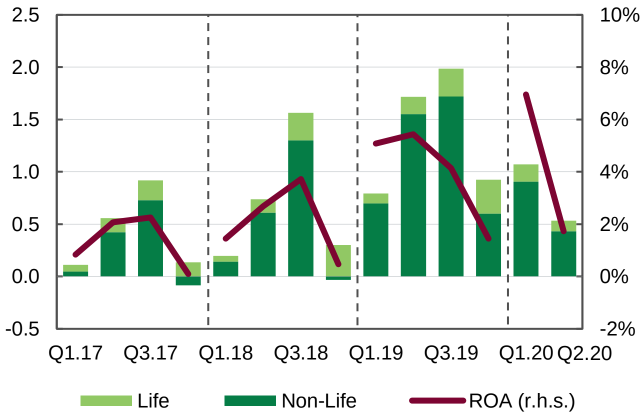
Figure 14. Financial result (income/loss), cumulative total and operational indicators of non-life insurers, UAH billions



* The combined ratio is calculated as the loss ratio plus the ratio of operating expenses to premiums adjusted for the amount of unearned premium reserves.

Overall, profitability remained acceptable, with a return on assets of 1.7%.

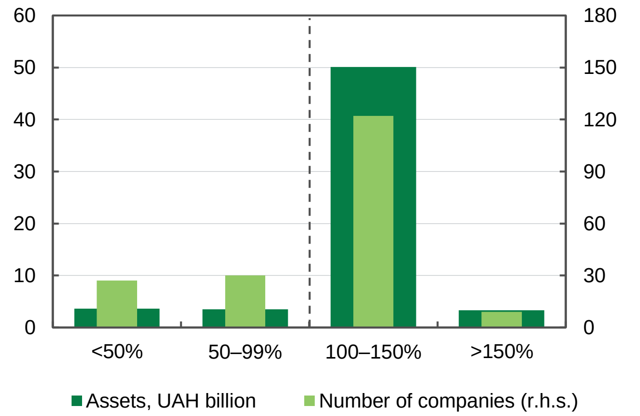
Figure 15. Profit or loss of insurance companies, cumulative, UAH billions



ROA is the return on assets, calculated as annualized profit or loss divided by average assets for the corresponding period.

A large number of insurers do not comply with the solvency requirements and need to restructure their assets or increase capital.

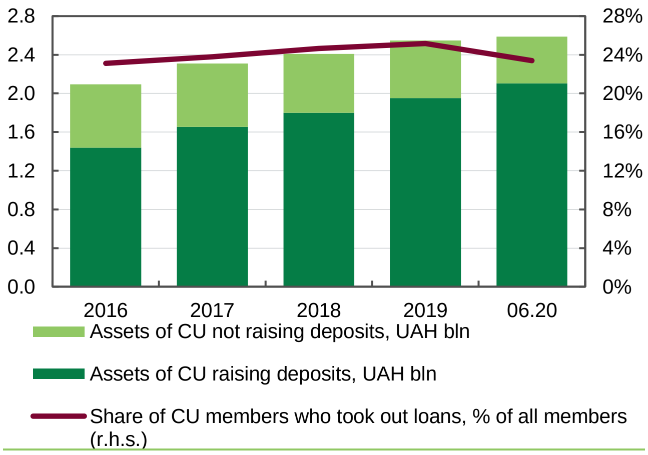
Figure 16. Distribution of number and assets of insurance companies by ratio of eligible assets to required solvency margin, as of 1 July 2020



Credit Unions

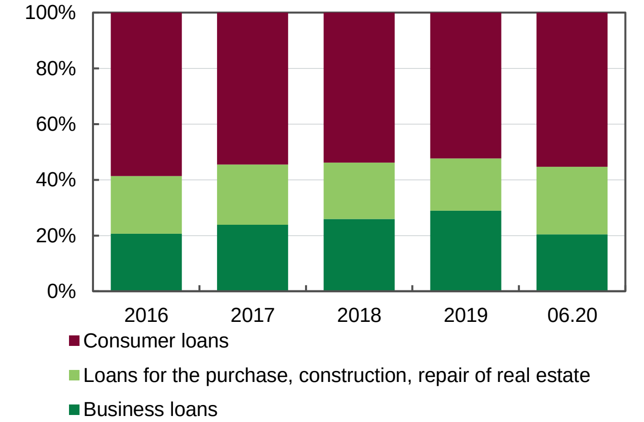
Credit union assets have been growing very slowly, and the number of credit unions is declining. A third of operating credit unions do not take deposits. Around a quarter of credit union members have taken out loans.

Figure 17. Total assets of credit unions (CU) and share of credit union members who took out loans



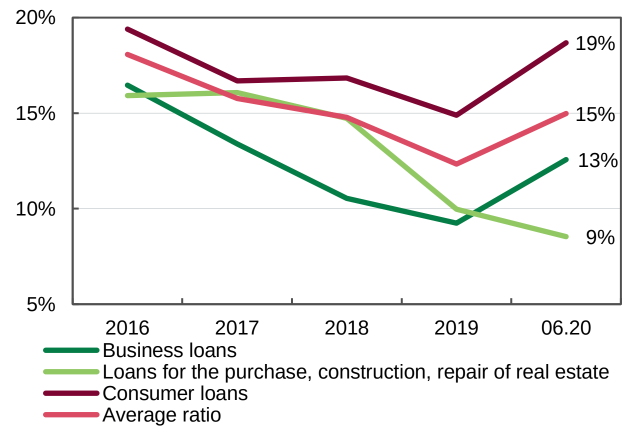
Consumer loans account for the largest share of credit unions' loan portfolios. Loans to finance business needs are mainly issued to agricultural producers. Growth in lending slowed after the quarantine was introduced.

Figure 18. Structure of outstanding loan principal, UAH billions



The nonperforming loan ratio started to grow, terminating its trend of gradual decline seen in recent years. Consumer loans remain the most risky: 19% of them are more than 90 days past due.

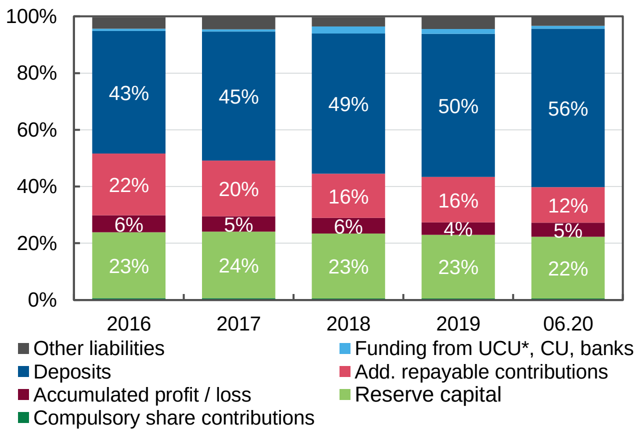
Figure 19. NPL ratio*, by type of loan



* 90+ days past due loans.

Credit union liabilities are dominated by deposits, which grew by 24% yoy. Additional share contributions as a percentage of total funding decreased. The capital is largely comprised of reserve capital, which declined slightly.

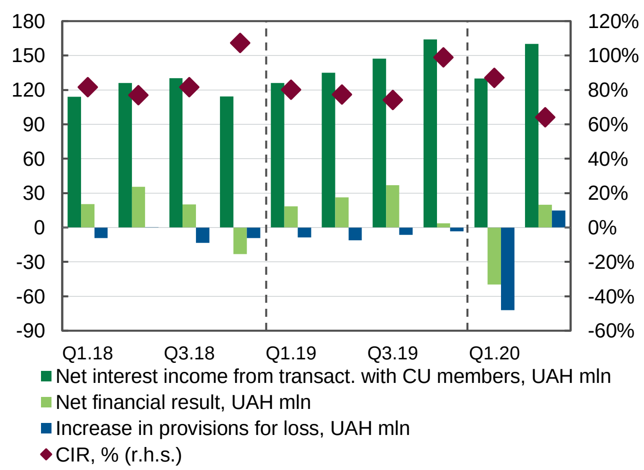
Figure 20.Composition of funding sources



* United credit unions.

Operational efficiency is low because of high administrative costs. In Q1, provisioning increased while financial performance worsened markedly. However, this trend reversed in Q2.

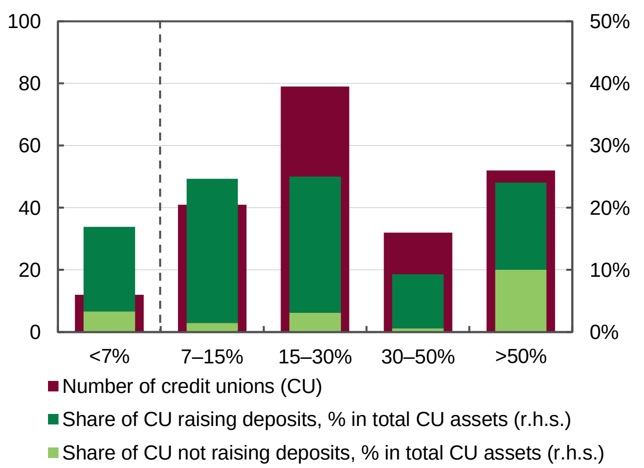
Figure 21. Operational efficiency



CIR (cost-to-income ratio) is the ratio of operating expenses to operating income.

Currently, most credit unions have regulatory capital adequacy in excess of the minimum requirement of 7%. At the same time, 12 credit unions did not meet the minimum solvency requirements as of 1 July 2020.

Figure 22.Distribution by core capital adequacy as of 1 July 2020



Finance Companies

Finance companies' assets are dominated by accounts receivable, which are very volatile. According to current reporting requirements, accounts receivable include credit assets. The larger portion of liabilities are funds the origin of which is not specified in reports. This points to insufficient disclosure of information about operations of many finance companies.

Figure 23. Asset structure, UAH billions

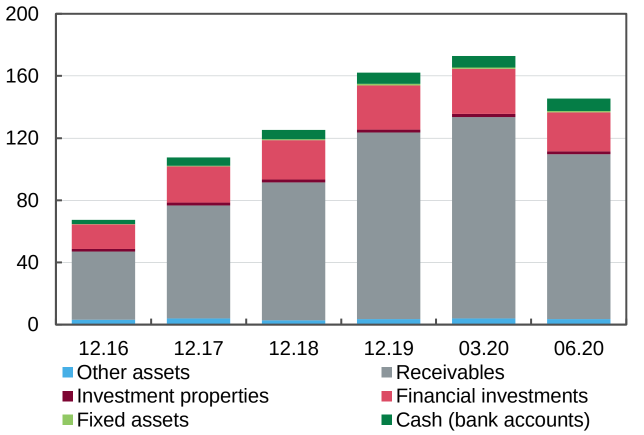
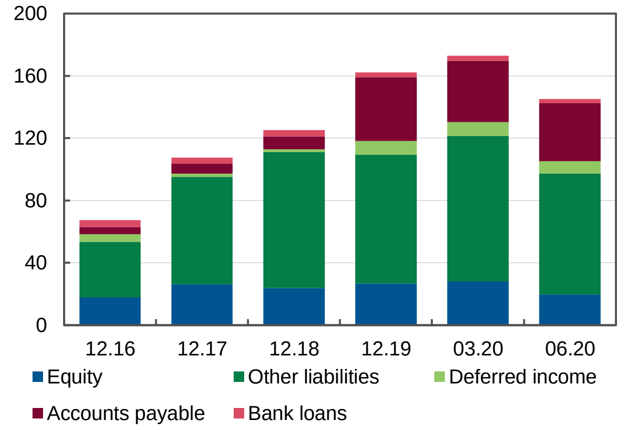
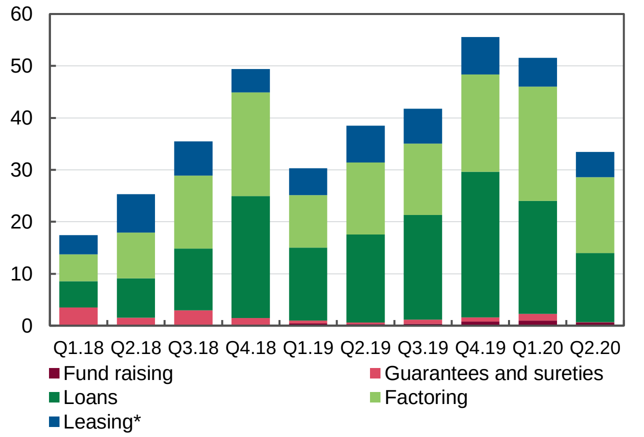


Figure 24. Composition of finance companies' liabilities, UAH billions



Lending has been the primary financial service provided by finance companies for a long time. However, volume of factoring somewhat exceeded lending in 2020.

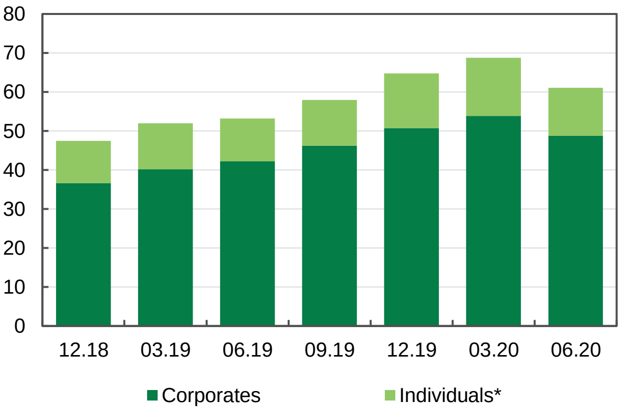
Figure 25. Volume of financial services provided by finance companies, by type of service (quarterly data), UAH billions



* Legal entities-lessors and leasing companies.

The gross loan portfolio of finance companies is largely comprised of corporate loans, which account for 78% of the portfolio.

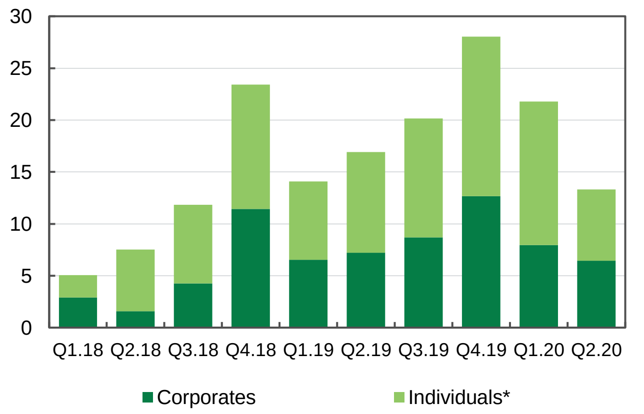
Figure 26. Gross outstanding loans of finance companies, UAH billions



* Including sole proprietors.

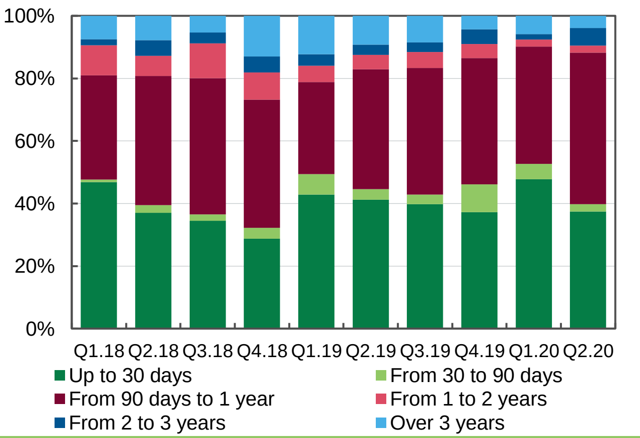
New loans are primarily retail. In Q2 2020, 37% of new loans were issued for up to 30 days and 49% for up to 12 months. Growth in lending slowed markedly in Q2, though lending volumes are rising in annual terms.

Figure 27. Loans issued during quarter, by borrower category, UAH billions



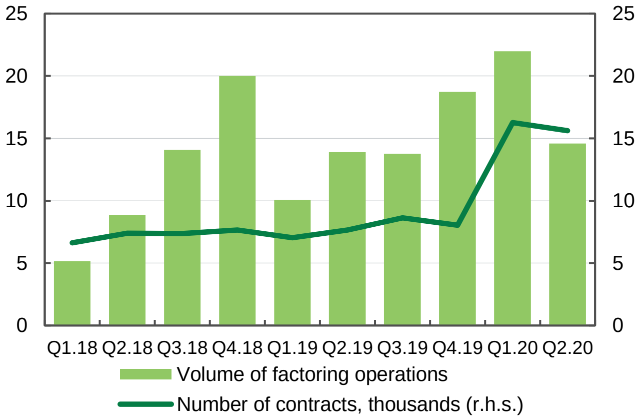
* Including sole proprietors.

Figure 28. Breakdown of loans issued during quarter, by maturity



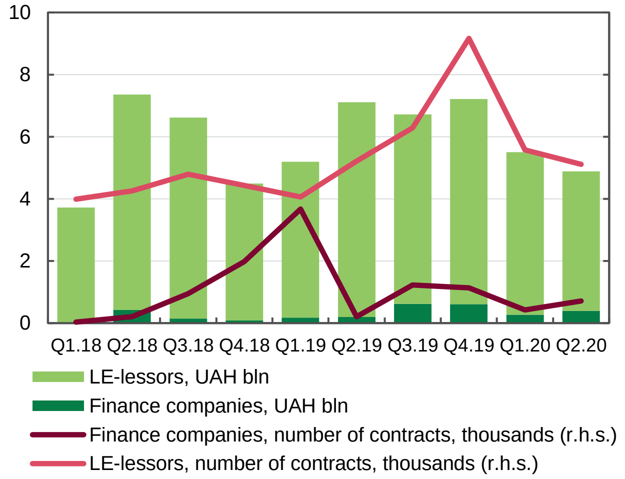
Factoring is strongly influenced by seasonality, with both the value and number of underlying agreements increasing gradually. Assignments of claims on loans account for a large share of the agreements.

Figure 29. Volume and number of factoring agreements, UAH billions



Presently, a large majority of leasing contracts are concluded by legal-entity lessors, both in number and value terms. The value of leasing agreements is relatively stable, with a pronounced seasonality component.

Figure 30. Volume and number of financial leasing agreements



Overall, profits of finance companies have been on the rise in recent years. At the same time, large losses incurred in early 2020 led to a steep drop in profitability ratios.

Figure 31. Financial performance of finance companies on cumulative basis, UAH billions

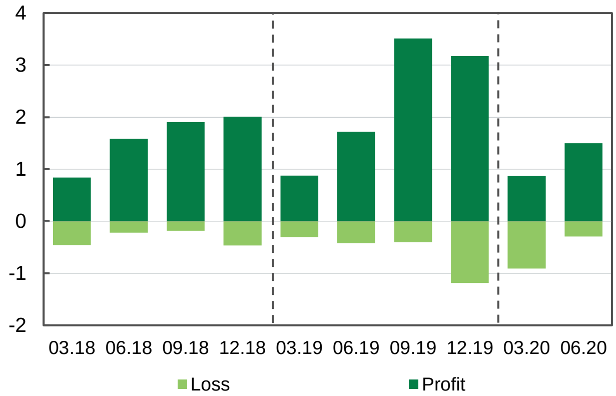
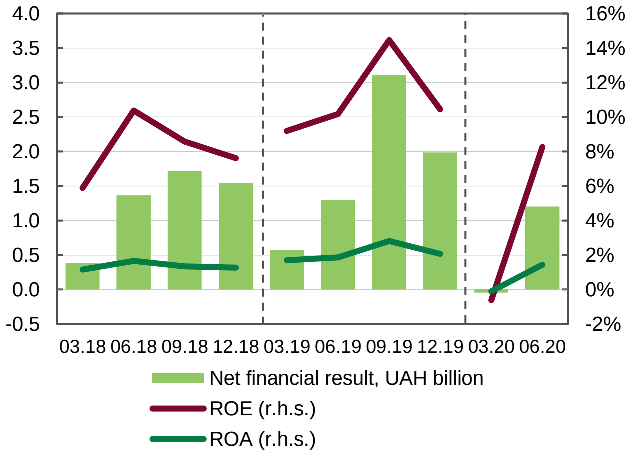


Figure 32. Financial performance of finance companies (on cumulative basis) and their return ratios



ROA is the return on assets, calculated as annualized profit or loss divided by average assets for the corresponding period.

ROE is the return on equity, calculated as annualized profit or loss divided by average equity for the corresponding period.

Pawnshops

Pawnshop assets were increasing until 2020, recording the highest growth rate in 2019 (+12.9% yoy). However, this was due largely to an increase in the value of fixed assets. Since the beginning of 2020, their assets have dropped by 5.4%. Loans make up 73% of total assets. Equity accounts for 40% of total liabilities.

Figure 33. Assets, UAH billions

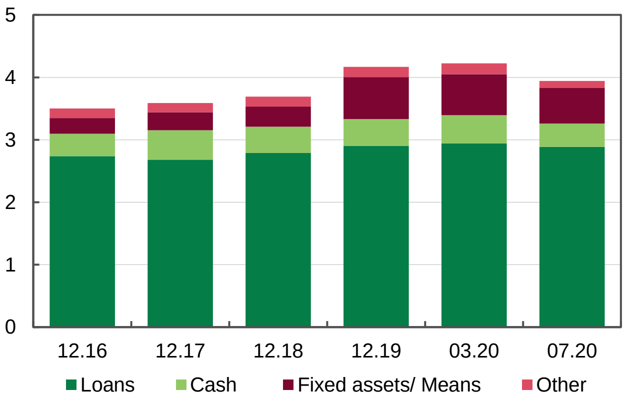
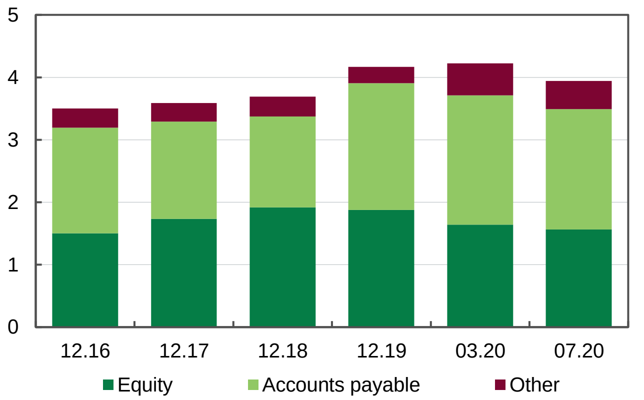


Figure 34. Liabilities, UAH billions



Lending fell by 25% in Q2 2020, terminating a prolonged period of growth. The collateral coverage ratio has been decreasing gradually, currently totaling 112%. Around 80% of loans are secured with jewelry and another 19% with home appliances. The share of loans secured with other collateral is negligible.

Figure 35. The amount of loans issued during the quarter and collateral coverage, UAH billions

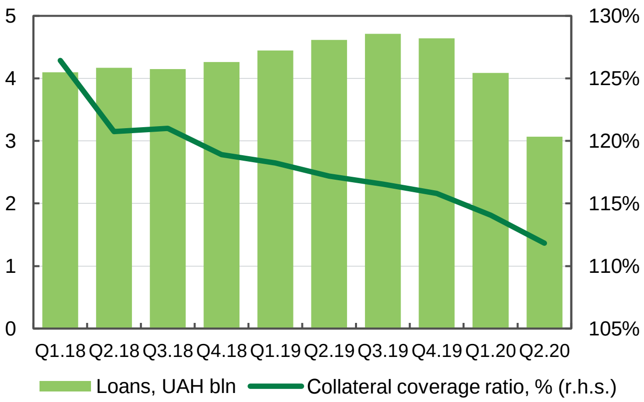
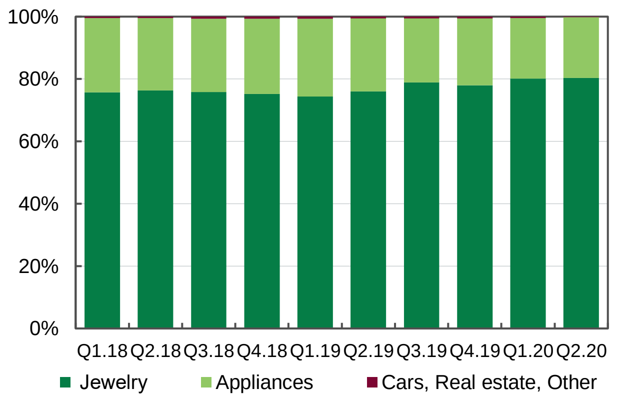


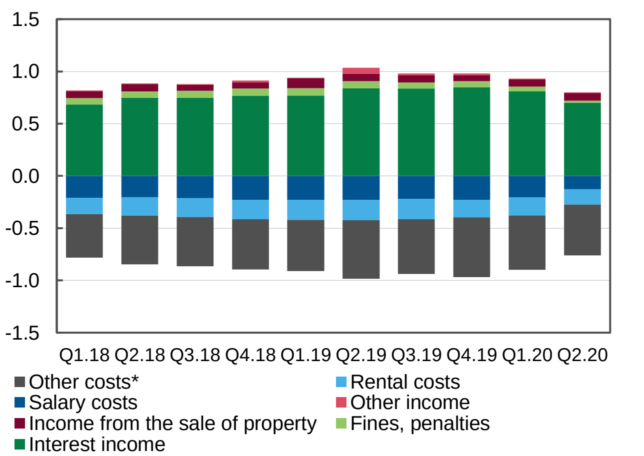
Figure 36. Loan portfolio structure by type of collateral



The share of loans secured with cars, real estate, and other assets is 0.24%.

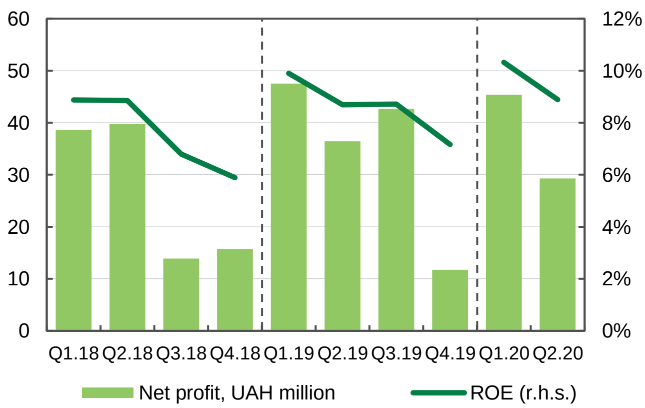
Pawnshops mainly earn their income from interest. Pawnshops receive minor proceeds from fines and penalties (2.7% of total income) and property sales (9.0%). Provisioning and financial expenses account for 1.6% and 2.4% of total expenses, respectively. Pawnshops are profitable with a return on equity of 8.9%, which is higher than in 2019.

Figure 37. Structure of income and expenses, UAH billions



* Including expenses related to selling and maintaining pledged property

Figure 38. Financial performance indicators



ROE is the return on equity, calculated as annualized profit or loss divided by average equity for the corresponding period.

Notes:

The source for the data is the National Bank of Ukraine unless otherwise noted.

This review covers non-bank financial institutions (NBFIs) that are regulated by the National Bank of Ukraine unless otherwise noted.

NBFIs submitted their Q2 2020 reports to the new regulator, the National Bank of Ukraine, for the first time. Due to new algorithms applied, performance indicators were not always correctly displayed in the report files. Therefore, consolidated reports may contain discrepancies in some aspects. The National Bank of Ukraine understands the situation and works on improving reporting control procedures in order to enhance data quality and ensure the full and proper disclosure of information about operations of NBFIs in the future.

Unless otherwise noted, the sample consists of institutions that were solvent at each reporting date and submitted their reports.

The sum of individual components and total sum may differ due to the rounding effect.

Terms and Abbreviations:

CASCO	Comprehensive vehicle insurance
CIR	Cost-to-income ratio. The ratio of operating expenses to operating income
Combined ratio	The loss ratio plus the ratio of operating expenses to premiums adjusted for unearned premium reserves
CU	Credit unions
GDP	Gross domestic product
LE	Legal entity
Loss ratio	The ratio of claim payments adjusted for the change in claims provisions and claims handling expenses to premiums adjusted for unearned premium reserves
MTIBU	Motor (Transport) Insurance Bureau of Ukraine
NBU	National Bank of Ukraine
NBFIs	Non-bank financial institutions
MTPL	Compulsory Motor third party liability insurance
Ratio of claims paid	The ratio of claim payments to premiums for four quarters preceding the estimate date
ROA	Return on assets
ROE	Return on equity
pp	Percentage point
UAH	Ukrainian hryvnia
USD, US dollar	United States dollar
Q	Quarter
H1 / H2	First / second half (of a year)
mln	Million
bln	Billion
r.h.s.	Right-hand scale
yoy	Relative to the same date/period a year before