Financial Stability Council Report on Activities

(August 2023–July 2024)

Kyiv, 2024

Preface

The Financial Stability Council (the "Council") had three meetings from August 2023 to July 2024. As in the previous reporting period, the Council's agenda was shaped by the need to face the challenges caused by russia's full-scale aggression against Ukraine. The Council members conducted regular monitoring of current systemic risks and their potential impact on the financial sector and the economy as a whole, discussed the most problematic issues, and agreed on priority steps to be taken to maintain the sustainability of the financial system.

The protracted full-scale war and an intensification of russian terror against Ukraine's civil infrastructure remains the dominating risk to the financial sector, which affected the dynamics of key macroeconomic indicators. However, continued inflows of international assistance and the adaptation of businesses to the extreme conditions of war allowed the Ukrainian economy to gradually recover. The financial sector thus remains resilient and capable of withstanding existing challenges. The Council members looked into the results of banks' resilience assessment conducted by the National Bank of Ukraine (NBU) and agreed that the current state of the banking sector is satisfactory and its profitability is sustainable. The banks continue to increase their capital, which enables the NBU to keep implementing regulatory requirements in line with European standards.

In the reporting period, the Council focused on Ukraine's tasks and commitments set forth in the Memorandum of Economic and Financial Policies signed with the International Monetary Fund. In February, the Council approved a concept note on establishing a fully functional system of war risk insurance, which became the basis for the NBU to prepare the Roadmap for Establishing and Implementing the War Risk Insurance System and a draft law on war risk insurance system. In June, the Council members reviewed and approved the Lending Development Strategy, which defines priority steps to activate lending amid the war and foster further development of the lending market. Thanks to joint efforts of the NBU and the government, the implementation of the strategy will strengthen the role of the financial sector in economic recovery.

The Council members also considered setting the target for the retail deposit guarantee system and the deadline for its achievement. In view of the proposal of the dedicated working group, the Council recommended the Deposit Guarantee Fund (DGF) to set the target at 3.5% and reach this level by 1 January 2028. Setting the target at this level allows for capitalization of the deposit guarantee system that is sufficient to cover potential expenses.

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Composition of the Financial Stability Council[1]

Co-chairs of the Council:

Serhii Marchenko	– Minister of Finance of Ukraine
Andriy Pyshnyy	– Governor of the National Bank of Ukraine

Members of the Council:

Yuriy Draganchuk	– Deputy Minister of Finance for European Integration
Ruslan Mahomedov	– Head of the National Securities and Stock Market Commission
Dmytro Oliinyk	– Deputy Governor of the National Bank of Ukraine
Svitlana Rekrut	– Managing Director of the Deposit Guarantee Fund
Kateryna Rozhkova	– First Deputy Governor of the National Bank of Ukraine
Yuliia Svyrydenko	– First Deputy Prime Minister – Minister of Economy of Ukraine
Rostyslav Shurma	– Deputy Head of the Office of the President of Ukraine

[1] During the reporting period.

Key Issues Considered by the Council

1. Overview of Systemic Risks and Macroeconomic Forecast

Each meeting of the Council traditionally began with an overview of systemic risks to the financial sector (Table 1). The protracted full-scale war and russia's continued terrorist attacks on Ukrainian civilian infrastructure remained the dominant risks to Ukraine's financial system. Combined, these factors worsened the economic recovery dynamics. However, businesses continued to adapt to operating in extreme conditions, and the financial sector kept developing.

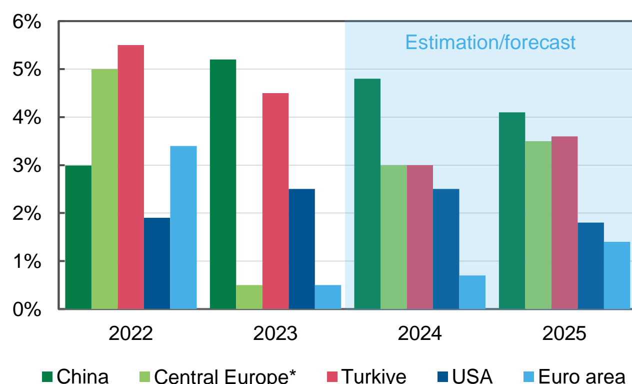
Table 1. Evolution of systemic risks

	Risk change				Risk level as of	
	2023		2024			
	Q3	Q4	Q1	Q2	5 Feb 2024	6 Jun 2024
Global economy	→	→	↗	→	yellow	yellow
External environment	→	↗	→	↗	yellow	yellow
Economic conditions	→	→	→	↗	yellow	yellow
Public finances	→	↗	↗	↗	red	yellow
FX market	→	→	→	→	yellow	yellow
Geopolitics	→	↗	↗	→	red	red

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

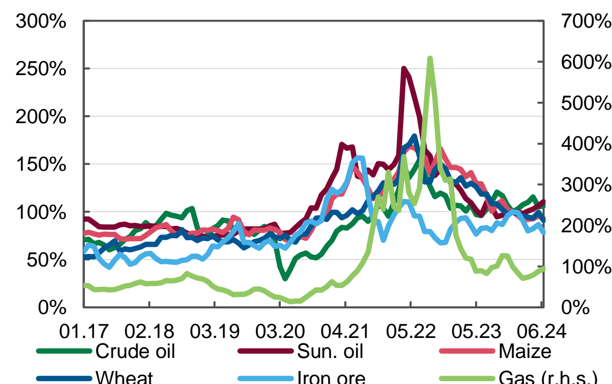
Global economy. Economic growth in the majority of Ukraine's main partners was slow last year, and expectations for this year's dynamics were pessimistic. However, the growth in the partners' economies is now forecast to gradually revive, especially in Europe. In the meantime, China's economic development is slowing due to domestic economic problems. Global inflation is slowing down: it is to approach target levels in advanced economies over a one- to two-year horizon. Accordingly, leading central banks are cutting their policy rates, although the process is slower than previously expected. Global trade growth is gradually recovering. At the same time, protectionism and the fragmentation of international trade by tacit geopolitical alliances are growing. The fragmentation will be deepened by increased geopolitical tensions, so new barriers to trade will arise.

Figure 1. Change in GDP of Ukraine's main trading partners



** Central Europe: Bulgaria, Poland, Romania, Hungary, and Croatia.*
Source: World Bank, Global Economic Prospects, June 2024.

Figure 2. Global prices for some goods*, December 2023 = 100%



** Change in U.S. dollar prices. Brent crude; natural gas in EU hubs; Chinese iron ore concentrate; sunflower oil; wheat and maize on international markets.*
Source: World Bank, Pink Sheet data, July 2024

External environment. Prices for Ukrainian exports will remain lower than last year. Global grain prices have fallen significantly since last summer due to an ample supply. However, wheat prices are gradually rising

due to lower crop yields in the Black Sea region, the EU, and some North African countries. Corn prices will fluctuate within a narrow range, as production in major exporting countries will remain high. Prices for Ukrainian agricultural products are expected to increase gradually in the coming years. Active supply growth will put pressure on iron ore and steel prices. An increase in crude oil production in non-OPEC countries will contribute to a decline in oil prices. However, the escalation of the conflict in the Middle East poses a risk of new hikes. Natural gas prices have been driven down by stocks accumulated in Europe and ample supplies. The prices for natural gas are likely to rise as the heating season approaches, but should be lower than last year on average.

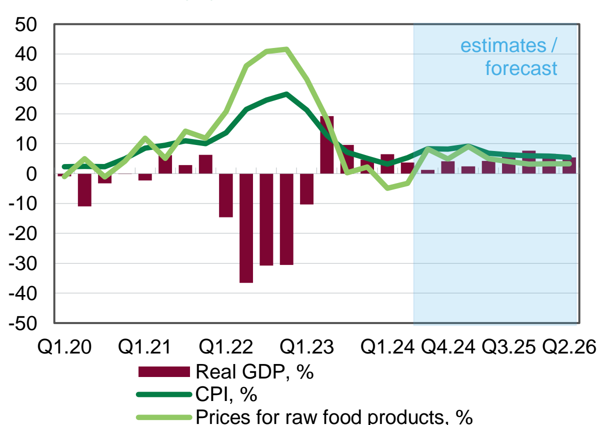
While logistical difficulties and restrictions remain a problem for Ukrainian exports, their impact on domestic exports has eased. Ukraine and its partners managed to organize the operation of the sea corridor, although russia continues its terrorist attacks on it. Since the end of last year, the blocking of truck traffic from Ukraine, primarily at the Polish border, had been a problem for exports. Now the Polish border is unblocked.

Economic conditions. Ukraine's economy continues to withstand the challenges of the war and is gradually recovering. However, GDP growth will be rather slow this year, at 3.7%, down from 5.3% last year, primarily due to the destruction of energy infrastructure. Businesses are experiencing a growing shortage of staff, and the persistence of security threats is restraining investment.

At the same time, the rapid decline in inflation at the start of 2023 enabled the NBU to switch to a cycle of key policy rate cuts and reduce it from 25% in July last year to 13% in July this year. Market interest rates on loans and deposits have been gradually declining in response to the NBU's interest rate cuts. The downward movement of the rates is likely to continue. Going forward, inflation is expected to accelerate moderately, primarily due to last year's low comparison base, revisions to some administrative prices, and higher labor costs of businesses. Nevertheless, inflation will remain in single-digits, and is expected to return to its target range in 2025.

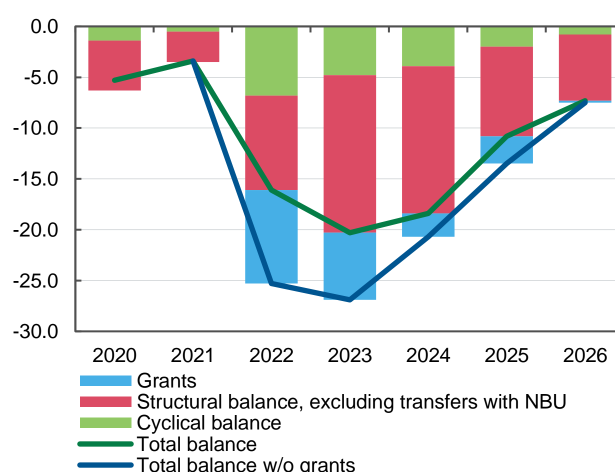
The current account deficit will gradually widen this year and in the coming years. This is driven by the expected continued high demand from the defense sector and the need to rebuild production and logistics infrastructure. International assistance remains the main source of capital inflows in 2024. Its volumes will cover the current account deficit with some to spare, which will allow international reserves to stay at a high level.

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



Source: NBU, Inflation Report, April 2024.

Figure 4. Consolidated budget balance, % of GDP



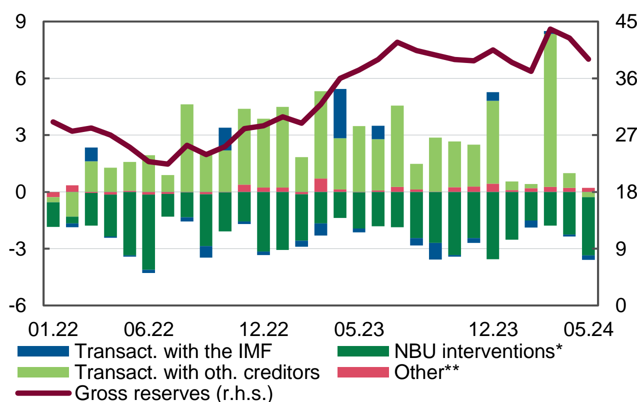
Source: NBU, Inflation Report, April 2024.

Public finances. The need to finance significant defense and security spending (which are covered from domestic sources) and the uncertainty over the volume of international financial assistance will remain key challenges in the coming years. This uncertainty is significantly reduced by the arrangement at the G7 level on additional financing through the use of frozen russian assets. At the same time, domestic borrowing will continue to play an important role in financing the government’s current needs. The current state of the market allows the government to increase its domestic borrowing if needed. Increasing tax revenues is

another way to ensure the continuity of spending. The increase in the corporate income tax rate for banks to 50% for 2023 and to 25% going forward played an important role in this. The additional one-time tax charged last year was an exceptional measure that helped solve fiscal problems. However, searching for domestic sources of covering the budget deficit requires systemic efforts. The government has planned to take steps to more efficiently accumulate revenues, which was primarily outlined in the *National Revenue Strategy* published last year. These steps include better tax administration and the harmonization of the tax burden with EU laws.

FX market. From October 2023, the NBU switched to a regime of managed exchange rate flexibility, while also easing a number of FX restrictions. Together, these decisions somewhat revitalized the market and increased its liquidity. At the same time, the shortage of foreign currency in the market remains significant. Therefore, the NBU continues to be the key market participant and to balance the market through its interventions. The NBU will continue to cover the structural shortage of foreign currency in the market. In the meantime, inflows of assistance from partners and the high level of international reserves are sufficient to maintain the sustainability of the FX market and smooth out excess volatility.

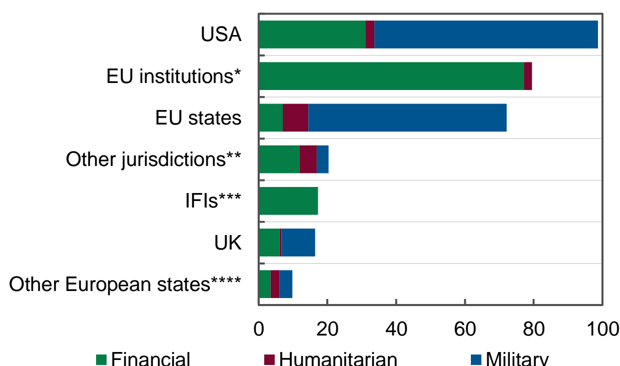
Figure 5. Change in gross international reserves, USD billions



** The NBU's net interventions: (+) refers to purchasing foreign currency to increase reserves; (-) refers to selling foreign currency from reserves; ** "Other" refers to 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. Committed official assistance for Ukraine from end-January 2022 to end-April 2024, EUR billions



** The European Commission, the EU Council, and the European Peace Facility. ** Australia, Canada, New Zealand, South Korea, Taiwan, Turkey, and Japan. *** The IMF, the World Bank, and the EBRD. Assistance under IFI multidonor programs is counted as assistance from individual countries and excluded from IFI assistance. **** Iceland, Norway, and Switzerland.*

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

Geopolitics. The war is grinding on, and the prospects for ending it are unclear, while international efforts to bring peace have so far had limited effect. This year, moscow intensified its terror campaign against Ukraine's civil infrastructure, in particular energy infrastructure. The enemy's pressure increased in various parts of the frontline, but the Ukrainian defense forces managed to stop the aggressor's offensive. From an economic point of view, the protracted war causes increased government spending, further mobilization of the population, and new threats to infrastructure. International financial and military support enables Ukraine to withstand the challenges. The support remains systemic and meets the current needs of the state. At the same time, the prospects for receiving assistance next year and beyond are uncertain, which is a source of risk. The global security situation remains tense, especially in the Middle East. On the one hand, this distracts the attention and resources that Ukraine's partners could allocate to the country. At the same time, these tensions have made countries realize the complexity of the threats to democracy in the world, and double their efforts to strengthen their own defense capabilities and support Ukraine.

The Council's position. The Council has taken into consideration the information from the overview of the macroeconomic forecast and agrees with the systemic risk assessment presented by the NBU.

Box. Risks and Key Recommendations of International and Foreign Financial Stability Councils and Committees

The Secretariat to the Council monitors the conclusions of leading international and national financial stability councils and committees (hereinafter referred to as "councils and committees") on the nature of systemic risks and recommendations on neutralizing them. russia's full-scale invasion of Ukraine and the escalation of conflicts and tensions in other regions of the world continued to be the focus of many councils and committees, and made it relevant for these platforms to review the geopolitical risks periodically. This risk remained constantly valid for Central and Eastern Europe. A new aspect of geopolitical vulnerabilities that started to be discussed only in Q2 of this year is the fragmentation of global trade and protectionism within geopolitical blocs. The attention to this challenge is likely to grow going forward.

Chart 1. Main risks mentioned by financial stability councils and committees

Risk / vulnerability	**Change in frequency of mentions and their spread**	**Mentioned by***
Geopolitical risks	Constantly mentioned with varied frequency, especially in Europe	FSB, ESRB, FPC, KSF, FSR, FSC
including the uncertainty related to elections, primarily in Europe	Spread in Europe starting from Q2 2024	ESRB, FPC
including geo-economic fragmentation in the world	First mentioned in Q2 2024	FSC
Environment of high / volatile interest rates and their impact on borrowers	Constantly mentioned through the reporting period. Spread mostly among advanced economies	FSB, ESRB, FPC, FSC, FSR
Deterioration of economic growth prospects	Relevant in late 2023 and early 2024; no mentions afterward.	FSB, ESRB, FPC
Problems of the commercial real estate sector and the financial sector's exposure to it	The risk has been mentioned in Europe and globally since the end of 2023, and became especially frequently discussed in Q2 of this year	FSB, ESRB, FPC, FSOC, FSC, FSR
Cyber risks	Mentioned as a relevant risk in various countries since the end of last year	FSOC, FSC, FSR
Private investment risks[2] due to the rapid growth of this opaque and unregulated segment	Started to be actively mentioned at the international level and in some developed jurisdictions in Q2 2024	FSB, FPC, FSOC
High leverage and risks of the non-bank financial sector	Regularly mentioned as a relevant risk at the global level	FSB

** FSB – Financial Stability Board of G20; ESRB – European Systemic Risk Board; FSOC – Financial Stability Oversight Council (USA); FPC – Financial Policy Committee of the Bank of England; HCSF – High Council for Financial Stability (France); KSF – Financial Stability Committee (Poland), FSC – Financial Stability Committee (Netherlands), FSR – Financial Stability Council (Sweden).*

Another risk that was constantly in focus of the discussion was the environment of high interest rates that may remain so for longer than expected. The rest of the risks were either rarely mentioned or were considered only by some councils or committees. For example, a deterioration of economic growth prospects was viewed as a vulnerability only at the end of last year and at the start of this year. An improvement in the dynamics of macroeconomic expectations in Europe and across the globe reduced the attention of councils and committees to this risk, leading to a decline in the number of mentions. From the end of last year, many jurisdictions, especially economically developed countries, have identified risks related to prospects of the commercial real estate market. These are the potential consequences of an increase in loan rates with a concurrent decrease in demand for real estate due to subdued economic growth and the spread of remote work and e-commerce. This is causing financial problems for the sector, thus raising credit risks.

It should be noted that councils and committees also discussed methodological approaches to assessing and neutralizing climate risks and treats stemming from cryptoassets, but these risks were not mentioned as relevant during the reporting period.

[2] This refers to the system of non-bank non-state lending to companies, mainly those that cannot obtain bank loans due to high risks or lack access to financial markets.

2. Results of Banks' Resilience Assessment and Subsequent Recommendations

The agenda of the Council's meeting held in February included the NBU's report on results of the bank's resilience assessment of 2023.

The banks' resilience assessment consisted of the asset quality review (AQR) conducted by the NBU through bank inspections; extrapolation of AQR results (if needed) and verification of collateral value assessment; forecasting the banks' performance over the horizon of three years; and assessment of capital adequacy and capital needs.

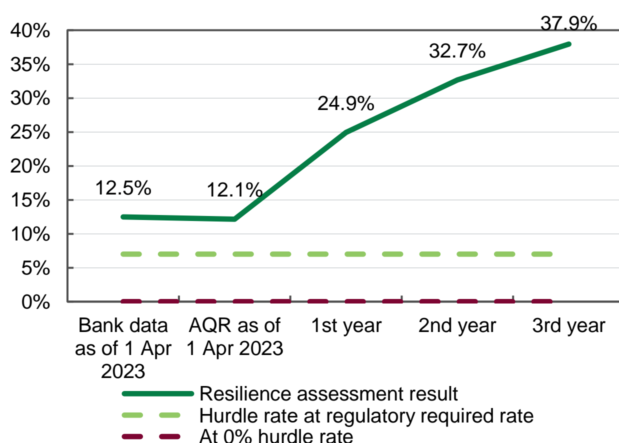
The resilience assessment was conducted for 20 banks, which together accounted for more than 90% of the banking sector's assets. The banks selected for the assessment were the largest ones by the weighted average of three indicators: risk-weighted assets, loans, and retail deposits. Bank-specific results of the resilience assessment were published in January 2024.

The resilience assessment has confirmed that most banks have adequate capital and that the system has a high safety margin: the central bank set higher capital requirements for only five banks. The reason for the higher required ratios was the inability of these banks to cover potential losses from credit risk or even sometimes compensate for their administrative expenses because of their operational inefficiency. The net interest margin of these banks was significantly below the system's average, while their cost-to-income ratios were much worse than the banking system's average. The main priority of capitalization / restructuring programs prepared by the banks with higher required capital adequacy ratios is increasing the efficiency of their operations.

The resilience assessment revealed some drawbacks and weaknesses in business models and strategies of the banks, including state-owned ones. The Council discussed the above as well as recommendations to the banks based on results of the resilience assessment at its meeting in February 2024. The banks that had been set higher required capital adequacy ratios submitted their restructuring or capitalization programs to the NBU and are implementing the requirements so as to reach the set ratios.

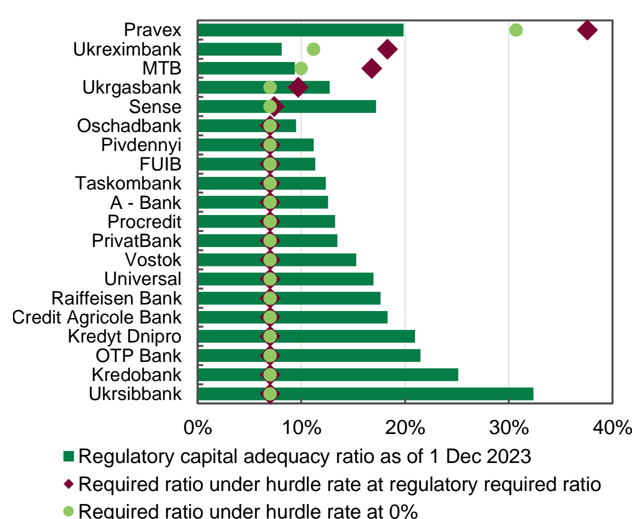
The NBU is using the information obtained in the course of the resilience assessment in the supervision process, in particular when updating the SREP assessment and holding inspections. The NBU is also guided by the results of the resilience assessment when planning the implementation of EU regulations.

Figure 7. Weighted average estimates of the core capital adequacy ratio based on stress-test results



Source: NBU.

Figure 8. Required levels of banks' core capital adequacy ratios based on the results of resilience assessment



Source: NBU.

Based on results of the resilience assessment and supervision, the NBU has provided the banks with recommendations for minimizing risks in their further operation and for updating the banks' strategies.

The Council's position. The Council has taken into consideration the information on the results of the banks' resilience assessment.

3. War Risk Insurance in Ukraine

At a scheduled meeting of the Council held in February 2024, the NBU presented the concept of war risk insurance as a joint product of the NBU, the government, and World Bank experts. To create such a full-fledged mechanism for a long-term war risk insurance system, the Council set up a Working Group on Building a Fully Functional War Risk Insurance System, which includes representatives of the NBU, the Ministry of Economy of Ukraine, and the Ministry of Finance of Ukraine (the "Working Group").

The Working Group's the key tasks include developing draft legislation on the establishment of a fully functional war risk insurance system. Another major task is to hold consultations with participants of the insurance market and the international reinsurance market to identify aspects of the creation of such an insurance system and the terms for joining it.

The proposed model would involve local insurers, international reinsurers, and the state represented by a specially established State Agency (or another institution to be determined together with international donors based on the outcomes of discussions). The model provides for the possibility of various models of responsibility distribution among the participants. The insurance system may be implemented using an agency model, whereby the State Agency will bear the risks, and insurance agreements may be offered by insurance intermediaries, including insurers and banks. The insurance system may also involve international reinsurers (if they are ready). The State Agency will be responsible for developing a common underwriting policy, defining standardized insurance terms / products, pricing criteria, and subsequently centralizing the placement of a portion of war risks on the international reinsurance market.

The introduction of a long-term war risk insurance system is planned in several stages. At the first stage, it provides for the introduction of compulsory insurance for certain categories of property, such as cargo transported by road and rail, mortgaged property and other collaterals, and residential real estate under construction/reconstruction. Such property will be insured against the minimum list of war risks (only direct losses as a result of external military aggression), subject to restrictions on their location. Other items may be insured on a voluntary basis in accordance with individual agreements between clients and insurers. The first stage can be launched even before the end of active hostilities.

In the next stages, taking into account the growing depth of the Ukrainian market and the accumulation of funds in the State Agency's fund, the scope of coverage under the war risk insurance system is expected to be revised. This will involve covering an expanded list of insured items/industries, widening the list of war risks, and revising the limits and coverage areas of the system's participants. Within the war risk insurance system, insurance coverage will be provided with restrictions set by insurers and international reinsurers depending on the types of items/industries, their location, and other factors.

After the war in Ukraine is over and security guarantees are in place, the war risk insurance system may cover a wider range of war risks (including risks of losses from strikes, riots, etc.) and include insurance against natural disasters.

The creation and implementation of the proposed fully functional war risk insurance system requires the adoption of a separate law that will provide for the specifics of such insurance, including the specifics of functioning and corporate governance of the State Agency. With the support of the World Bank, the relevant draft law was prepared by the Working Group and reviewed and agreed upon with representatives of the Ukrainian insurance market. After agreement is reached on certain points, the final version of the legislative proposals will be submitted to the Verkhovna Rada of Ukraine for consideration.

The Council's position. The Council has approved the concept note on the establishment of a fully functional war risk insurance system to implement the Extended Fund Facility program with the International Monetary Fund.

4. Lending Development Strategy

At its meeting in June 2024, the Council reviewed and approved the *Lending Development Strategy* (the “Strategy”), which reflects a comprehensive vision of the key principles of lending development in Ukraine and necessary actions that will contribute to a sustainable recovery of the country’s economy.

The Council members agreed that lending conditions for businesses and households are improving as macroeconomic stability is being maintained thanks to the consistent policies of the NBU and the government as well as significant international assistance. At the same time, demand for loans remains segmented, and a number of industries and regions have limited access to necessary financing due to severe war risks. The Strategy is aimed at addressing these issues. Its goal is to provide financial resources for economic recovery, including energy infrastructure, and to stimulate demand aimed at increasing the country's defense capability.

The Strategy implementation will have two tracks. The first track includes actions and measures aimed at ensuring lending to the priority sectors of the national economy in times of war, while not compromising financial stability. The second track is to lay the legal groundwork for the postwar development of market lending. It involves measures that will have a fundamental impact on the overall lending market and will take longer to implement.

The key role in creating the necessary environment for lending development is played by measures without which the full implementation of the Strategy would be impossible. Namely, these are measures to be taken by:

- the NBU – further support for macrofinancial stability; balancing regulatory requirements to ensure financial stability and lending development
- the Ministry of Finance of Ukraine – promoting an increase in the risk appetite of state-owned banks to lend to viable and economically sound projects in priority areas; focusing the state guarantee instruments on lending to projects in resilience areas, which have been de-occupied or are close to the frontline
- the Ministry of Economy of Ukraine – optimizing and improving state program mechanisms to focus further on the identified priority sectors of the economy and companies operating in resilience areas.

The priority areas for lending under martial law are defense industry companies, critical energy infrastructure, the manufacturing industry, the agricultural sector, support for the recovery of businesses operating in resilience areas.

The strategy was made public in late June 2024 and is available at the link.

The Council’s position. The Council has approved the *Lending Development Strategy*.

5. Setting the Target for the DGF and the Deadline to Achieve It

The Council considered the issue of setting the target for the DGF and the deadline to achieve it in December 2023 and June 2024.

The target for the DGF was introduced in accordance with amendments to the Law of Ukraine *On Households Deposit Guarantee Scheme* in April 2022. Setting the target will allow to build up financial resources in the deposit guarantee system for it to cover, if necessary, the risks arising from the insolvency of banks participating in the guarantee system. The target reflects the necessary level of resources of the deposit guarantee system sufficient to cover the expected future expenses of the DGF (taking into account the possibility of future crises) relative to the amount of guaranteed deposits.

In order to achieve the target, the DGF's adjusted capital must be no less than the size of the target fund, which is determined based on the target. Adjusted capital is the amount by which the book value of assets reduced by the amount of intangible assets exceeds the book value of liabilities, excluding provisions for expected expenses related to repayments to depositors as a result of bank insolvency. In other words, the DGF's adjusted capital reflects the funds available to the DGF, which must be at least equal to the target.

According to the legislation, the DGF target cannot be less than 2.5% of the amount of depositors' funds guaranteed by the DGF within the repayment amount. The DGF calculates the necessary value of the target indicator to protect against the risks inherent in the domestic financial system. If the target value calculated by the DGF exceeds the minimum value, the DGF proposes an updated target value and a deadline for its achievement for consideration by the Council for the latter to provide its recommendations. Then, the DGF Executive Board decides on setting the value of the DGF target and the deadline for its achievement. The Administrative Board of the DGF approves the decision of the Executive Board, taking into account the recommendations of the Council.

At the December meeting, the Council members were presented information on the methodology for calculating the DGF target and setting the deadline for its achievement, developed by the DGF and approved by a working group specially created in February 2023. The working group included representatives of the DGF, the NBU, and the Ministry of Finance of Ukraine.

The methodology was developed based on the recommendations of the World Bank with the support of the EBRD and USAID. While working on the methodology for calculating the target, the DGF considered various options. Taking into account the availability of information and the ability to model further bank bankruptcies, the DGF decided that the expected loss method was the most appropriate for Ukraine.

The Council members reviewed the proposals of the above-mentioned working group and recognized the calculated value of the DGF target of 3.5% as adequate for covering the projected volume of bank insolvency risks in the event of a crisis. At the same time, the Council instructed the above-mentioned working group to re-work the proposals regarding the deadline for achieving the target.

At its June meeting, the Council recommended a gradual increase in the target, starting with 2.5% as of 1 January 2025, and reaching 3.5% by 1 January 2028.

Setting the DGF's target at 3.5% of the total guaranteed amount of repayment ensures the deposit guarantee system to have sufficient capital to cover potential expenses. Contributions from banks participating in the DGF are the main source of capitalization of the guarantee system.

The Council's position. The Council has recommended the DGF to set the target at 3.5% and reach this level by 1 January 2028.