National Bank of Ukraine

Financial Stability Report

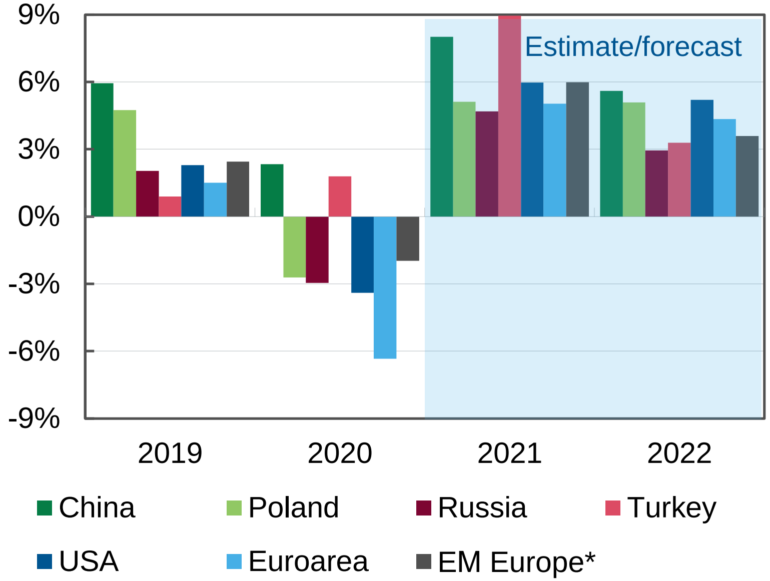
21 December 2021

Summary

- Escalation of conflict by Russia, high energy prices, and spread of new COVID variants combined led to deterioration of economic growth expectations.
- Premium for Ukrainian risk increased, thus limiting access to global financial markets. Therefore, maintaining cooperation with the IMF is important. At the same time, the banking sector virtually does not fund itself from external markets, so the direct impact on it is limited.
- The economy is resilient enough to face these risks. However, grows slower that expected. It needs investment to boost the growth.
- The banks are profitable, well-capitalized and liquid. Therefore, they are ready to ramp up lending. Foreign investors show higher interest in the banking sector.
- Higher incomes, lower rates, and government programs underpinned demand for loans from households and businesses: loan portfolio surged.
- Loan portfolio quality improves, so provisioning significantly declines.
- Bank funding is sufficient to support further lending. However, financial institutions are interested to extend maturities of deposits, so they have started to raise deposit rates in H2. Another reason behind higher interest rates is policy rate hikes by the NBU.
- Further loan rates decrease squeezes banks' interest margins. However, their incomes rise thanks to fast growth of loan portfolio.
- Banks' profitability and available capital show that there are no reasons to postpone new regulatory requirements.
- The banks will have to build up capital conservation and systemic importance buffer (where applicable) in full by 1 January 2024.

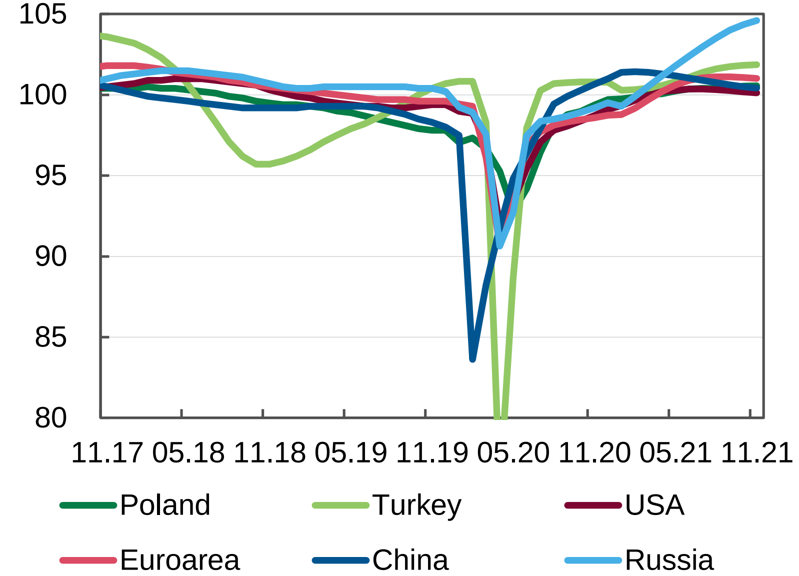
External risks increase

Change of real GDP of Ukraine's major trading partners



* Belarus, Hungary, Moldova, Romania, Russia, Turkey, Ukraine, and six states of Western Balkans.
Source: IMF, World Economic Outlook, October 2021.

OECD's composite leading indicators (CLI) for Ukraine's major trading partners



Source: OECD.

- Growth of partner countries decelerates, inter alia due to risk of spread of new COVID variants and winding down of some fiscal stimuli programs.
- A surge of energy prices while prices for Ukrainian exports contact worsens terms of trade.
- Increasing risk-free rates and risk premia complicate raising funds.
- Russia threatens with a large-scale invasion and pressures through "gas diplomacy".

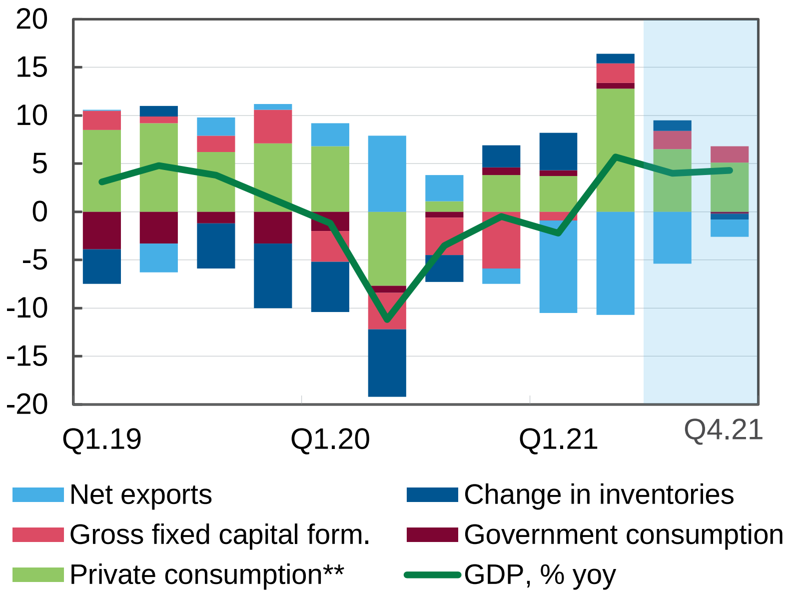
Financial stress index remains low

Source: NBU.

- Financial stress index remains low but volatile.
- Russia pulled its troops to Ukrainian borders, which brought up cost of CDSs and yields on Ukrainian Eurobonds.
- In spite of the increase in certain components, there is no shock spillovers between markets. This shows that there is no systemic stress.

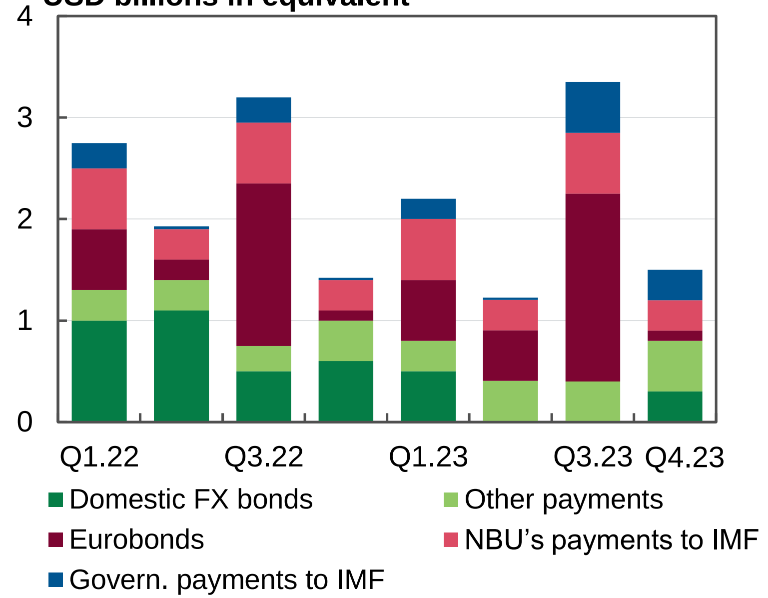
Economic recovery is slow

Contributions to annual GDP growth by final use, pp*



* Forecast for the III-IV quarters of October 2021 (will be updated in January). ** Together with non-profit organizations serving households.
Source: State Statistics Service of Ukraine, NBU calculations..

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

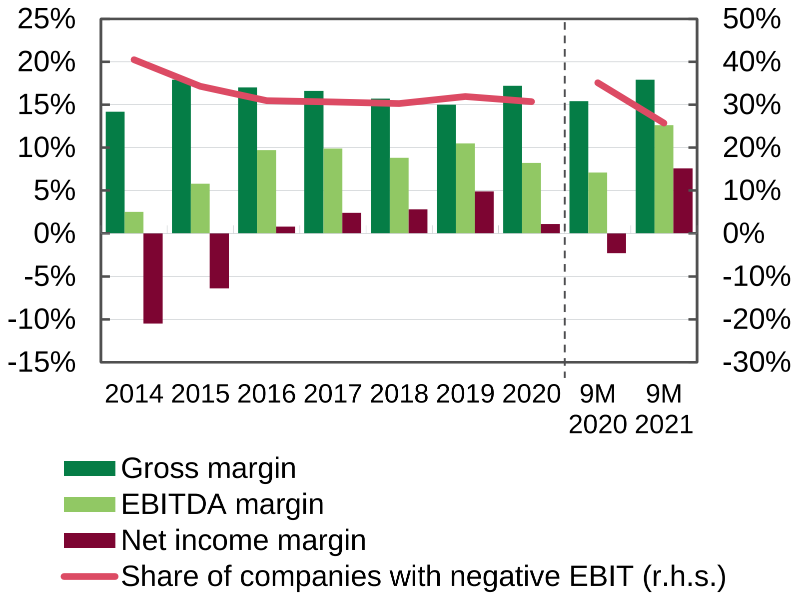


* Including interests, as of 1 December 2021.
Source: NBU calculations.

- Conservative fiscal support, moderate budget deficit and public debt, sufficient international reserves, and cooperation with the IMF enhance economy's resilience to shocks.
- According to preliminary estimates, GDP rose by only 2.7% yoy in Q3 2021.
- Inflation remains above previous forecasts, the NBU continued to hike the policy rate.

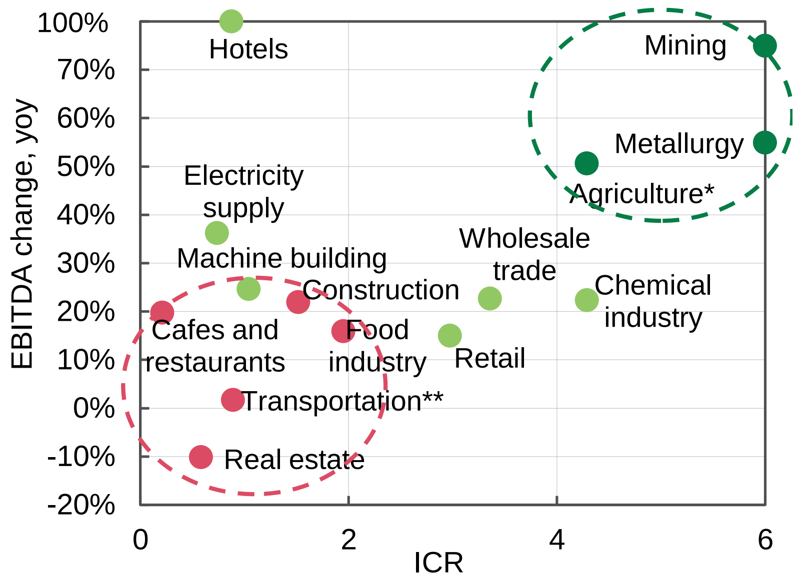
Incomes in the real sector grow faster due to higher prices

Margins in the real sector and proportion of companies making operational losses



Source: State Statistic Service of Ukraine, NBU estimates.

Interest coverage ratio (ICR) and change of EBITDA by industries

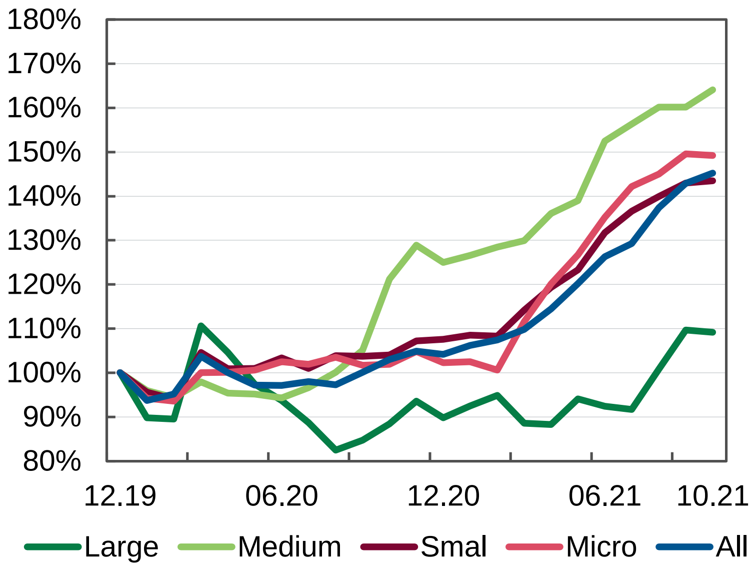


For 12 months ending in September 20021
* Based on 2019 and 2020 data.
** Excluding pipeline transportation.
Source: State Statistic Service of Ukraine, NBU estimates.

- Income of enterprises in the first three quarters of 2021 increased by 39%, mostly on the back of higher prices. In real terms, the recovery was much slower.
- Some industries reached the limit of their output capacities. It is unlikely that they can continue to grow without an increase in investment.

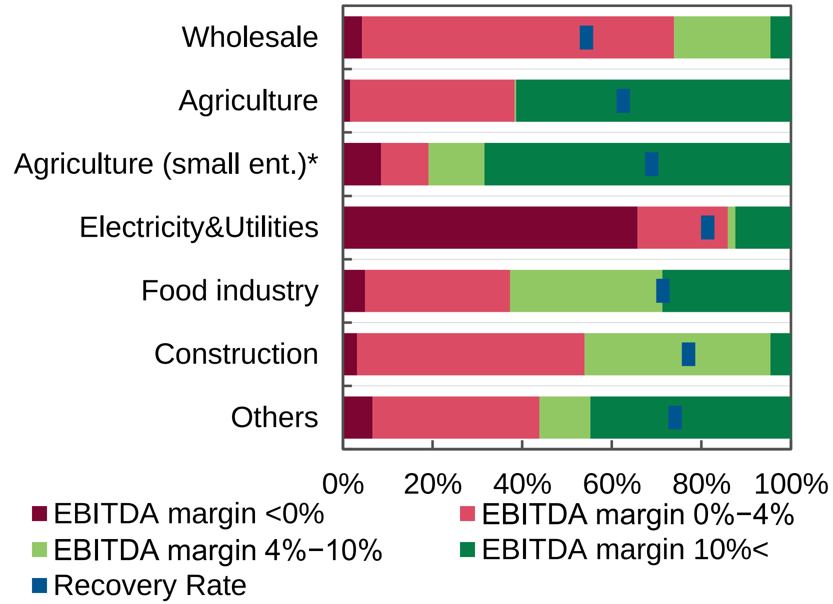
Banks ramp up corporate lending in hryvnia

Net corporate loans in hryvnia, 2019 = 100%



At banks that were solvent as of 1 November 2021.
Source: NBU.

Corporate borrower profile for exposures over UAH 2 million originated in the last 12 months

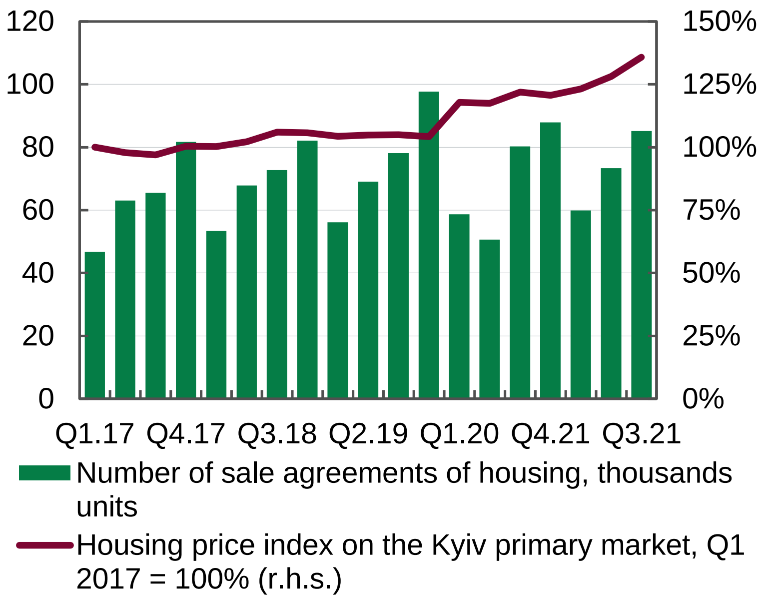


* Performing loans with outstanding debt of over UAH 2 million.
Source: NBU, data.gov.ua.

- Corporate hryvnia lending grows at the rate of over 40% yoy, with the surge in lending to micro-, small and medium business being the fastest.
- Loan portfolio growth was primarily generated by four industries: wholesale trade, agriculture, food industry, and construction.
- Banks lend to profitable companies with acceptable debt metrics.

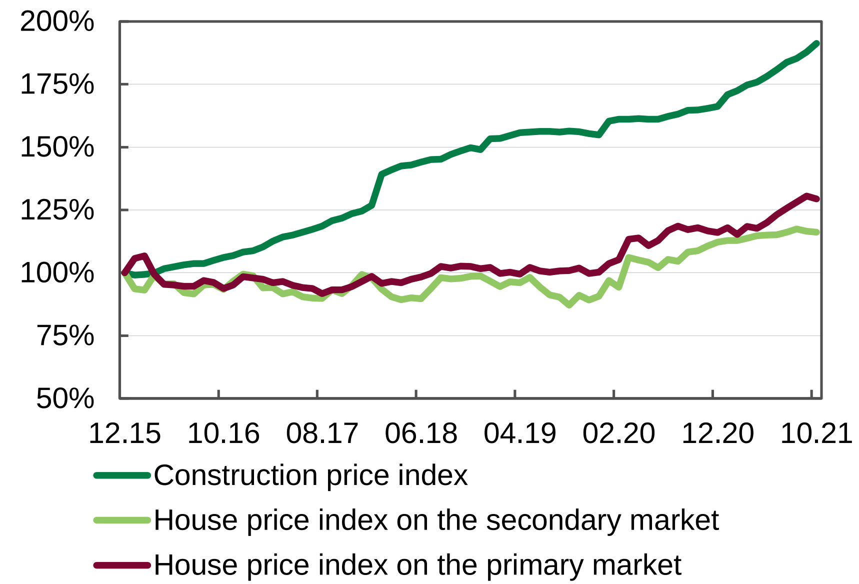
Higher cost and demand heat up the housing market

Housing market activity



Source: Ministry of Justice, real estate agencies, State Statistics Service of Ukraine.

Construction and house prices index, 12.2015 = 100%

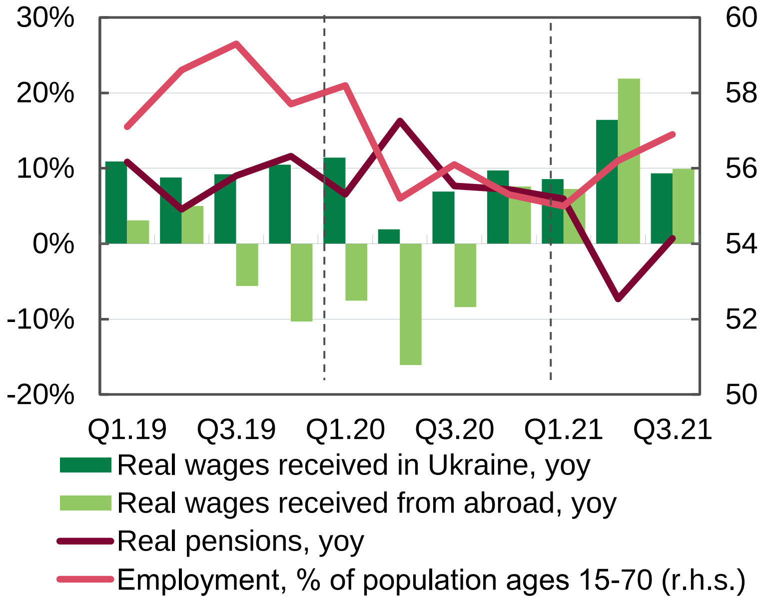


Source: real estate agencies, State Statistics Service of Ukraine, NBU estimates.

- Housing prices rise on the back of higher costs and expanding demand.
- The number of housing agreements concluded on housing market in Q3 2021 was up 6% yoy.
- As household incomes have been rising faster than prices, housing remains affordable in relative terms.

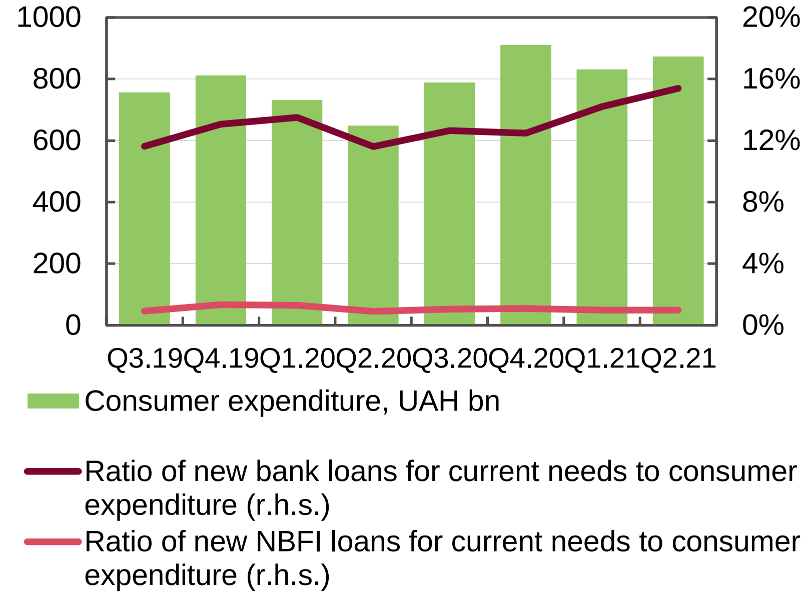
Growth in real incomes of households slows down

Change in real wage, pensions, and employment



Sources: State Statistics Service of Ukraine, NBU calculations.

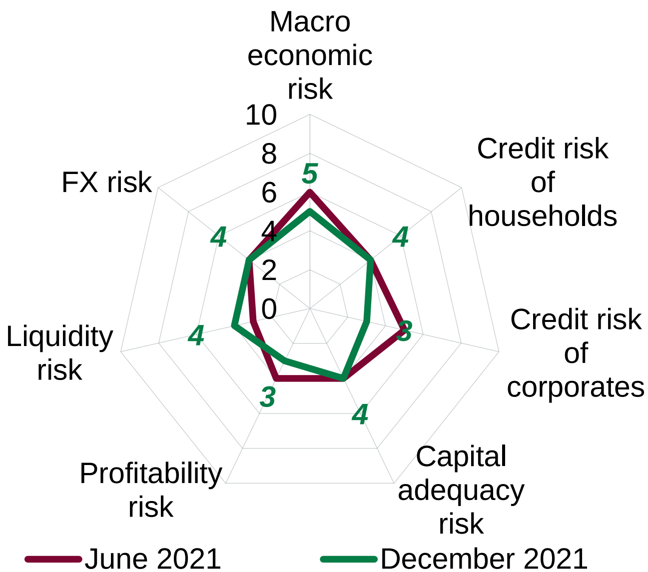
Ratios of consumer lending and consumer spending



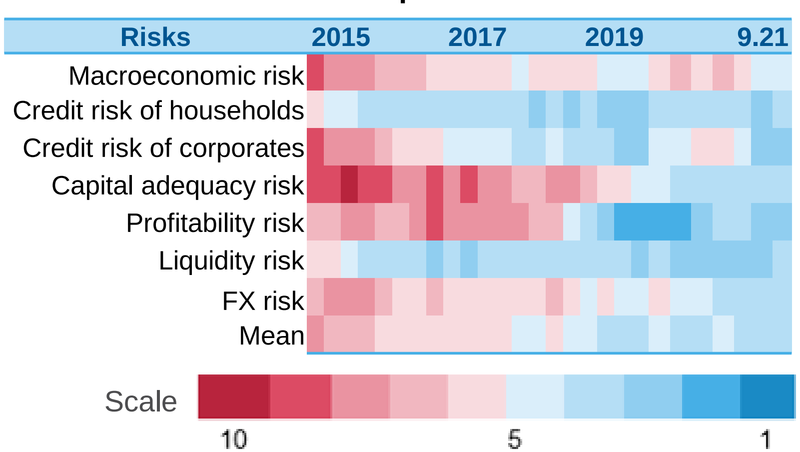
Sources: State Statistics Service of Ukraine, NBU calculations.

- High inflation slows down increase in real disposable income.
- Stable consumer demand fuels surge in lending, however, in limits propensity to save.
- Total debt burden of households remains at historically low of 5.2% to GDP.

Financial sector risk map



Financial sector risk heatmap



Macroeconomic risk declined (-1), prompted by lower budget deficit, public and external debt relative to GDP.

Credit risk of households was the same. Bank expectations on loan portfolio quality have deteriorated. However, NPL ratio has declined.

Credit risk of corporates abated (-2), thanks to lower leverage of businesses and improved assessment of quality of bank loan portfolio.

Capital risk did not change. A slight decline in capital adequacy ratios was offset by an increase in ratio of core capital to bank assets, an equivalent of leverage ratio.

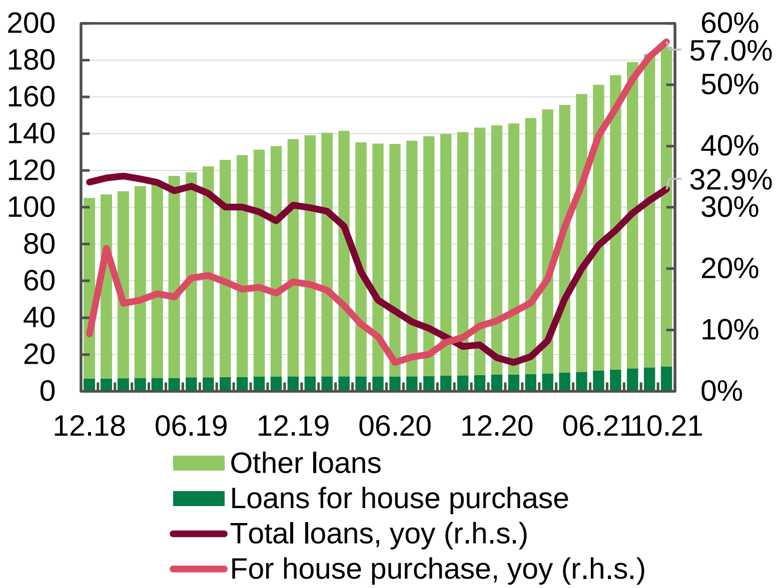
Profitability risk decreased (-1). Improved operational efficiency supported banks' profitability indicators.

Liquidity risk increased (+1). The inflow of retail deposits persists. However, it comes under adverse impact from worse bank expectations, decrease in LCR, and an increase in loan-to-deposit ratio.

FX risk remained unchanged. FX rate fluctuations were moderate, while dollarization rate of banks' balance sheet declined.

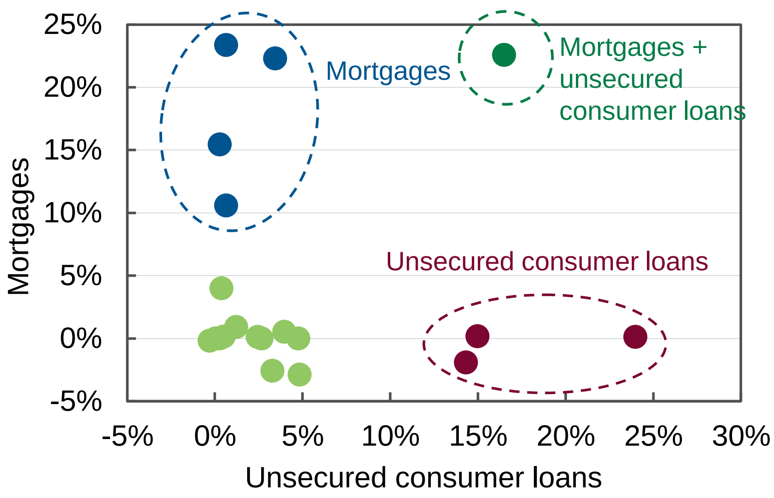
Growth in retail loan portfolio accelerates

Net hryvnia retail loans, UAH billions



In banks that were solvent as of 1 November 20021.
Source: NBU.

Share of Top-20 banks in increase in retail loan portfolio by purpose

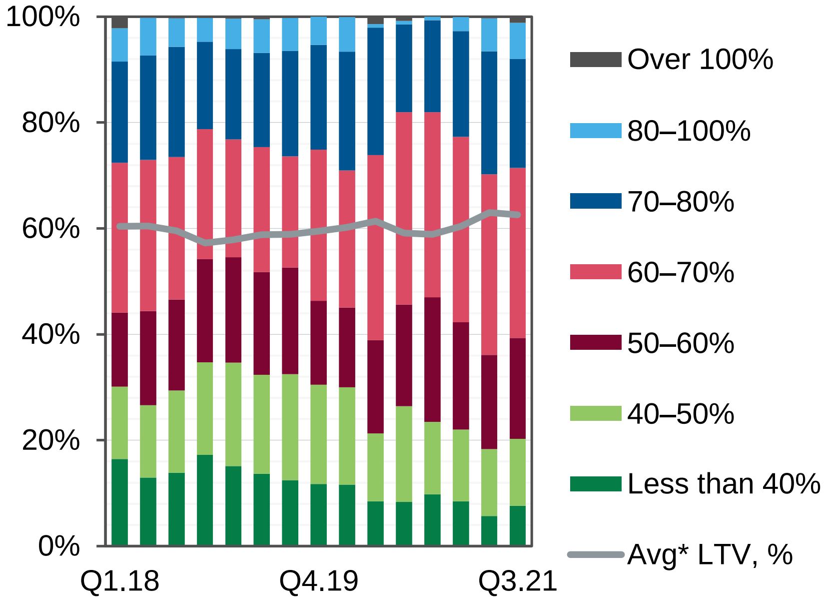


Source: NBU.

- Growth rates of retail loan portfolio recovered to over 30%.
- Effective 1 January 2022, risk weights for unsecured consumer loans rise to 150%.
- In the first ten months of 2021, banks issued 2.5 times more mortgages yoy. However, mortgage penetration is low in GDP terms.
- Retail lending market is concentrated and fragmented.

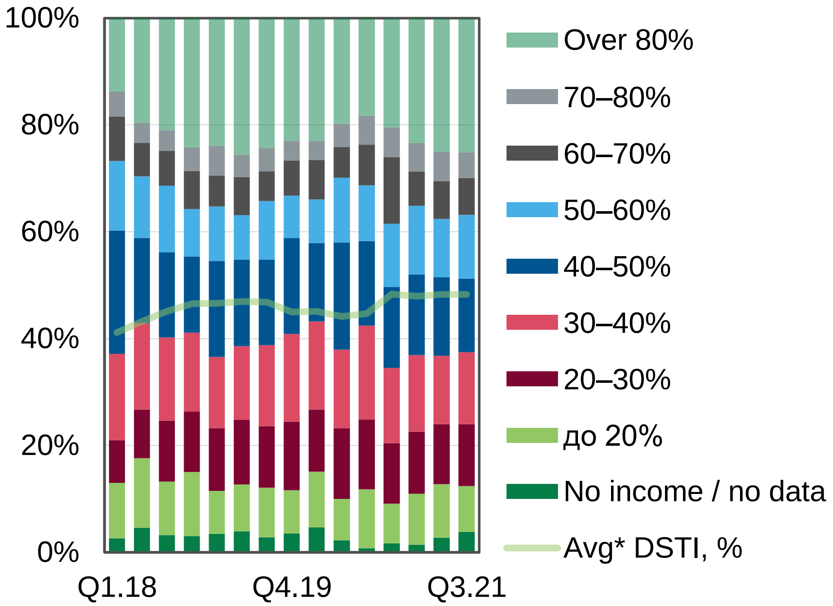
Mortgage lending standards are moderately conservative

Loan distribution by LTV at origination



*Average, weighted by the volume of loans issued.
Source: banks' data.

Loan distribution by DSTI

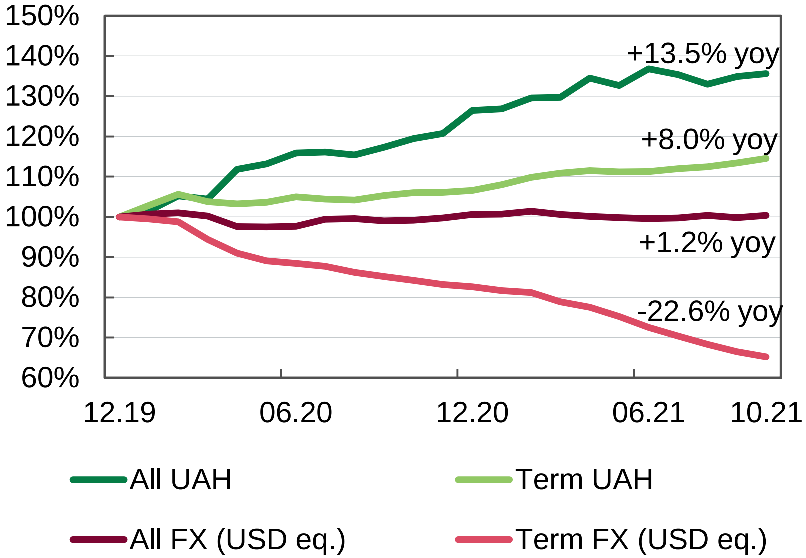


*Average, weighted by the volume of loans issued.
Source: banks' data..

- Loan-to-value (LTV) ratio was relatively low, at 63% in Q3 2021.
- In the meantime, Debt Service-to-Income (DSTI) ratio for households has risen over the year and stands comparatively high at 48%.

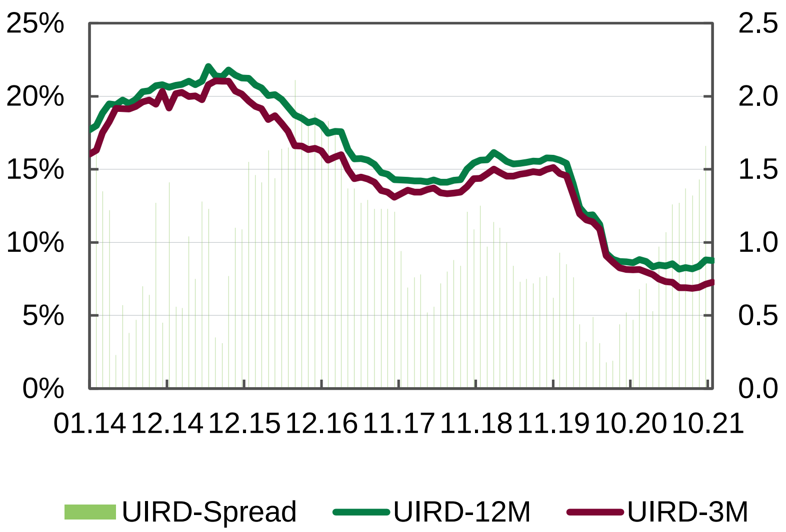
Inflow of retail deposits decelerates

Retail deposits, 2019=100%



Source: NBU.

12- and 3-month UIRD* rates in UAH, % per annum, and spread between them**

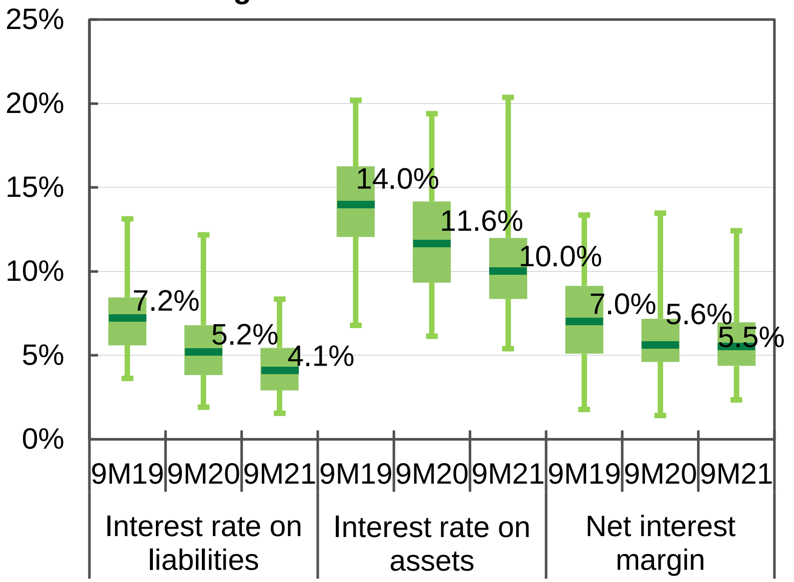


* Ukrainian Index of Retail Deposit. ** 5-day moving average.
Source: NBU based on Thomson Reuters data.

- Current funding structure does not hinder active lending.
- Longer-term lending, including mortgage lending, encourages banks to extend deposit maturities.
- Higher inflation, policy rate hikes, and a wish to extend maturity of funding encourages banks to raise interest rates on term deposits.

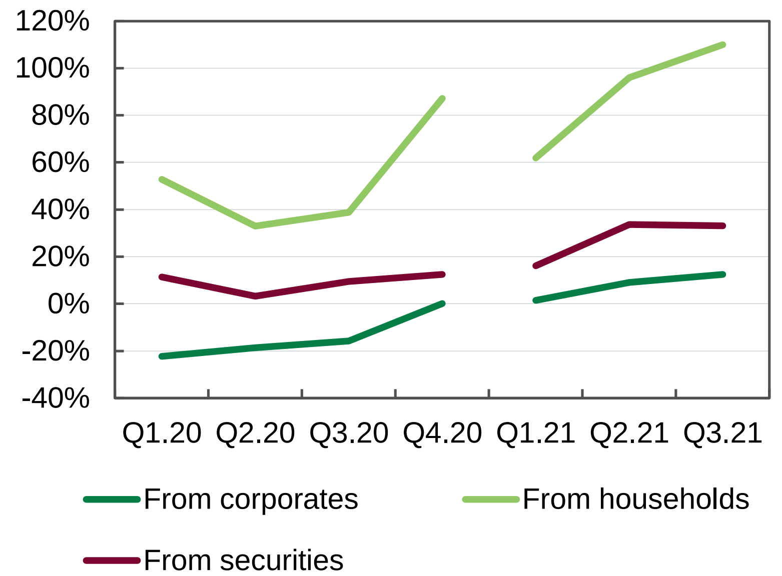
Incomes grow due to more intensive lending

Interest rates on assets and liabilities of banks and net interest margin



* Upper and lower edges of the green rectangles represent the first and the third quartiles of the indicator distribution across the banks for the date. Dashes inside the rectangle show the median. Upper and lower dashes outside the rectangle show the minimum and maximum.
Source: NBU.

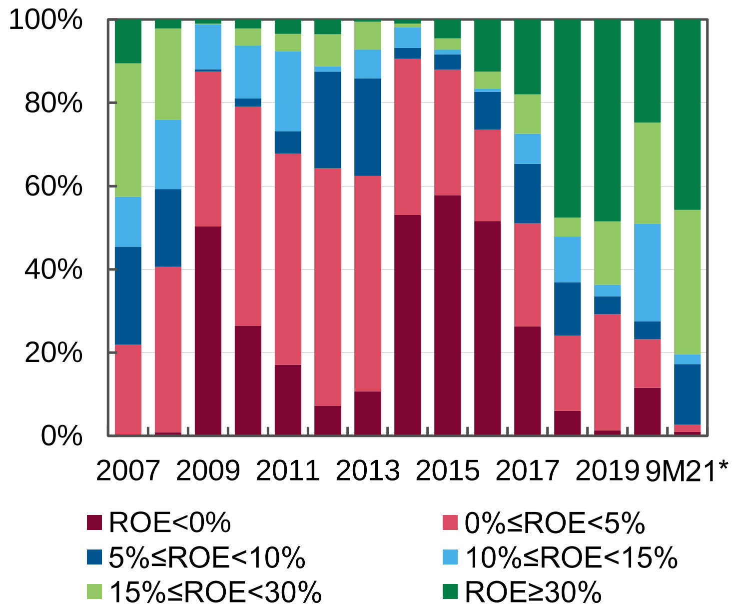
Change in net interest income, yoy



- Further decline in interest rates squeezes net interest margin of banks.
- Net interest income for the first none months increased by 28.5% yoy, mostly due to an increase in loan portfolio volume.
- Fee and commission income also rises thanks to larger volume of transactions.

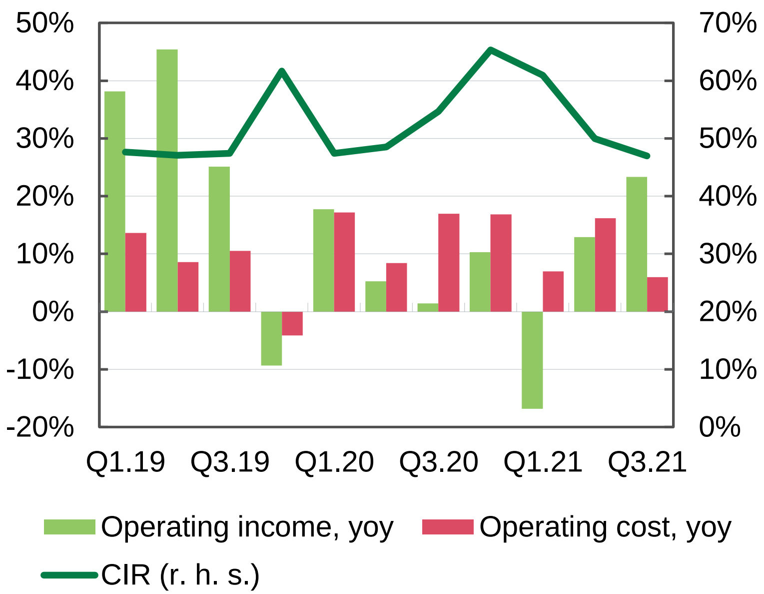
Sector's profits are record high

Breakdown of banks' ROE by assets , %



* For nine months, annualized.
Source: NBU.

Operational efficiency of banks

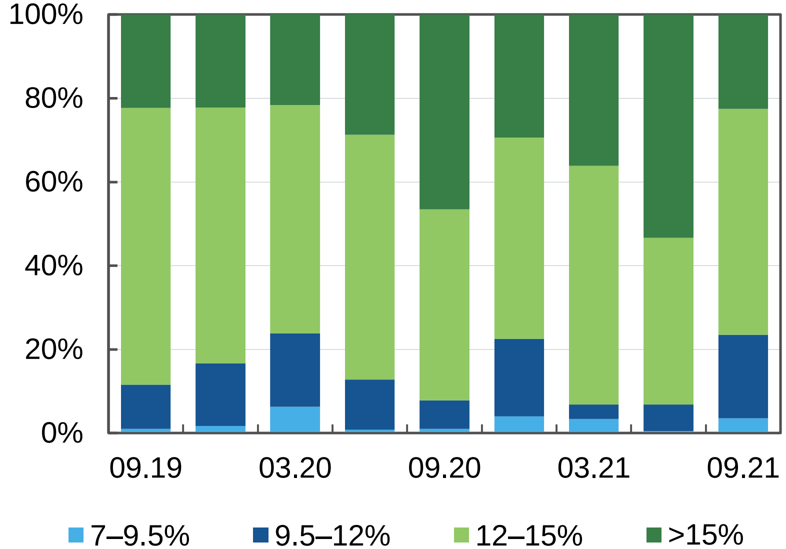


CIR – Cost-to-Income Ratio.
Source: NBU.

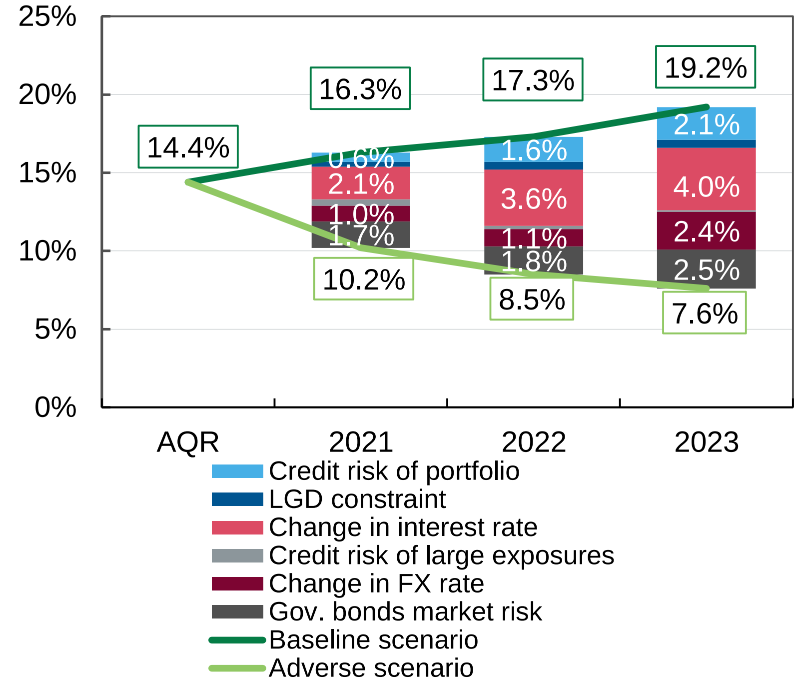
- Operational efficiency of banks surged, primarily thanks to soaring incomes.
- Weighted average return on equity (ROE) of the sector reached record high of 32%.

Stress test confirmed that risk of capital is moderate

Change in distribution of bank capital adequacy ratios by share in assets



Drivers of change in bank core capital under adverse vs baseline scenario

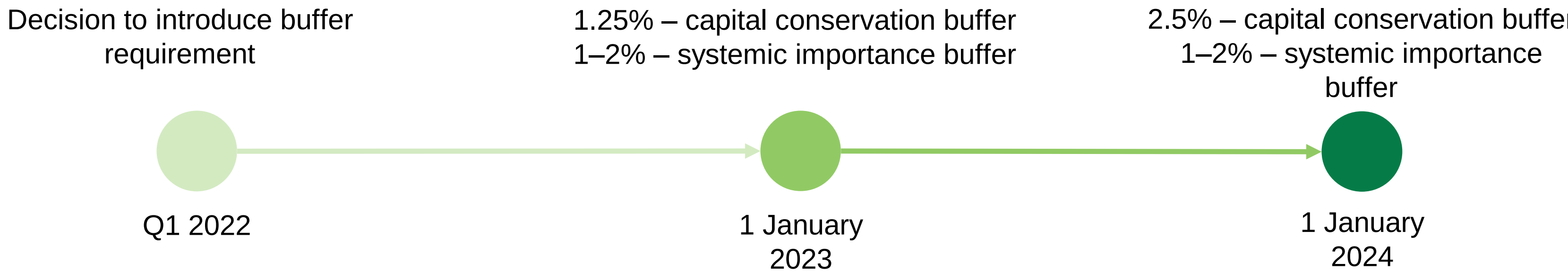


Source: NBU.

- Average weighted capital adequacy ratio of banks is more than twice higher than the minimum required ratio. Meanwhile, capital needed under the adverse stress test scenario is half of the one observed before the crisis.
- The key risk for the banking sector is the interest rate risk including the risk of loss of value of government securities.

NBU plans to activate gradually capital buffers

- Given record-high profits of banks, now is a good time to activate capital buffers.
- In Q1 2021, the NBU will make a decision to set requirements to capital conservation buffer and systemic importance buffer:
  - effective 1 January 2023, at 50% for capital conservation buffer (1.25%) and at 100% for systemic importance buffer (1–2%, depending on the score of systemic importance of a bank)
  - effective 1 January 2024, at 100% for both buffers.



Recommendations to financial institutions

To banks

- To prepare for new capital requirements.
- To implement in a timely manner restructuring and recapitalization plans approved upon stress tests.
- To speed up the sale of noncore assets.
- To step up efforts on clearing balance sheets from nonperforming loans, including legacy FX mortgages.
- To work further on upgrading operational efficiency.
- To take into account that LIBOR cessation.
- To enhance vigilance to AML.

To nonbank financial institutions

- To comply with solvency requirements.
- To comply with disclosure requirements.
- To submit reports in full and in time.

Recommendations to state authorities and NBU plans

To state authorities

- To meet in full commitments to the IMF.
- To approve the law on credit unions, to put into effect the new law on financial services and finance companies.
- To resolve the DGF solvency issue.
- To focus state programs on investment project support.
- To enhance regulation and transparency of primary real estate market.
- To reform courts and restore trust with the court system.

NBU plans

- To approve the schedule for building capital buffers.
- To hold regular annual bank resilience assessment.
- To continue preparations for launching a deposit guarantee system for credit union members.
- To start implementing its sustainable financing policy.
- To finalize and approve requirements to cyber-security framework in the banking system.