Financial Stability Council Report on Activities

(August 2022 – July 2023)

National Bank of Ukraine

Ministry of Finance of Ukraine

Deposit Guarantee Fund

Office of the President of Ukraine

Ministry of Economy of Ukraine

National Securities and Stock Market Commission

Kyiv 2023

Foreword

The Financial Stability Council ("the Council") held five meetings from August 2022 to July 2023. During this time, the Council's agenda was primarily shaped by the challenges posed by russia's on-going full-scale war against Ukraine. The priority issue on the Council's agenda was to support the banking sector and its clients during the war. In particular, the Council members reviewed and supported the proposals of the government and the National Bank of Ukraine ("the NBU") to optimize the State Program Affordable Loans 5%–7%–9% *and implement the* Power Banking *project to promote lending and financial stability.*

At each meeting, the Council discussed systemic risks of the financial sector and problematic issues of its development in the context of the war. At the same time, the Council members noted that despite the protracted war and constant terrorist attacks by russia, Ukraine's financial sector and economy as a whole have adapted to operating in extreme conditions, including thanks to international financial assistance.

The Council paid considerable attention to Ukraine's fulfillment of commitments under the Memorandum of Economic and Financial Policies with the International Monetary Fund ("the Memorandum"). To this end, the Council reviewed and approved a new Strategy of Ukrainian Financial Sector Development prepared by the Financial Development Committee. The new document is aimed at withstanding russian aggression and reconstructing the country. The Council also heard reports on the activities of the working groups established by the Council, in particular the one on the revival of the domestic debt market. The Council members supported the need for further assessment of market demand as a condition for revitalizing the domestic debt market and ensuring full refinancing of redemptions on domestic government debt securities in 2023.

In the reporting period, the Council also supported the NBU's proposed concept for resilience assessment of banks and the banking system and heard a report from the Deposit Guarantee Fund (DGF) on its efforts to recover the assets of insolvent banks.

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Composition of the Financial Stability Council[1]

Co-chairpersons of the Council:

Sergii **MARCHENKO**	– Minister of Finance of Ukraine
Andriy **PYSHYY**	– Governor of the National Bank of Ukraine (NBU)

Members of the Council:

Yuriy **DRAGANCHUK**	– Deputy Minister of Finance of Ukraine for European Integration
Ruslan **MAGOMEDOV**	– Head of the National Securities and Stock Market Commission (NSSMC)
Dmytro **OLIINYK**	– Deputy Governor of the NBU
Svitlana **REKRUT**	– Managing Director of the Individuals' Deposits Guarantee Fund (DGF)
Kateryna **ROZHKOVA**	– First Deputy Governor of the NBU
Rostyslav **SHURMA**	– Deputy Head of the Office of the President of Ukraine
Yuliia **SVYRYDENKO** *(since May 2023)*	– First Deputy Prime Minister of Ukraine - Minister of Economy of Ukraine.

[1] Over the reporting period.

Key issues considered by the Financial Stability Council

1. Overview of systemic risks

Each Council meeting traditionally began with a review of systemic risks to the financial sector. The dominant risks to Ukraine's financial system were a protracted full-scale war and russia's terrorist attacks on Ukrainian infrastructure. At the same time, the financial sector and the economy as a whole were adapting to operating under extreme conditions. The threat of a global recession was averted, the economies of Ukraine's main partners grew, albeit slowly, and external inflationary pressures eased. Thus, overall, risks subsided compared to the record-high levels of H1 2022 (Table 1).

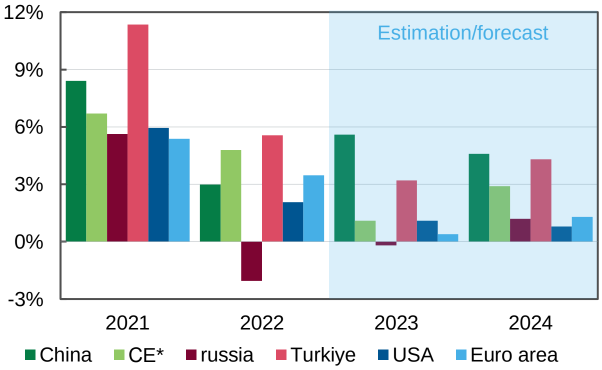
Table 1. Evolution of systemic risks

	Change of risk				Level of risks as of			
	2022		2023					
	Q3	Q4	Q1	Q2	08.12.22	03.02.23	04.05.23	19.07.23
Global economy	→	↗	→	↘	yellow	yellow	yellow	yellow
External demand	↘	→	→	↗	yellow	yellow	yellow	yellow
Economic conditions	↗	↗	↗	→	red	red	yellow	yellow
Public finance	↗	↗	→	→	red	red	red	yellow
FX market	↗	↗	→	→	red	yellow	yellow	yellow
Geopolitics	↗	→	↗	→	red	red	red	red

Assessment of change of risk. The arrows pointing up mean an increase in risk, and arrows pointing down mean a decrease in risk.
The level of risk refers to its intensity: ● *green = low,* ● *yellow = medium,* ● *red = high.*

Global economy. Economic growth in Ukraine's main partners and the global economy slowed. Although a global recession was averted, a number of countries, including some in Central and Eastern Europe, experienced a downturn at the start of the year. As a result, the economies of Ukraine's main partner countries are expected to grow rather slowly this year. More and more central banks in emerging market economies are moving to monetary policy easing. However, persistently high inflation in advanced economies has led to further tightening of monetary policy by leading central banks. Therefore, interest rates will remain high for longer than expected. Growth rates of global trade will likely stay low.

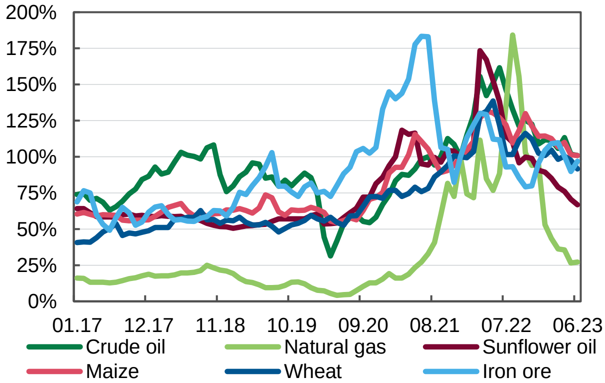
Figure 1. GDP change of russia and Ukraine's main trading partners



** Central Europe including Bulgaria, Hungary, Poland, and Romania.*

Source: World Bank, Global Economic Prospects, June 2023.

Figure 2. World commodity prices*, December 2021 = 100%



** Change in USD terms. Crude oil – Brent; natural gas – in Europe; iron ore – CFR China; sunflower oil, wheat, maize – international markets.*

Source: World Bank, "Pink sheet" data, July 2023.

External environment. After rising in the autumn of 2022, energy prices declined at the start of this year, in particular in Europe natural gas prices dropped due to a mild winter and crude oil prices decreased due to a slowdown in the global economy. However, the risks of further price increases remain – for natural gas prices with the onset of the cold period and for crude oil prices with an acceleration of the global economy.

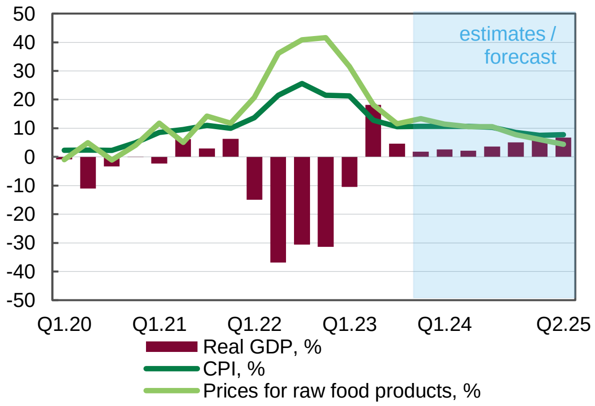
Food prices have also been declining from last year's highs, although they remain at record-high levels. However, the key risk to Ukrainian exports was the uncertainty of supply channels: the short-term nature of the arrangements for the functioning of the grain corridor, obstacles to its operation created by russia since the start of 2023, and the county's withdrawal from the grain initiative this summer. At the same time, since the onset of the full-scale invasion, alternative supply routes have been actively developed, including those through the Danube ports, which partially compensated for the suspension of the grain corridor. In 2023, the ban on imports of certain agricultural products by five neighboring EU countries added to the negative factors. This has already caused some losses for domestic exporters. However, there are no restrictions on the transit of Ukrainian goods.

Economic conditions. Ukraine's economy has been slowly recovering from the sharp fall in H1 2022 caused by russia's full-scale invasion. However, deliberate destruction of infrastructure by the aggressor, including energy infrastructure, hampered economic recovery. At the same time, businesses have generally adapted to operating in conditions of a full-scale war.

Inflation reached 26.6% last year. However, it was contained and continued to decline, to 12.8% at the end of June 2023. This was facilitated by the NBU's tight monetary policy. The taming of inflation allowed the NBU to begin a cycle of key policy rate cuts earlier than expected.

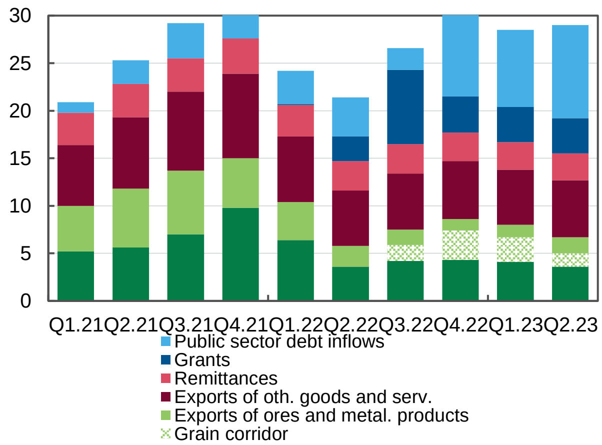
A significant foreign trade deficit remains the main driver of foreign currency outflows in the reporting period and in the near term. In H1 2023, it reached USD 17 billion, or 22.3% of GDP, according to NBU estimates. Thus, exports of goods declined markedly due to limited logistics and destruction and damage to production facilities and infrastructure. Meanwhile, imports of goods grew fueled by the recovery in domestic demand and the high needs of the defense sector. At the same time, large inflows of international financial assistance covered the foreign trade deficit and enabled a surplus in the overall balance of payments.

Figure 3. Change of GDP, consumer price index (CPI) and change of raw food prices, % yoy



Source: NBU Inflation Report, July 2023.

Figure 4. Key components of FX inflows, USD billions

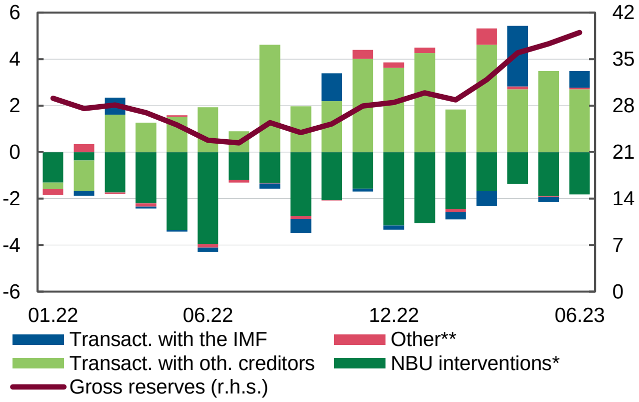


Source: NBU Inflation Report, July 2023.

Public finances. International financial support, which has become more systematic and large-scale, covers a large part of the budgetary needs and provides liquidity to the government. This makes it possible to expand the expenditure planning horizon and to fulfill obligations when they fall due. Another factor in reducing budget risks was the intensification of the government's domestic borrowing (read more in Section 3). The increase in domestic borrowings significantly reduces the risks of monetary financing, which remained relevant in H1 2022 and thus were considered by the Council at that time (read more in the previous Report). In addition, in accordance with the Memorandum, the government is to reach a full rollover of its domestic liabilities in 2023.

FX market. In 2022, FX market risks were high, and exchange rate expectations were pessimistic. However, a number of measures taken by the NBU to stabilize the FX market and inflows of international assistance helped to reduce risks and increase international reserves. In 2023, a comfortable level of international reserves, together with the NBU's measures to increase the attractiveness of hryvnia assets and prevent unproductive capital outflows, stabilized exchange rate expectations. The hryvnia exchange rate in the cash market has strengthened since the start of this year and approached the noncash market level. The substantial level of international reserves also creates a safety margin for a gradual easing of FX restrictions.

Figure 5. Change in gross international reserves, USD billions

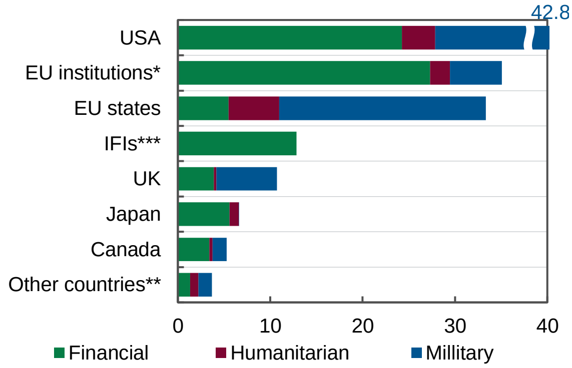


** NBU interventions: (+) refers to purchasing FX to increase reserves; (-) refers to selling FX from reserves.*

*** "Other" means the revaluation of financial instruments due to changes in their market value and exchange rate fluctuations, as well as other transactions.*

Source: NBU.

Figure 6. Commitments of international assistance (both pledged and provided) for Ukraine between end-January 2022 until May 2023



** European Commission, European Council, European Investment bank, European Peace Facility.*

*** Norway, Australia, Switzerland, South Korea, New Zealand, China and Taipei, Iceland, and Türkiye.*

**** IMF, World Bank, EBRD.*

Source: Kiel Institute for World Economy.

Geopolitics. The war continues to drag on, and the continuous mobilization in russia shows moscow's unwillingness to finish it. Russia continues its campaign of terror against civilian infrastructure – energy, transport, and food infrastructure. At the same time, the Ukrainian defense forces have held the front and liberated a significant part of the territories seized by the enemy since February last year. International financial and military assistance to Ukraine is becoming more systematic and increasingly matches the country's needs. At the same time, conflicts are spreading within the enemy's ranks, and sanctions are depressing its economy, although the existing sanctions are still insufficient.

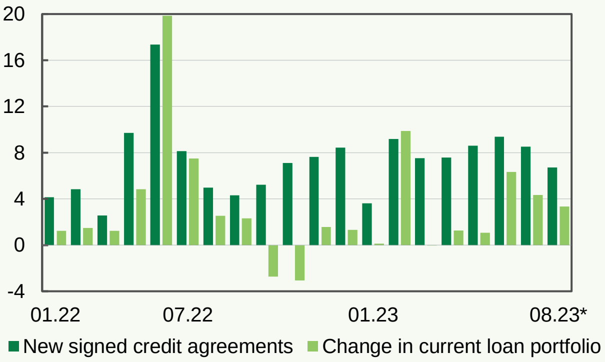
Council's position. The Council agrees with the risk assessment presented by the NBU.

Box 1. Supporting Banks and Their Clients during the War

Since the start of the full-scale invasion, financial regulators have been taking active measures to support the financial sector and its clients.

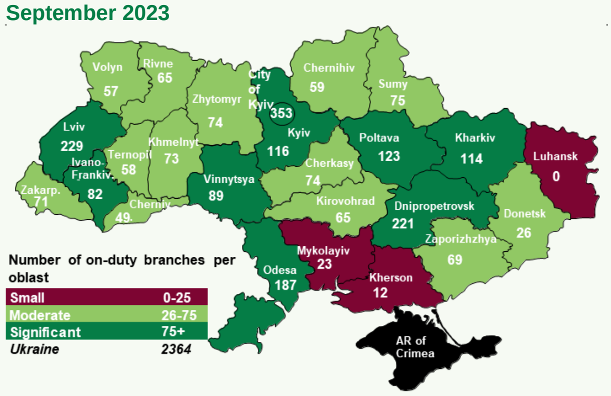
In wartime, government support programs, primarily the *Affordable Loans 5%–7%–9%* program, became the main drivers of lending. Therefore, the Council paid special attention to their development. At the start of 2022, the program was expanded to provide emergency support to businesses, focusing on the sowing campaign. For this purpose, the program envisaged loans at zero interest rate for debtors. By the end of 2022, given the gradual adaptation of businesses to the war, the design of the *Affordable Loans 5%–7%–9%* program needed to be revised. Therefore, in December, the Council discussed expanding the scope of borrowers and adjusting interest rates to ensure the optimal use of resources. In March 2023, the government changed the design of the program, which continues to be in demand for a significant number of borrowers.

Figure 7. Lending under "Affordable loans 5-7-9%" programs, UAH billions



** As of 28 August 2023.*
Source: NBU.

Figure 8. Number of on-duty bank branches as of 4 September 2023



Source: NBU.

At the end of 2022, in view of russia's energy terror and the threat of prolonged power supply disruptions, the NBU initiated the *Power Banking* project to ensure the uninterrupted continuity of banking services. The banks had to ensure the operation of their systems, the functioning of critical business processes, and communication with the NBU's data processing center even in the event of a long-lasting blackout. The NBU presented the project at the Council meeting in December. The meeting's participants supported the *Power Banking* initiative and agreed to cooperate with other authorities to ensure banks' business continuity in an effort that will bolster the financial sector's resilience. The banks set up a network of on-call branches and maintained their uninterrupted operation even during prolonged power outages. As of mid-August, the network of on-call branches included about 2,300 branches of 61 banks, which was about 45% of all structural units of financial institutions.

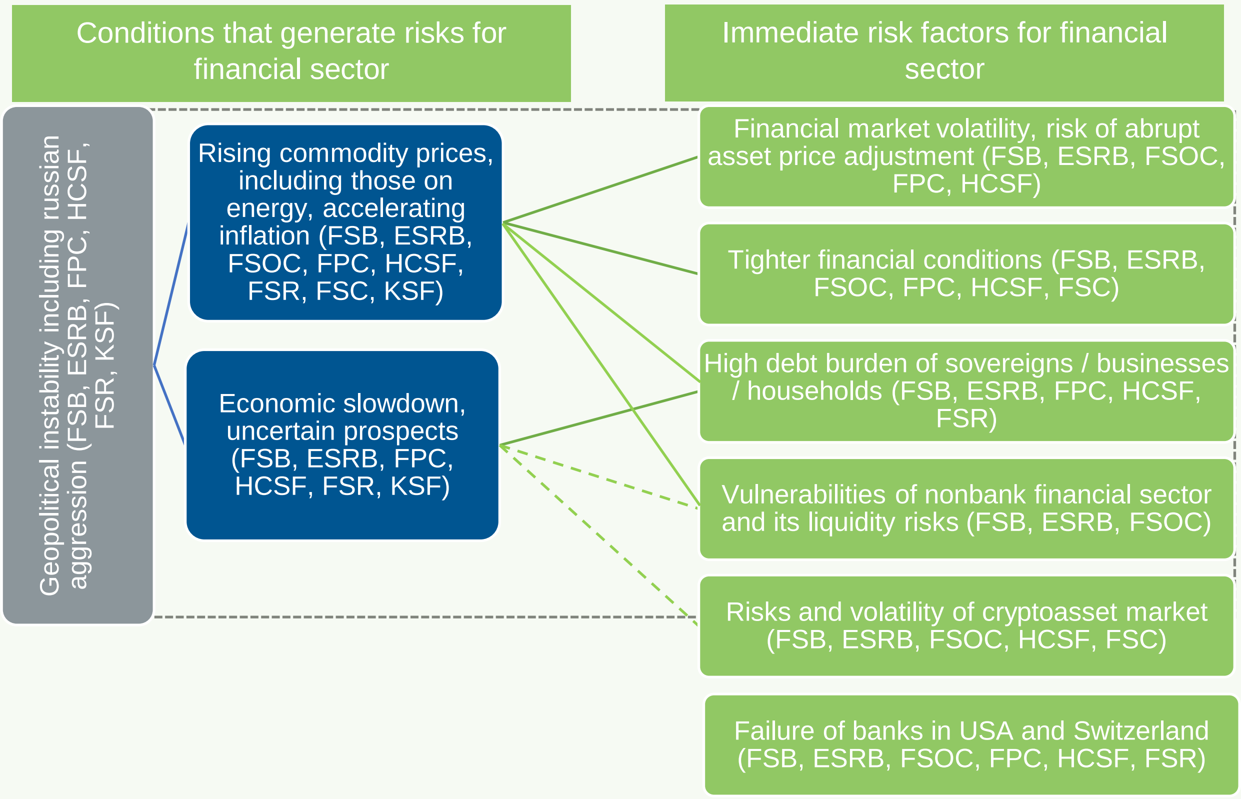
The operation of payment systems – and card payment systems for retail clients – has been an important element in maintaining the uninterrupted provision of banking services since the onset of the war. This includes the National Payment System PROSTIR ("NPS PROSTIR"). This is a card payment system created and developed by the NBU on the basis of open international standards. NPS PROSTIR has a well-established infrastructure in Ukraine (100% of POS terminals, 94% of ATMs) and technologies comparable to cards of international payment systems. In addition, NPS PROSTIR offers affordable connection costs and low fees. Overall, the system is capable of providing full service for domestic transactions with lower-cost payment cards. Therefore, the NBU plans to develop the NPS PROSTIR as an element of Ukraine's national security. The NBU communicated its intentions to the Council members.

Council's position. To support the proposals of the government and the NBU to optimize the State Program *Affordable Loans 5%–7%–9%* and the *Power Banking* project, given their importance for the smooth operation of the banking system and financial stability in general.

Box 2. Risks and Key Recommendations of Financial Stability Councils/Committees around the World

The Council's secretariat monitors systemic risks that have been identified by international and national financial stability councils and committees (councils and committees), as well as the recommendations made by these bodies. The repercussions of the full-scale invasion of Ukraine remain the focus of many councils and committees. That said, there was less talk about geopolitical risks in 2023, with the focus of attention shifting to the risk factors generated by these risks – last year's growth in prices, mainly energy prices, slowing economic development, and uncertainty.

Figure 9. The main risks covered by financial stability councils and committees



FSB – Financial Stability Board (G20); ESRB – European Systemic Risk Board; FSOC – Financial Stability Oversight Council (USA); FPC – Financial Stability Committee of the Bank of England; HCSF – High Council for Financial Stability (France); KSF – Financial Stability Committee (Komitet Stabilności Finansowej, Poland); FSC – Financial Stability Committee (Financieel Stabiliteitscomité, Netherlands), FSR – Financial Stability Council (Finansiella stabilitetsrådet, Sweden).

Councils and committees are paying increasingly more attention to the issue of financial stability outside the perimeter of the banking sector. An additional reason for this attention was the shaky situation with the liquidity of some investment funds when the commodity and financial markets were highly volatile at the beginning of the previous year.

The failures of a few banks in the United States and Switzerland were a challenge for the authorities responsible for financial stability at the beginning of the year. Although the U.S. and European financial systems proved to be resilient in the face of this challenge, councils and committees launched an in-depth analysis of the causes of these events. As expected, this analysis will result in enhanced regulation and supervision of banks at national and international levels.

Following last year's shock, the cryptoasset market was very volatile. In view of this, and in response to a rise in the number of real and potential points of contact between traditional and virtual finance, councils and committees paid increasing attention to this market. This, in turn, led to a gradual enhancement of the regulation of the sector.

Last year, the intensity of cyber attacks increased significantly, especially in H1. That is why analyzing the experience gained and boosting resilience to new cyber incidents remained high on the agenda of councils and committees during the reporting period.

2. A new Strategy of Financial Sector Development

This year, the Council considered and approved a new Strategy of Ukrainian Financial Sector Development (strategy), which aims to fight off russian aggression and to restore the country. The previous strategy, which was adopted in December 2019, had to be revised because of russia's full-scale invasion of Ukraine. The revision of the strategy was also envisaged by the Memorandum.

The strategy has five sections. Section I, The Current State of Ukraine's Financial Sector, contains a description of the sector's key problems and achievements since the start of russia's full-scale invasion of Ukraine. Section II is about the Council's prospect of the future, which includes the vision and the mission of Ukraine's financial sector.

VISION OF UKRAINE'S FINANCIAL SECTOR

Ukraine's financial sector is stable, efficient, competitive, integrated into the global environment, and capable of meeting challenges, developing, and contributing to the recovery of the Ukrainian economy

MISSION OF UKRAINE'S FINANCIAL SECTOR

Regulation of the financial sector ensures the accumulation, distribution, and circulation of financial resources on the basis of financial stability, inclusion, cybersecurity, and the spread of cutting-edge technologies, in order to promote the recovery of Ukraine's economy and support the well-being of people.

Section III contains strategic goals, expected results and a description of the methodology used to draw up this strategy. All measures envisaged by the document were broadly classified into two focuses. The resistance focus comprises short-term measures aimed at ensuring stability and preventing a deterioration of the situation in the financial system and the economy in general. The recovery focus contains medium-term measures that will form the basis for future reconstruction and growth of the economy.

The strategic goals of the documents are as follows:
- macroeconomic stability
- financial stability
- a financial system operates for the country's recovery
- modern financial services
- the institutional capacity of the regulators and the DGF.

Section IV decomposes the goals into strategic initiatives and the measures needed to implement these initiatives. Section V addresses Ukraine's international commitments in financial services so as to ensure Ukraine's further integration into the EU.

This strategy was drawn up by the Task Force (Committee) On Financial Development at the Financial Stability Council. Recommendations provided by International Monetary Fund and World Bank experts informed this strategy.

The strategy was made public in August 2023. It is available at the following link or on the websites of the signatory institutions.

Council Position. To approve the new Strategy for Developing Ukraine's Financial Sector.

3. Developing the Domestic Debt Market

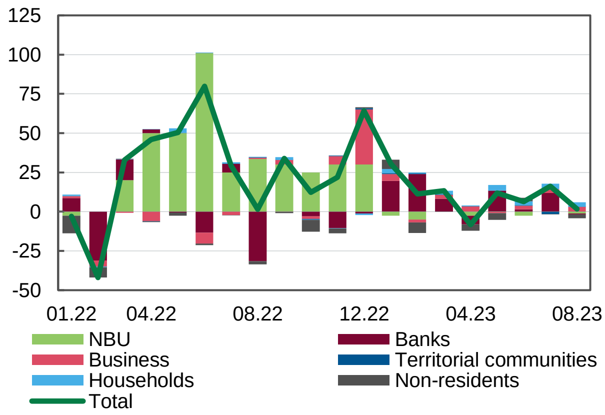
The Council's agenda included revitalizing the primary market for domestic government debt securities so as to avoid the need for the monetary financing of the budget in 2023. This was needed to curb inflation and safeguard macroeconomic stability in wartime, as is envisaged by the Memorandum. Council members discussed measures to revive the domestic debt market. In April 2023, they decided to set up a task force to develop the domestic debt market. The task force consisted of NBU and Finance Ministry representatives.

The main job of this task force is to exchange information and to prepare recommendations as to how to mobilize the resources of the domestic debt market to finance the state budget deficit. The task force analyzes liquidity risks in the banking system and engages in dialogue with market participants, while also drawing up recommendations for the Finance Ministry and the NBU as to how to resolve the problems of the government bond market.

The joint efforts of the NBU and the government have revived the domestic debt market. In particular, in 2023, the NBU allowed the banks to use benchmark domestic government debt securities from the list proposed by the Finance Ministry to meet up to 50% of their total required reserve ratios. This noticeably pushed up the banks' demand for purchasing bonds on the primary market. Promoting investment in benchmark domestic government debt securities also gradually increased the banks' interest in other government debt instruments. Growth in market placements was also fueled by a significant decline in inflation, which increased real yields on domestic government debt securities. As a result, the government's hryvnia borrowing in the first five months of 2023 has already exceeded that for the whole of 2022.

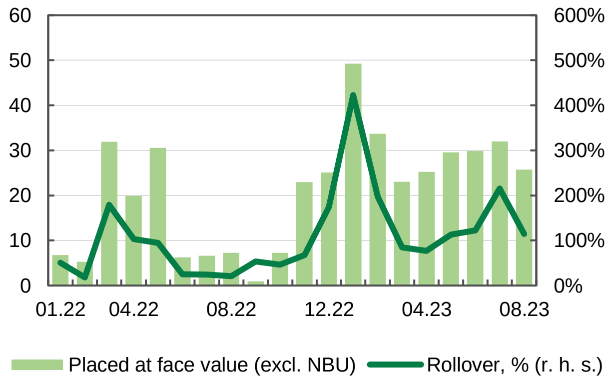
The key factor for the rebound of the domestic debt market was the approaching of the level of yields on domestic government debt securities to market-driven ones, while the success criterion was 100% rollover on the market. In January – July 2023, the Finance Ministry's borrowing, through issuing hryvnia domestic government debt securities, exceeded the nominal value of redemptions of these securities by UAH 85.8 billion (excluding repayment of the ministry's debt to the NBU), while the rollover of these securities hit 144%.

Figure 10. Change in the amount of domestic government debt securities in circulation, at their nominal value, UAH billions



Source: NBU.

Figure 11. Rollover of domestic government debt securities (at their face value, excluding the NBU)



** Excluding domestic government debt securities issued to inject additional capital of UAH 30 billion into Ukrfinzhytlo in December 2022.*

Source: NBU.

Council Position. Take into account information about the rebound on the domestic debt market.

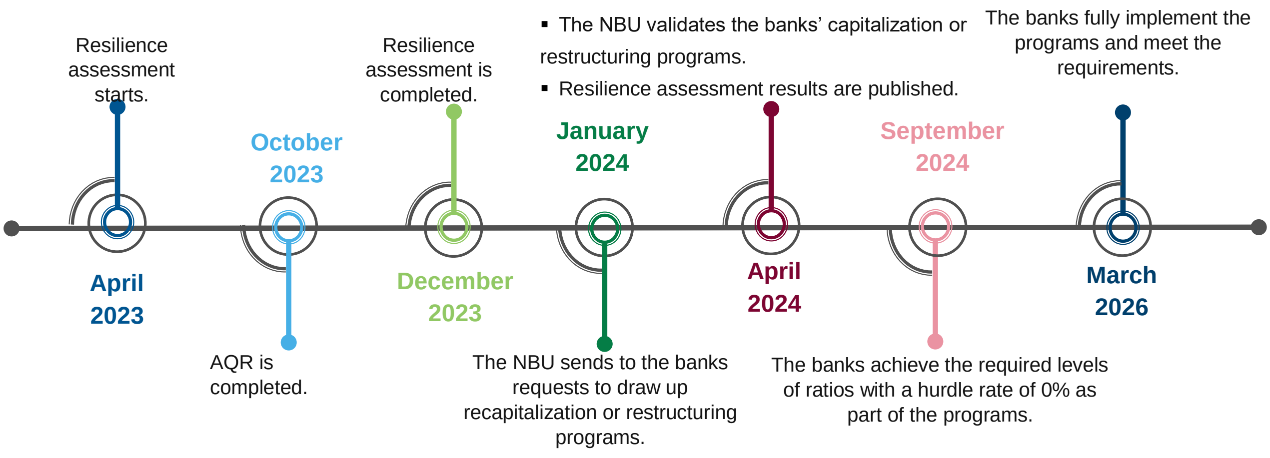
4. Resilience Assessment of the Banking Sector in 2023

At a scheduled meeting of the council in February 2023, the NBU presented its concept of assessing the resilience of the banks and the banking system in 2023. The resumption of resilience assessments resulted from the need to assess the sector's condition after the hardest phase of the current war-induced economic crisis was over. The underying approaches of this year's bank resilince assessment are similar to those applied in previous annual resilience assessments. However, there are some differences: the NBU will conduct the assessment itself, the number of banks to be assessed will be smaller, and the time given to comply with assessment-based requirements will be longer.

As usual, the NBU will conduct resilience assessments in three stages: an asset quality review (AQR) based on bank's asset sample, extrapolating the findings to all lending transactions of a bank (if necessary), and assessing the bank's performance indicators and its capital under a baseline scenario over a three-year horizon. In 2023, the central bank will assess 20 banks that account for over 90% of the banking system's assets. This is sufficient to assess the overall situation in the sector. When assessing the banks' resilience, the NBU will scrutinize loan collateral, in particular the appropriateness of the approaches for assessing this collateral. To estimate a bank's indicators, the NBU will rely solely on a baseline scenario, which is based on a macroeconomic forecast. The findings of the assessment will be used to assess the banks' capital needs to hold positive capital levels, and to prepare a plan to gradually meet the minimum capital adequacy ratio.

The resilience assessment started on 1 April 2023 and will last until the end of the year. The NBU will require the banks that will be identified as having a need for capital to draw up recapitalization or restructuring plans. The banks will be given enough time to restore capital, if necessary – two years from the completion of the resilience assessment. Banks that generate operating profits will be capable of implementing their plans using their current operating profits. As a standard practice, the banks can also comply with the NBU's the requirements by restructuring their balance sheets and, as a result, mitigating the risks identified in the resilience assessment. Capitalization may be required only as an extreme measure.

Figure 12. Resilience assessment timeline



Source: NBU.

The findings of the resilience assessment will shape an adjustment of the regulatory easing regime and inform decisions that will sustain the bringing of banking requirements into line with the EU acquis.

Council Position. To support the NBU's concept for assessing the resilience of the banks and the banking system in 2023.

5. The DGF's Efforts to Recover the Assets of Insolvent Banks

In line with the agreement the Council reached in 2021, the DGF informs the Council, on a regular basis, about how it is implementing the measures to decrease the state's losses through implementing the mechanism for holding bank owners and related parties accountable, including through prosecuting them in foreign jurisdictions.

The DGF provided information about four ways to recover funds from related parties.

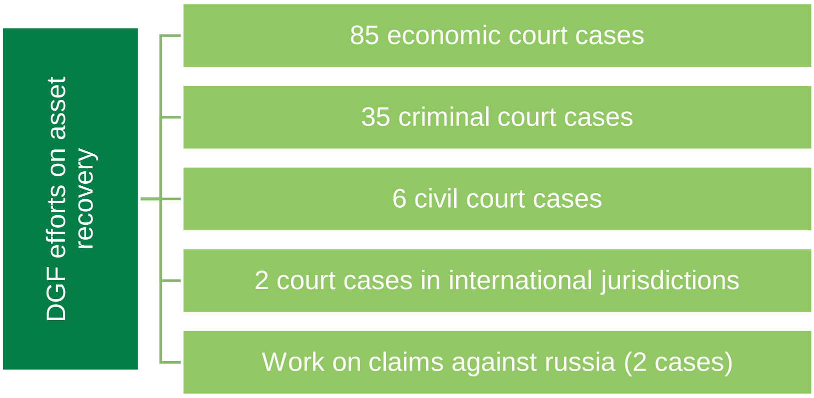
The first and main way is through economic courts, which are currently handling 85 lawsuits that were brought against the former owners and top managers of 53 banks. The DGF is claiming UAH 171.1 billion in damages from 987 defendants.

The second way is through criminal proceedings as part of which civil claims for the recovery of damages have been filed. A total of 35 cases amounting to UAH 24.6 billion are being considered today, and the number of civil defendants is 68 persons. The third way is through civil court cases related to persons who have been found guilty of committing a criminal offense, and/or reached a plea-bargaining agreement with investigators and against whom criminal charges were dropped. The amount claimed in damages in these cases is UAH 5.2 billion. The prospects of recovering damages in six of these cases are uncertain, as the defendants were neither top managers of banks nor their beneficial owners.

In 2021, a new initative was launched – filing court cases in international jurisdictions. Currently, two cases against two banks are being handled. The claims in these cases amount to UAH 2.3 billion.

The DGF Directorate also decided to initiate a new initiative – filing lawsuits against russia for the damage it has inflicted since 2014 and since the start of the full-scale invasion on 24 February 2023. The DGF has drawn up and started implementing the strategy for claiming these damages in Ukrainian courts, and subsequently enforcing the relevant court rulings in international jurisdictions. Currently, two cases against two banks claiming UAH 2.6 billion in damages are being handled.

Figure 13. Ways the DGF uses to recover the assets of insolvent banks



All information about the DGF's efforts is in the public domain, and is available on the fund's website.

Council Position. Take the DGF's report into account.