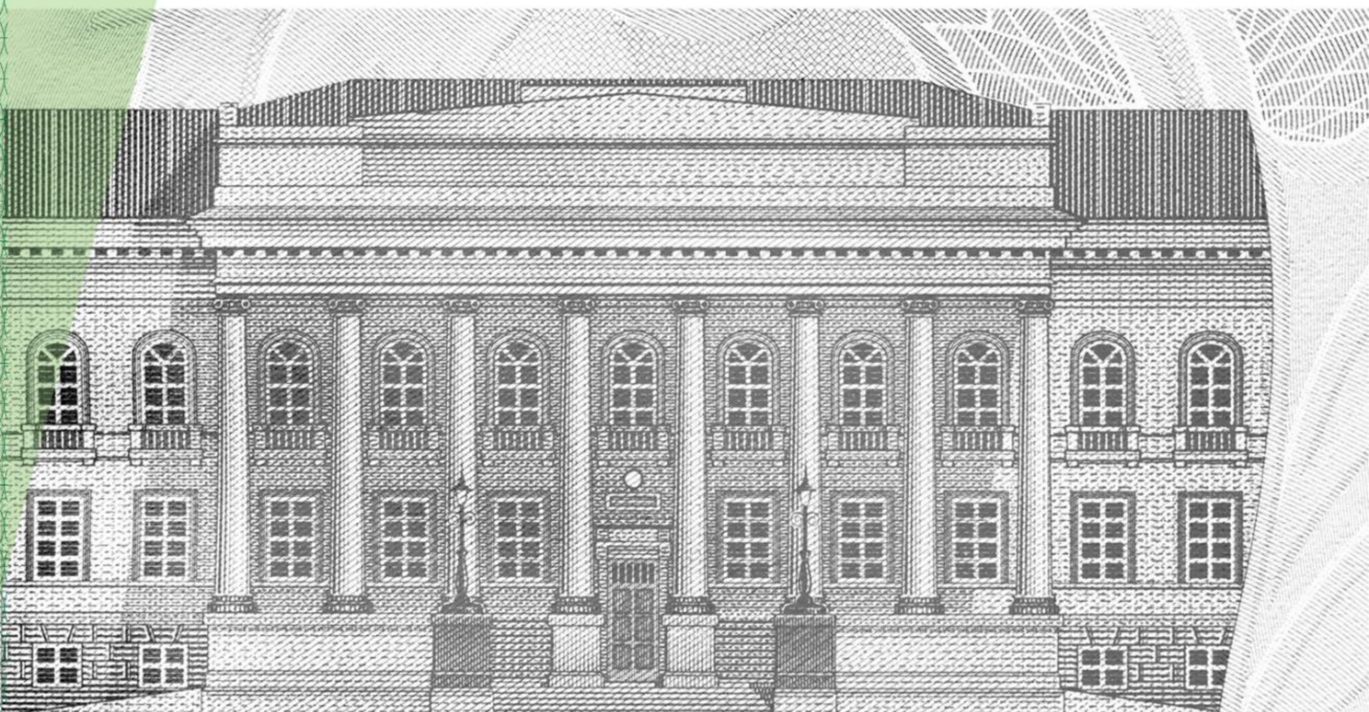
National Bank of Ukraine

Financial Stability Report

June 2024



The Financial Stability Report (hereinafter the FSR) is a key publication of the National Bank of Ukraine (the NBU). It aims to inform about existing and potential risks that can undermine stability of Ukraine's financial system. This report further focuses on risks that Ukrainian financial sector and economy face under protracted full-scale war. The report also offers authorities and financial institutions recommendations that aim to mitigate wartime risks and enhance financial system's resilience to these risks.

The report is primarily aimed at financial market participants, and all those interested in financial stability issues. Publication of the report promotes higher transparency and certainty of macroprudential policy, helps to boost public confidence in the policy, and thus facilitates National Bank's management of systemic risks.

The Financial Stability Committee of the NBU approved this report on 18 June 2024.

Content

Summary

The banks maintain the financial resilience, retain their clients' confidence, and step up lending to businesses and households. They are also expanding financing of the budget deficit. The key risks inherent to banking remain moderate, while capital and liquidity cushions ensure that the banking system operates on even during a protracted war. The banks continue to identify the war as the key systemic risk that affects their current operations and long-term development strategies.

International assistance to Ukraine continues, and recently chances of its future rise have increased. The G7 countries fundamentally agreed on a USD 50 billion financial assistance package for Ukraine secured with income from immobilized russian assets. These funds are to strengthen the foundation for macroeconomic stability in the next few years. At the same time, the progress in implementing the planned reforms facilitates the timely receipt of financial assistance packages from the EU, the IMF, and other partners.

Significant international financial support remains the key to controlling macroeconomic risks, which arise, in particular, from the large state budget deficit and the structural deficit in the FX market. On its part, the government is taking steps to efficiently accumulate revenues and gradually reduce the deficit. The financing from partners augments international reserves. This allows the NBU to effectively smooth out fluctuations in the FX market and take resolute steps towards FX liberalization: in May, a number of restrictions were lifted for businesses. The easing has not caused significant pressure on the FX market, moreover, it will further promote better investment climate.

Overall, the economy remains resilient to shocks from the war, but risks have risen. The higher intensity of hostilities, the destruction of energy infrastructure, electricity shortages, and a lack of skilled personnel have worsened businesses' expectations. This is holding back real GDP growth: under the April forecast of the NBU, the pace will slow to 3% this year. Companies are postponing plans to increase production and investments, so their demand for loans remains moderate. Despite all of that, competition for workers is rising among businesses. This was one of the drivers behind the growth in average wages and household income in general. This in turn fueled consumer sentiment and underpinned the increase in households' demand for loans. Inflation remains low. Its slowdown has led to a further decline in interest rates in the economy. Going forward, inflationary pressures are expected to increase. Nevertheless, there is still considerable room for market rates to decline in response to the NBU's recent monetary policy easing.

As households' and businesses' incomes are growing, their bank deposits, primarily in hryvnia, are also increasing. These new funds are mostly invested in high-quality liquid assets, which account for over a third of financial institutions' net assets. Therefore, the banks' liquidity ratios remain high, with the average LCR in all currencies being more than three times higher than minimum requirements. As the banks paid the corporate income tax for the last year at a higher rate, their investments in overnight certificates of deposit declined. The significant decrease in yields on risk-free instruments in recent months has prompted the banks to raise the share of domestic government debt securities in their high-quality liquid assets. The banks are seeking to lock in attractive yields for longer. Therefore, the banks are involved to a large extent in the financing of the budget deficit. In general, the banks retain a strong margin of safety to manage liquidity risks, although the likelihood of their materialization is low.

The banks are building up their hryvnia corporate loan portfolios, with the annual growth rate standing at 12% in April. Such a pace is in line with the banks' plans for this year. The portfolio of loans to small- and medium-sized enterprises is growing faster, and the banks are trying to attract new clients. At the same time, demand from businesses is limited by the slow economic recovery, electricity supply disruptions, and still-high war-related risks. However, the quality of the banks' loan portfolios remains good, and their clients' debt burdens are acceptable. Lending standards continue to improve, with loans becoming cheaper: over the year, the interest rate on new corporate loans has dropped by almost 4 pp, to around 16%. Better access to credit is facilitated by the banks' use of credit risk sharing instruments, primarily from the government and international financial institutions (IFIs). The role of unsubsidized market lending outside the government's *Affordable Loans 5-7-9%* program is gradually growing. This is a positive trend, and the focus of the program should increasingly be on financing investment projects.

Despite the positive trends in lending seen over the past few quarters, the banks have not yet fully adapted this function to the conditions of the wartime economy. To this end, the NBU, together with the ministries, has developed the Lending Development Strategy. The Strategy outlines the priority actions to step up lending during the war as well as to develop lending market infrastructure in the future. The implementation of the strategy will enhance the role of the banking sector in meeting the needs of the economy for resisting the invaders and in the post-war recovery.

Loans are growing more popular among households: the ratio of loans to consumption expenditures is approaching all-time highs. Accordingly, the volume of the loans is increasing rapidly, with the mortgage portfolio showing the highest growth rates, albeit from a very low level. The banks issuing unsecured loans are continuing to search for new clients and are increasing the average size of loans. A couple of banks traditionally lead in the segment. Non-bank lenders, on the other hand, have faced difficulties in implementing the new requirements for responsible lending. This is holding back their portfolio growth, so it is still lower than before the full-scale invasion. Over the year, the banks almost doubled their mortgage portfolio thanks to the state *eOselia* program. The terms of the program re-shaped the mortgage loan profile compared to the pre-war one: the amount of the downpayment made by households decreased, while the loan term increased. It will take time to assess the quality of the new portfolio in full.

The growth in the loan portfolio is supporting the banks' interest income, although interest payments on risk-free instruments continue to be its largest share. The downtrend in interest rates led to a decline in yields on assets. However, it was significantly slowed by a shift in the asset structure in favor of longer instruments with higher yields. Deposit rates also declined, but the cost of funding remained relatively stable. Therefore, the net interest margin only slightly retreated from last year's record-high levels. Although there is still room for a further decrease in market rates, it will be more gradual, so risks to the banks' margins subside. The quality of the loan portfolio is improving. Default rates in both the corporate and the retail segments are declining, so the banks' provisioning is low. Credit risk losses remain moderate, and the banks are raising their administrative expenses cautiously. Therefore, financial institutions' profitability is unlikely to change dramatically in the coming years.

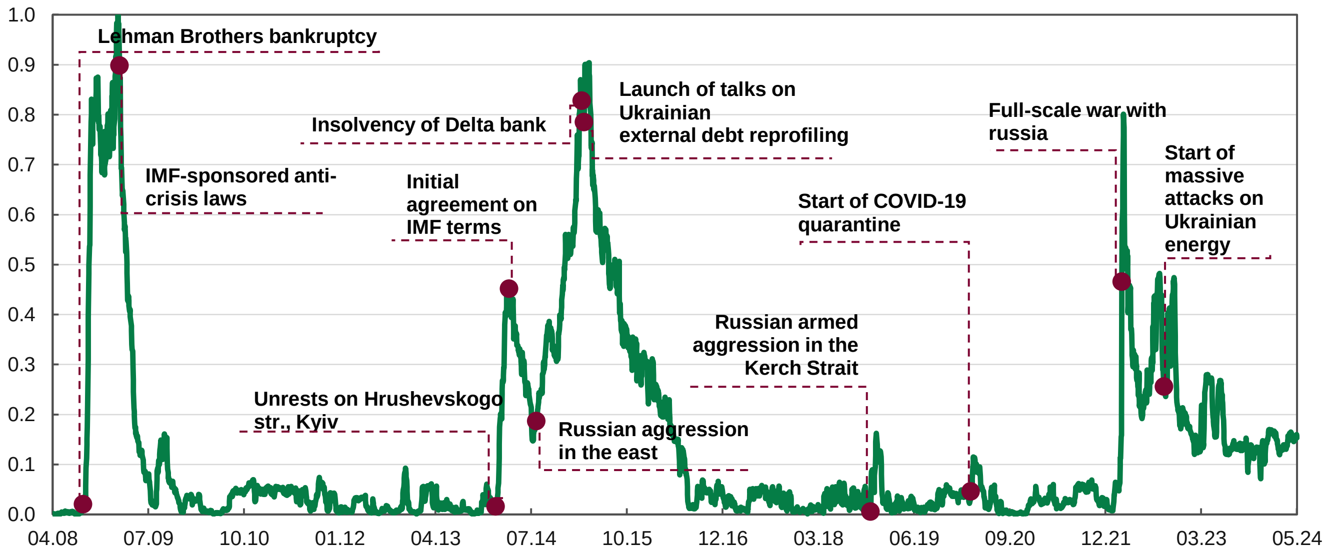
Sustained profitability contributes to steady growth in the banks' capital. Therefore, the NBU can proceed with the implementation of regulatory requirements in line with European standards. Starting in August, the banks will be required to fully cover all of their main risks with capital: credit risk, market risk, and operational risk. They will also switch to a new regulatory capital structure. The NBU has offered transitional rules to ensure that the banks have sufficient time to comply with the updated requirements. The new requirements will enhance the banks' resilience to the materialization of unexpected losses, while the transitional rules will boost the banks' ability to build up their loan portfolios.

Financial Stress Index

The Financial Stress Index[1] (FSI) has remained at a high level in H1. The government securities sub-index further made the greatest contribution to the overall index. Yields on Ukrainian sovereign Eurobonds are at an all-time high, and have continued to rise slightly in recent months. At the same time, the sub-index was balanced by a significant decline in yields on the government's domestic borrowings. The FX market sub-index grew slowly during the spring, due to the gradual weakening of the hryvnia. Higher yields on Ukrainian corporate bonds led to a slight increase in the corporate securities sub-index, which, however, remains low. In contrast, the households' behavior sub-index has declined somewhat over the last six months thanks to lower deposit rates. The already low indicators of the banking sub-index have improved somewhat over the past six months, thanks to a gradual decline in key policy rate and interbank rates.

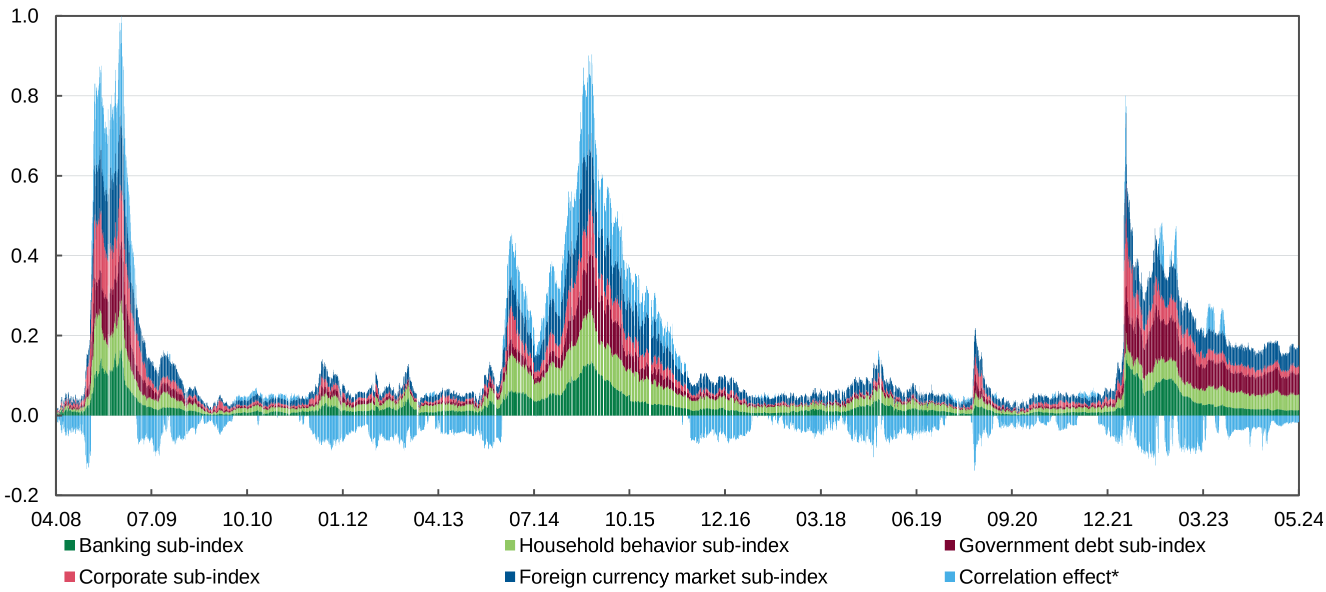
The FSI reflects only the current condition of the financial sector and does not signal future risks that may arise over the short or long term.

Figure FSI1. Financial Stress Index



Source: NBU.

Figure FSI2. Financial Stress Index decomposition



* The correlation effect is the contribution of the current correlation between sub-indexes compared to its average over the entire observation period.

Source: NBU.

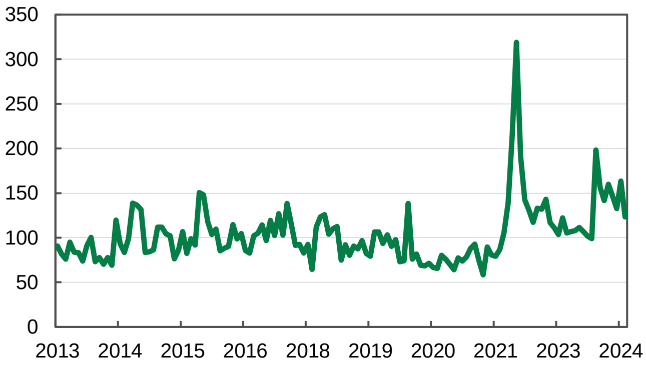
[1] Filatov, V. (2021). A New Financial Stress Index for Ukraine. Visnyk of the National Bank of Ukraine, 251, 37–54. https://doi.org/10.26531/vnbu2021.251.03.

Part 1. External Conditions and Risks

1.1. External Developments

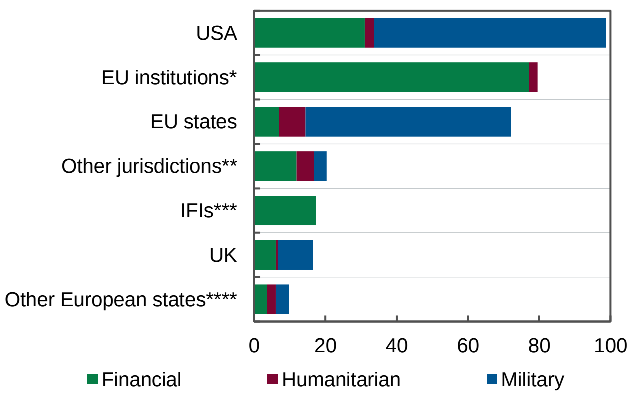
The war and its related risks continue to cloud the forecast horizon. The announced international assistance covers Ukraine's needs for weapons and budget financing for this year, but the scope of support for next year is as yet unclear. The recent decision of G7 countries to provide financial assistance secured with future incomes from immobilized russian assets was a major achievement. General geopolitical tensions and the fragmentation of international trade are adding to the uncertainty. Growth in the economies of partner countries is gradually reviving, but prices for Ukrainian exports remain relatively low.

Figure 1.1.1. Geopolitical Risk Index (GPR)



Source: Dario Caldara and Matteo Iacoviello. https://www.matteoiacoviello.com/gpr.htm.

Figure 1.1.2. Committed official assistance for Ukraine from end-January 2022 through end-April 2024*, EUR billions



* The European Commission, the EU Council, and the European Peace Facility. ** Australia, Canada, New Zealand, South Korea, Taiwan, Turkiye, and Japan. *** The IMF, the World Bank, and the EBRD. Assistance from countries provided as part of the IFIs' donor projects is counted as assistance from these countries and excluded from IFI assistance. **** Iceland, Norway, and Switzerland.

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

The situation at the frontline is difficult, but international aid allows Ukraine to resist the aggressor

The hostilities drag on, and in the spring, russia intensified its attacks: it launched a new offensive in the Kharkiv region, razed several towns and villages in Ukraine, and slightly shifted the frontline in its favor. The enemy is amassing forces for new offensives. In the spring, the aggressor country resumed terrorist air attacks on energy and other civilian infrastructure, destroying almost all thermal and a significant part of hydroelectric generation.

Today, support for Ukraine from foreign partners is growing again. Military aid from the United States has been unblocked, the prospect of Ukraine being provided with aircraft is closer, and the supply of other weapons has increased. Ukraine has already signed security agreements with 17 countries, including all of the G7 countries along with the United States, and new agreements are being prepared. These agreements will ensure long-term cooperation and armament for Ukraine's defense forces. Together with the expansion of domestic military production and additional mobilization, this is making it possible to successfully counter the enemy.

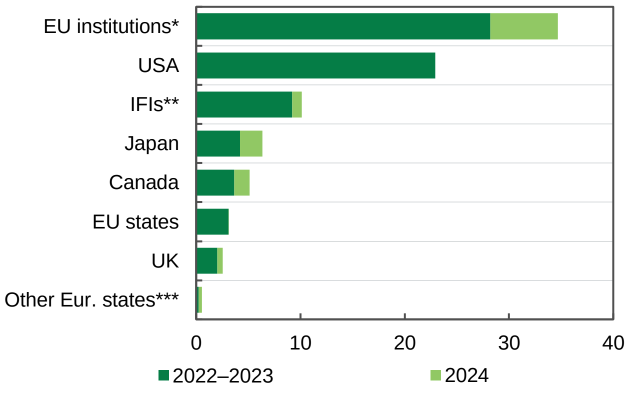
At the same time, international discussion of the Ukrainian peace formula is continuing. The Peace Summit in Switzerland became an important milestone. Almost a hundred of countries and international organizations, including most of G20 countries, attended the event. Most of the participants supported Ukraine's peace propositions, specifically principles ensuring nuclear and food security. New summits are being planned.

At the same time, the security situation in the world, especially in the Middle East, remains tense. On the one hand, this reduces the attention and resources that Ukraine's partners can allocate to the country. At the same time, geopolitical tensions have made countries realize the complexity of the threats to democracy in the world, and redouble their efforts to strengthen their own defense capabilities and support for Ukraine.

Systemic international financial support has resumed

Financial assistance from Ukraine's partners remains significant and has regained its regularity. The Ukraine Facility program was approved, providing for financial assistance from the EU amounting to EUR 50 billion over four years. It also contains a plan of reforms, including in the financial sector. After lengthy consideration, the U.S. Congress approved a USD 61 billion assistance package for

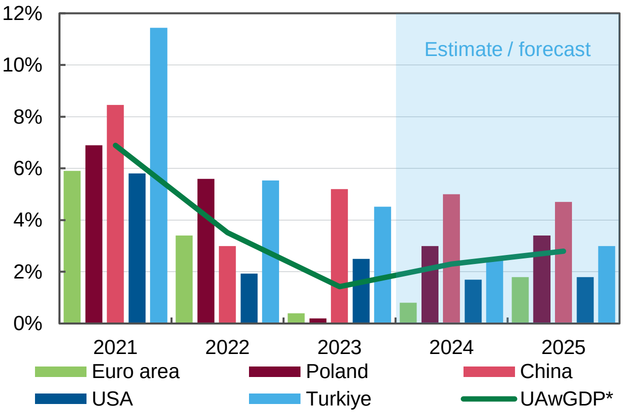
Figure 1.1.3. External financing of the state budget as of 28 May 2024, USD billions



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

Source: Ministry of Finance of Ukraine.

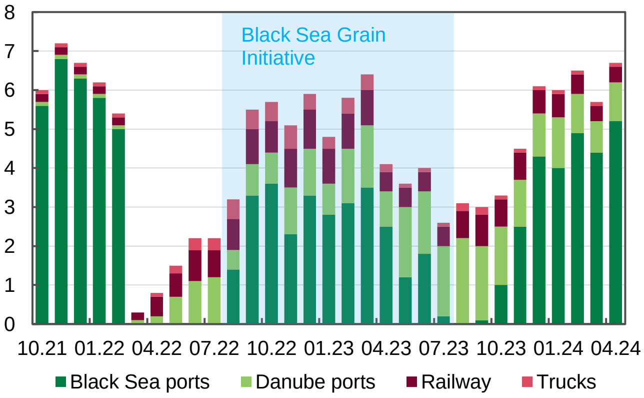
Figure 1.1.4. Change in real GDP of Ukraine's main trading partners, % yoy



* The weighted average of economic growth in Ukraine's main trading partners.

Source: NBU, Inflation Report, April 2024.

Figure 1.1.5. Exports of grains and oils from Ukraine, million tons



Source: Centre for Economic Strategy, May 2024.

Ukraine. Of this amount, about USD 8 billion is financial assistance to cover budgetary needs in the form of a loan with the possibility of a write-off, and USD 1.6 billion is economic assistance. Ukraine has successfully passed the fourth review of its IMF loan, which is a record number of successful reviews under one program in the history of the country's independence. The amount of financial assistance from partners this year will thus reach the level planned in the budget. However, high security risks are likely to persist, which will result in higher public spending. Therefore, the issue of raising the necessary amount of international financing will remain a key issue for economic policy in the coming years.

There is progress in finding additional sources of funding for Ukraine's needs

Given the escalation of hostilities and significant infrastructure damage in recent months, more funding for defense and reconstruction will be required than previously expected. Accordingly, discussions are intensifying about finding mechanisms to use the funds of the aggressor country in favor of Ukraine. Following the United States initiative, the G7 summit approved financial assistance for Ukraine of around USD 50 billion, which is to be repaid with income from immobilized russian assets. Moreover, in March, the European Parliament agreed on a draft update to the Directive on Asset Recovery and Confiscation, which will allow for the seizure of assets for attempts to violate the sanctions regime. At the same time, no decision has been taken on the fate of the russian central bank's assets frozen in the EU. The United States has passed a law that allows for the confiscation of russian assets frozen in the country to support Ukraine. This concerns around USD 5 billion. Mechanisms for transferring the funds to Ukraine are being developed.

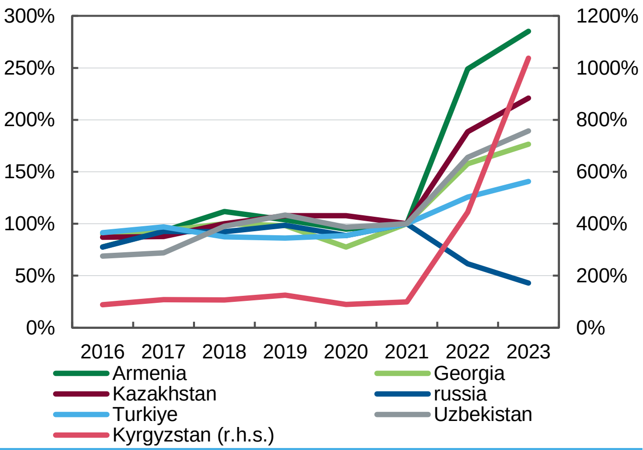
Economic growth in partner countries picked up slightly

Economic growth in Ukraine's partner countries will accelerate slightly this year, although it will remain relatively moderate. The Eurozone's GDP growth is underpinned by a recovery in consumer demand. It is constrained by tight financial conditions. GDP growth in Poland is reviving. Together, these factors create the preconditions for a revival in demand for Ukrainian exports. On the other hand, internal economic problems will cause slower growth in Turkiye and China.

Global trade growth will slowly recover to around 3% yoy, which is below the average level of the previous two decades. At the same time, protectionism and the fragmentation of international trade along lines of geopolitical alliances are growing. These will be fueled by increased geopolitical tensions, thus giving rise to new barriers to trade.

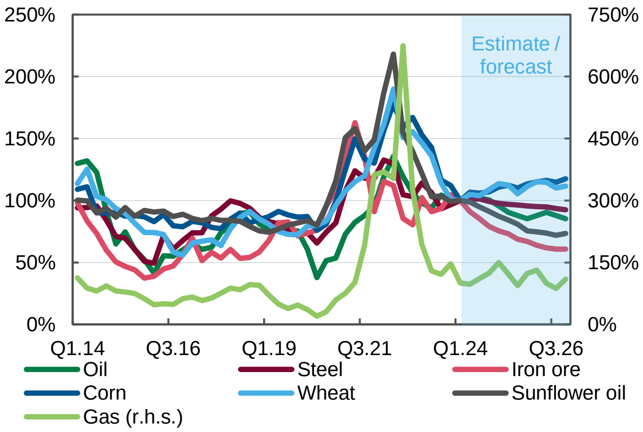
At the same time, the border with Poland being mostly unblocked is a positive factor for Ukrainian exports. However, the risks of renewed blocking are high. Despite russia's terrorist attacks, the sea corridor is operating successfully. The EU extended the duty-free trade regime with Ukraine for

Figure 1.1.6. **Exports of goods from the EU to russia and its neighbor countries, 2021 = 100%**



Source: European Commission.

Figure 1.1.7. **Global commodity prices, Q1 2024 = 100%**



Brent crude; natural gas at Netherlands Title Transfer Facility (TTF); steel square billets Exp FOB Ukraine; China import Iron Ore Fines 62% FE spot; average global quarterly prices for sunflower oil, wheat, and corn.

Source: NBU, Inflation Report, April 2024.

a year, although it provided mechanisms for rapidly reimposing restrictions on seven agricultural products.

Global inflation continues to slow down, approaching target levels in advanced economies in a one- to two-year horizon. The expected trajectory of inflation will lead to a gradual reduction in key policy rates by the leading central banks. This will not have a direct impact on Ukraine's financial system as the country's has no access to international private capital markets. However, it will contribute to a stronger global economic recovery and, in the longer term, to greater investor appetites, including for investing in Ukraine's recovery.

Sanctions against russia are still insufficient

russia's economy is adjusting to working under sanctions restrictions. The sanctions imposed over the past year have had less effect than those implemented in the first year of the war. The space for new sanctions is limited, so partner countries are focusing on strengthening controls over compliance with existing restrictions. These efforts, particularly in the area of energy trade and russia's purchases of sanctioned goods through third countries, will continue to restrain economic growth in russia. However, proceeds from selling energy remain relatively high due to relatively high crude oil prices. Several of russia's key export goods are still not covered by sanctions. Successful attacks on crude oil refineries are having a significant disruptive impact on moscow. However, according to IMF forecasts, russia's economy will only gradually slow down. Therefore, without increasing pressure – including a complete refusal by the EU to import russian gas – and stricter monitoring of sanctions compliance, russia will still have the resources to wage a war of attrition.

Prices for Ukrainian exports will remain lower than last year

Global grain prices have fallen significantly since last summer due to a large supply. However, wheat prices are gradually recovering 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. Active supply growth will put pressure on iron ore and steel prices. In general, lower global commodity prices compared to last year are having a negative impact on revenues from Ukrainian exports, especially agricultural products.

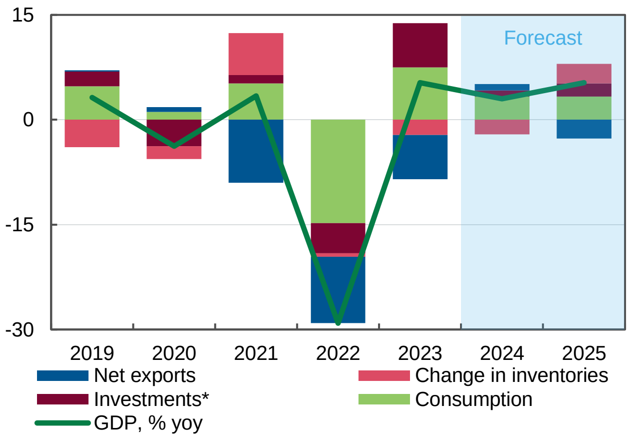
An increase in crude oil production in non-OPEC countries will contribute to a decline in prices. However, the escalation of the conflict in the Middle East poses a risk of new increases. Natural gas prices have fallen due to stocks being accumulated in Europe and there being ample supplies. The prices for natural gas are likely to rise as the heating season approaches, but should be lower than last year on average.

Part 2. Domestic Conditions and Risks

2.1. Macroeconomic and Fiscal Risks

Ukraine's economy is withstanding the challenges of the war and is continuing to recover. However, this year's GDP growth will be slower than previously forecast primarily because of the destruction of energy infrastructure. At the same time, the rapid decline in inflation at the start of the year enabled the NBU to continue the cycle of interest rate cuts. The approval of financial support packages by Ukraine's partners will cover budget needs and allow a sufficient level of international reserves to be maintained in 2024. The need to finance significant defense spending and the uncertainty over the provision of international financial assistance will remain key challenges in the coming years. This uncertainty is significantly reduced by the agreement on additional funding at the G7 level through the use of income from immobilized russian assets.

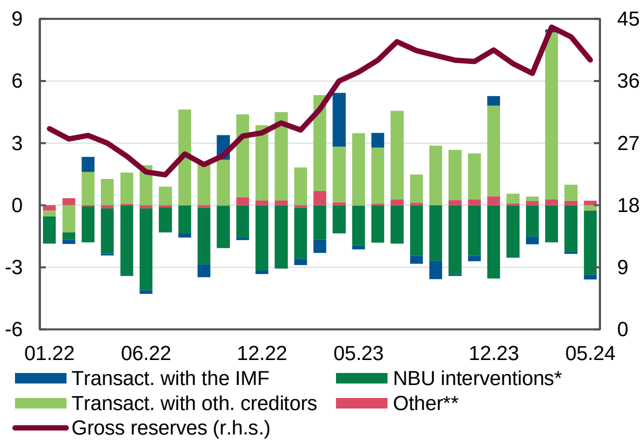
Figure 2.1.1. Contributions to GDP growth by component, pp



* Gross fixed capital formation.

Source: SSSU, NBU staff estimates.

Figure 2.1.2. Change in gross international reserves, USD billions



* The NBU's net interventions: (+) refers to purchasing FX to increase reserves; (-) refers to selling FX 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.

The pace of economic recovery will slow

In 2023, Ukraine's real GDP grew by 5.3% due to the high adaptability of businesses to the war, record-high harvests, and the arrangement of international logistics routes. However, a key contribution to economic growth was made by public sector spending – in particular on defense goods and services. Demand from the state will remain the main driver of growth in 2024. Economic growth will also be boosted by a revival in external demand and the further development of export routes. However, hostilities will restrain economic recovery, primarily due to a deterioration in business sentiment. The destruction of energy infrastructure in the spring as a result of massive air attacks has increased electricity shortages, and this has already led to imposition of limits on power supplies. Businesses are experiencing a growing shortage of staff, and the persistence of security threats is hindering investment. Therefore, in April the NBU lowered its GDP growth forecast for 2024 by 0.6 pp, to 3%. The potential for economic growth in a prolonged and exhausting war is limited.

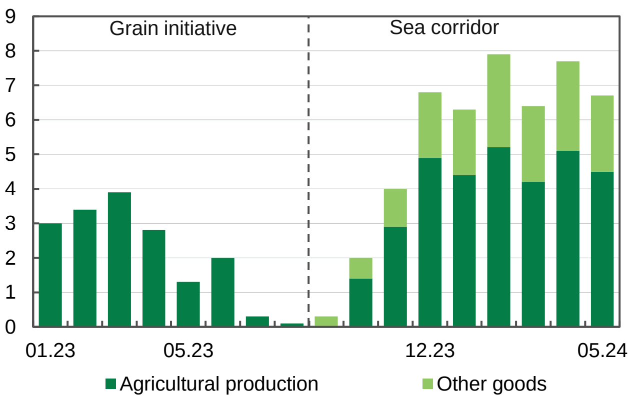
International assistance remains key to macroeconomic stability

Despite irregularity of international assistance inflows early this year, the government managed to pass through this period without significant problems, thanks to restrained spending and efficient administration. Already in March, Ukraine's partners had provided more than USD 9 billion in support, which made the necessary budget expenditures possible. The approval of the U.S. assistance package has increased confidence in the receipt of around USD 38 billion in official financing planned for this year. The disbursement of these funds is mostly conditional and will require the implementation of a specific list of reforms. International financing reduces the risks to macrofinancial stability, but uncertainty remains over Ukraine's potential needs and the amount of international assistance in the coming years. The uncertainty is reduced by the progress made in the G7's arrangement of additional funding for Ukraine through the use of income from immobilized russian assets.

The current account balance will gradually widen, despite some improvement in the trade balance

Gradual economic recovery and restored logistics are improving foreign trade performance. The NBU expects Ukrainian exports to recover gradually, primarily due to the stable operation of the sea corridor. Increasing volumes of agricultural products, products from the mining and metals

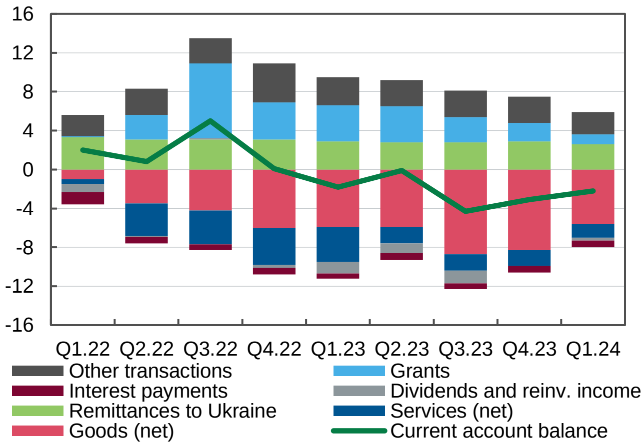
Figure 2.1.3. Exports from ports of Greater Odesa* in 2023–2024, million tons



* Ports Pivdennyi, Chornomorsk, and Odesa.

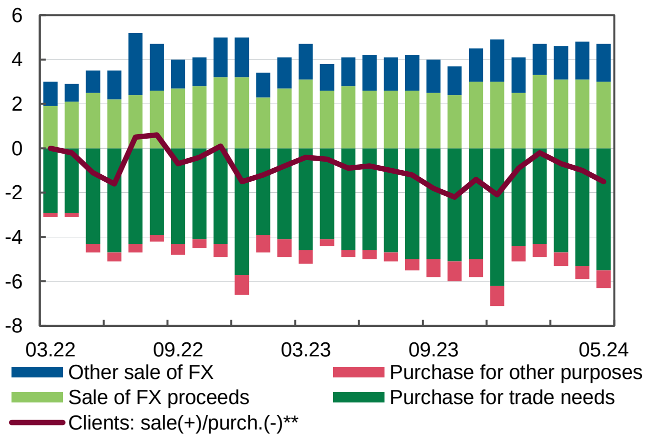
Sources: Ministry of Infrastructure, USPA.

Figure 2.1.4. Current account balance, USD billions



Source: NBU.

Figure 2.1.5. Purchase/sale of cashless foreign currency by bank clients, USD billions equiv.*



* The volume of transactions by bank clients to purchase/sell cashless foreign currency on TOD, TOM, and spot terms. The data for June and July 2022 reflects purchases/sales excluding Clearstream transactions.
** On a net basis.

Source: NBU.

industries, and other goods are being transported via this route. However, relatively low global prices compared to historical levels are holding back the growth in export revenues. On the other hand, imports are growing, fueled by consumer demand. Thus, the narrowing of the deficit in goods and services will be relatively minor. At the same time, the FX liberalization measures that have been introduced – primarily permission to service loans and partially pay dividends – will put pressure on the current account.

International assistance will continue to be the main source of capital inflows in 2024. Its volumes will cover the current account deficit with a margin, keeping international reserves at a high level. Capital inflows to the private sector are still modest due to high security risks. Private capital outflows will remain restrained for some time as some FX restrictions still apply in order to ensure external stability.

International reserves are sufficient to maintain FX market stability

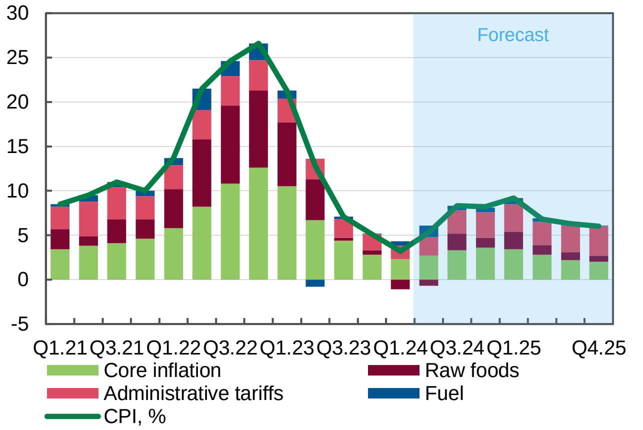
From October 2023, the NBU switched to a regime of managed exchange rate flexibility, while also easing a number of FX restrictions. Together, these decisions somewhat revitalized the market and increased its liquidity. However, a significant shortage of foreign currency persists. The NBU remains the market's key participant, and its interventions are the main mechanism for balancing the market. The NBU will continue to cover the structural shortage of foreign currency in the market. The continued inflows of international assistance and the international reserves that have been accumulated provide the NBU with the necessary margin of safety to maintain an active presence in the FX market and minimize excessive volatility.

The favorable macroeconomic situation and the stability of the FX market have enabled the NBU to continue FX liberalization. In particular, in May, the NBU lifted restrictions on businesses purchasing foreign currency to import works and services, repatriating dividends starting from 2024 profits, and paying interest on external loans. That said, the banking sector will not create a significant additional demand for foreign currency, as FX restrictions were not applied to the servicing of loans by Ukrainian banks. The easing of FX restrictions should improve Ukraine's investment attractiveness and facilitate capital inflows in the future. At the same time, the measures taken in 2024 should not put significant pressure on international reserves, which are expected to reach USD 43 billion by the end of the year, close to a historical high.

Low inflation enabled further reductions in interest rates

Inflationary pressures remain low. In May, inflation was 3.3% yoy. Going forward, inflation is expected to accelerate moderately, primarily due to last year's low comparison base, revisions of 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.

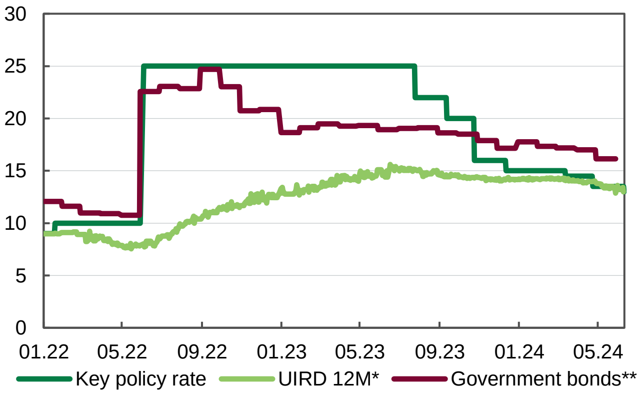
Figure 2.1.6. Contributions to annual change in CPI by component, pp



* NBU's forecast as of April 2024 for contributions from Q2 2024.

Source: SSSU, NBU staff estimates.

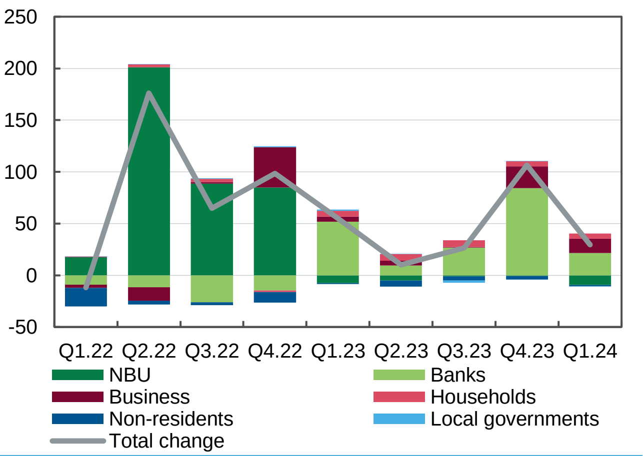
Figure 2.1.7. Yields on domestic government debt securities, key policy rate, and UIRD, %



* Ukrainian Index of Retail Deposit Rates. ** The average weighted yield on hryvnia-denominated domestic government debt securities placed on the primary market.

Source: Ministry of Finance, Thomson Reuters, NBU.

Figure 2.1.8. Change in portfolio of domestic government debt securities by holder category, UAH billions



Source: NBU.

The rapid decline in inflation and the controlled situation on the FX market enabled the NBU to continue the interest rate cuts. In H1, the key policy rate was cut by a total of 2 pp, to 13%. Over the same period, the rate on three-month certificates of deposit decreased even more significantly, by 3 pp, to 16%. At the same time, the NBU kept unchanged the parameters of another monetary instrument – required reserve ratios. This keeps deposit rates at a fairly high level and protects hryvnia savings from inflation. The NBU may revise its key policy rate forecast trajectory if there are changes to the balance of risks to inflation and to FX market sustainability.

Domestic funding will play an increasingly important role in government financing

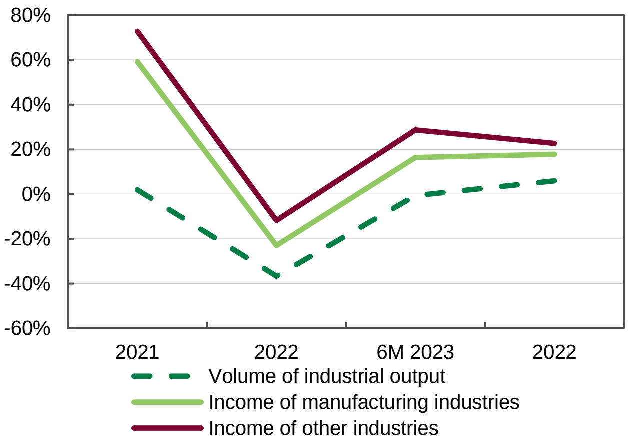
Defense and security expenditures will remain a key item in state budget expenditures for many years. In January–April this year, they grew by 8% yoy. The ability to ensure the continuity of these expenditures is, in part, the result of a much more significant increase in tax revenues. The increase in the corporate income tax rate for banks to 50% in 2023 (and to 25% afterwards) played an important role in this growth. The steps planned by the government to more efficiently accumulate revenues are outlined in the National Revenue Strategy published last year. The strategy primarily envisages better tax administration and the harmonization of the tax burden with EU legislation. At the same time, the government's domestic borrowing will play a prominent role in financing current needs.

The budget for the current year envisages net domestic borrowing of UAH 81 billion. In the first five months of the year, the banks, businesses, and households increased their portfolios of domestic government debt securities by UAH 69 billion. Investors' interest in domestic government debt securities was fueled by a decline in yields on other instruments. Market participants are seeking to lock in yields for a longer period before rates fall even further. Even if additional financing needs emerge, the government can rely more on the domestic market and increase its borrowing. The banking sector's liquidity is very high and there is no risk of a decline in the foreseeable future.

2.2. Real Sector and Related Risks

Real sector earnings continue to recover, albeit unevenly. Businesses' profitability and debt burden are stable and acceptable by historical standards. However, the increased intensity of the hostilities and their consequences have dampened business sentiment and will constrain economic recovery. Companies with rapidly recovering revenues and high profitability rarely need loans – they generate enough cash flow to finance themselves. Certain industries and categories of businesses affected by the war are in critical need of financing.

Figure 2.2.1. Change in production volumes and income of companies, yoy



Source: SSSU, Open Data Portal.

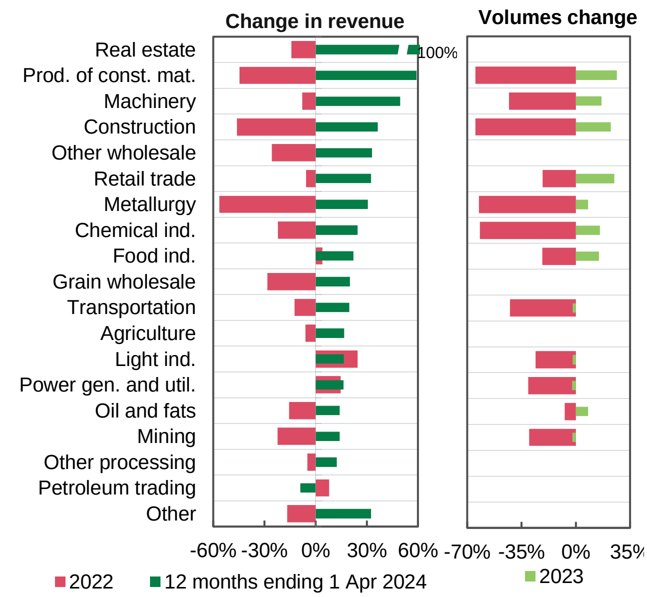
Business is recovering unevenly

In 2023, the total earnings of real sector companies grew in line with the growth in nominal GDP. Revenue growth was increasingly influenced by the increase in the volume of manufactured and sold products in several industries. Business recovery continues to be driven by higher demand from the public sector and to a large extent by private consumer demand. Budgetary spending on defense and infrastructure reconstruction is boosting revenue growth in the construction materials industry and certain segments of the construction and machine building sectors. Increased consumer spending is stimulating domestic trade.

The situation has been more difficult for export-oriented industries, such as mining and wholesale trade in grains. Nevertheless, in H2 2023, mining revenues and production grew moderately thanks to the operation of the Ukrainian sea corridor and greater opportunities for exporting products. The metallurgy sector increased production and is setting up supply chains. However, low export prices, electricity supply disruptions, and continued limits on rail and port infrastructure capacity are holding back the industry's recovery.

Strong harvests helped boost the agriculture sector's revenues last year. However, low prices by historical standards continue to dent this sector's EBIT. The share of companies incurring an operating loss is also growing.

Figure 2.2.2. Changes in revenues and production volumes of real sector companies, yoy



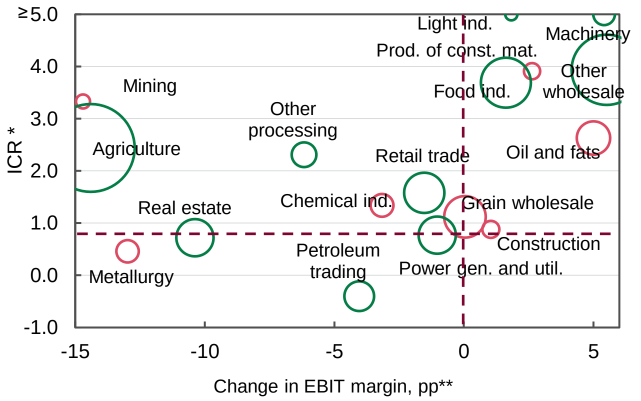
Source: SSSU, Open Data Portal.

Businesses' investment sentiment is extremely reserved

In Q1, companies maintained optimistic expectations, forecasting a moderate increase in production volumes. However, the increased intensity of hostilities and missile attacks, the destruction of infrastructure, and the shortage of electricity and skilled workers have dampened businesses' expectations across all sectors. In May, the business activity expectations index dropped below the neutral level, to 48, down from 52 in the previous month (see the Monthly Business Outlook Survey).

As of the start of 2024, production capacity utilization rose to 63%. This was still 5 pp below the pre-war level. The underutilization is due to lingering limited demand, a shortage of workers, and recurring problems with export logistics. Therefore, in many sectors, production can be boosted without additional investment in expanding production. In addition, investments in modernizing and increasing production are constrained by war risks. Thus, the demand for investment loans is limited. Investment is expected to pick up after the hostilities end. Currently, the key investment needs are related to ensuring a stable supply of electricity.

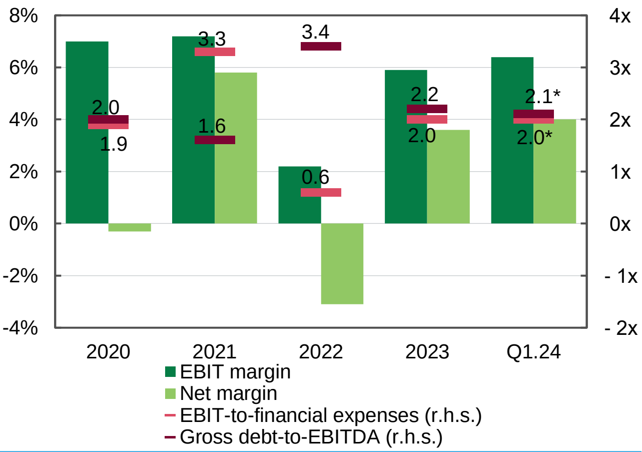
Figure 2.2.3. Debt burden and EBIT margin change of real sector companies



* ICR (Operating Profit / Financial Expenses) for the 12 months ending March 2024. ** Change in operating profitability for the 12 months ending March 2024 compared to 2021. Industries whose revenue did not reach the amount of revenue for 2021 are marked in red. The size of the circle is the sum of gross performing loans as of 1 May 2024, excluding loans to state-owned enterprises.

Source: NBU estimates, Open Data Portal.

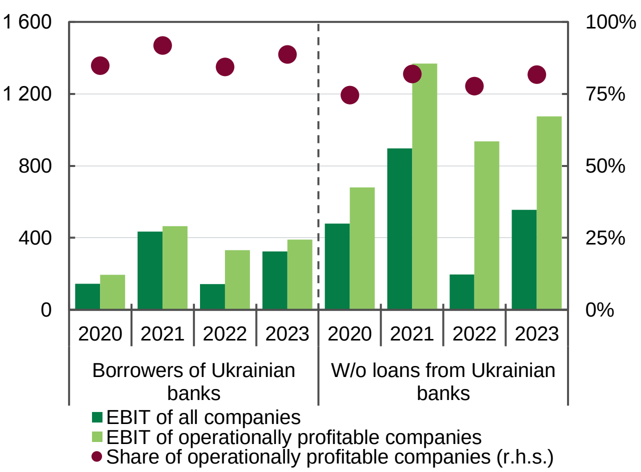
Figure 2.2.4. Profitability and debt burden



* Calculated for the 12 months ending March 2024.

Source: NBU estimates, Open Data Portal.

Figure 2.2.5. EBIT of companies borrowing from Ukrainian banks and companies without loans, UAH billions



A borrower of a Ukrainian bank is a company that has debt of more than UAH 2 million as of the end of the year.

Source: Open Data Portal, NBU.

Businesses retain financial resilience and pre-war debt burden

The profitability of enterprises has recovered from the fall in the first year of the war and remains acceptable and stable, albeit still somewhat below pre-war levels. The debt burden on businesses is not excessive. Over 12 months through April 2024, the coverage of financial expenses by EBIT was 2.0x, which is acceptable by historical standards. The ratio of debt to EBITDA decreased by 1.3 compared to the first year of the full-scale invasion – to 2.1x. The share of companies incurring an operating loss decreased by 4 pp, to 17.9%.

Low demand for loans is holding back lending

As growth rates vary across industries, demand for financing is also rather uneven. In industries with fast income growth and high profitability, companies often generate enough cash flow to finance their own needs – at least for replenishment of working capital. Businesses' bank deposits have been growing significantly since the start of the full-scale invasion. The need for long-term loans is limited due to subdued investment activity. At the same time, companies in need of financial support for reconstruction and recovery can count on subsidized loans.

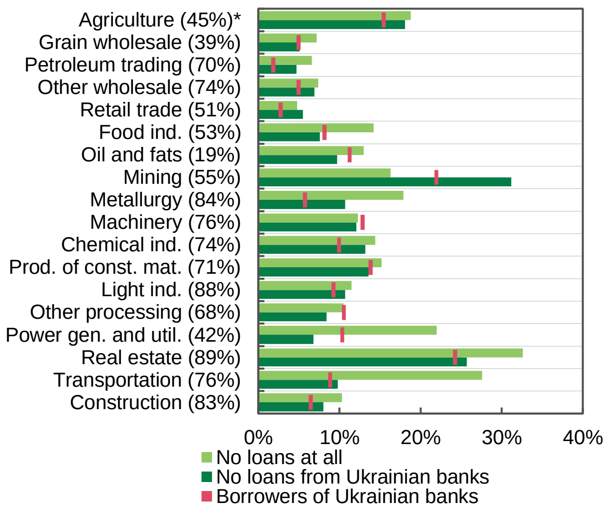
Currently, bank loans are held by operationally profitable companies that account for about a third of total operating profits. The companies that are generating the vast majority of operating profits are not taking out bank loans. Half of them use financing from alternative sources, including external borrowing and intra-group debt.

Operationally profitable companies that do not use bank loans generally have comparable and sometimes higher operating profitability compared to the borrowers of Ukrainian banks. In 2023, the total operating profitability of operationally profitable borrowers of Ukrainian banks was 8.6%, while that of companies that do not take loans from Ukrainian banks was 13.7%. Companies that do not use bank loans usually have similar liquidity compared to bank borrowers, and have high cash turnover rates. This suggests that a significant portion of these companies are able to finance their operations from their own funds and are unlikely to need additional credit. However, they might generate a significant demand for loans when the economy and domestic and external demand start to recover rapidly.

In recent years, lending has been most active in highly profitable industries or industries that have been offered preferential terms under state programs. These include, for example, agriculture, the food industry, and trade. Prior to the full-scale invasion, the energy sector was also among them. Currently, the penetration of bank lending in these sectors is high, so the pace of lending in these segments will depend more on the needs of companies that have already taken out loans than on new clients.

The penetration of bank lending in the metallurgy, machine building, and transportation sectors is rather low. Historically, however, these industries have been highly concentrated and have relied heavily on external financing. The latest round of

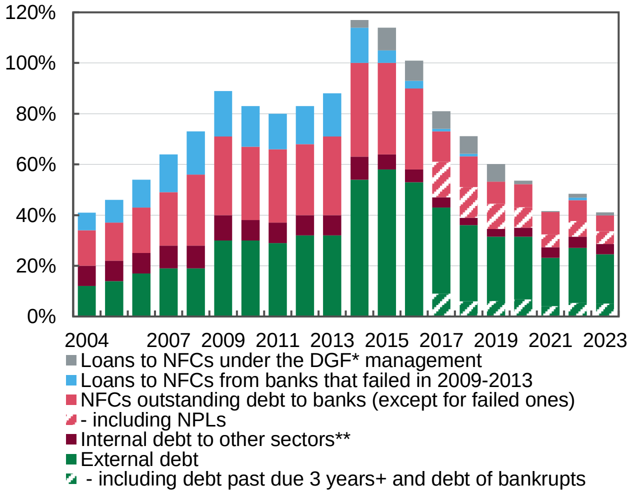
Figure 2.2.6. Average EBIT margin of operationally profitable companies in 2023 by existence of debt



* The share of EBIT of companies that do not have loans from Ukrainian banks is shown in parentheses. A borrower of a Ukrainian bank is a company that has debt of more than UAH 2 million as of 1 January 2024.

Source: Open Data Portal, NBU estimates.

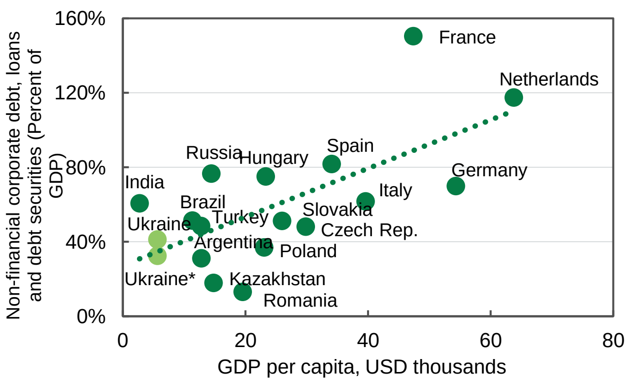
Figure 2.2.7. Non-financial corporate debt, % GDP



* Book value of loans at the time a bank was declared insolvent. ** To non-bank financial institutions, on debt securities. *** On Eurobonds and loans to non-residents, including direct investment enterprises. Excluding trade credit.

Source: NBU, Open Data Portal, NSSMC, STSU.

Figure 2.2.8. Non-financial corporate debt (loans and debt securities) in 2023, % GDP



* Excluding non-performing bank loans, external debt past due for more than three years, and the debts of bankrupt companies. 2022 data for Kazakhstan, Romania, and Slovakia.

Source: Bank for International Settlements (BIS), IMF, NBU.

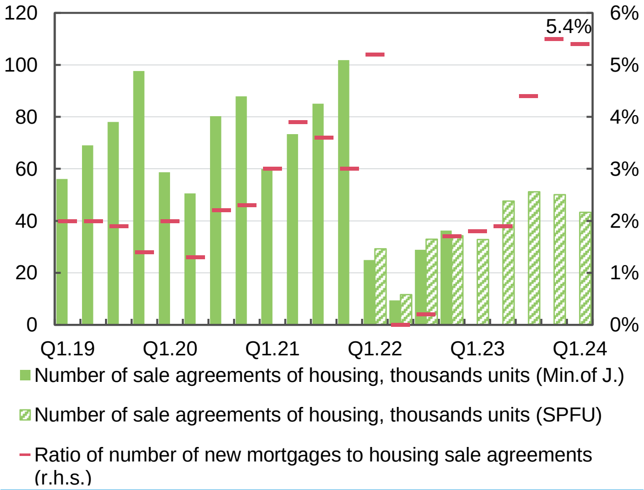
easing of FX restrictions, particularly in terms of the ability to service external debts, allows companies with good record in attracting external loans to raise additional financing outside Ukraine in the future.

Despite the low level of bank lending penetration, businesses' leverage is not low. Combined with external debts, the ratio of loans to GDP is around 41%. Excluding bad loans, the level is 32%. The sharp decline in this indicator from over 100% in 2014–2015 was the result of the banks writing off loans issued to low-quality borrowers. Significant volumes of such loans were written off the balance sheets of operating banks or were lost for good in banks that were withdrawn from the market. The second factor behind the decline in the indicator was sluggish lending in recent years, which was due to a decrease in the banks' appetite for risk. The low leverage of businesses has helped them successfully pass through the crisis period since the start of the war. However, economic recovery requires an increase in borrowing on both the domestic and foreign markets.

2.3. Real Estate Market and Mortgage Lending

Demand for residential property is slowly rising, but remains well below pre-war levels. It is being supported by state programs, in particular *eOselia*, a mortgage program that is increasingly becoming a noticeable driver in the development of certain market segments – the secondary market in particular. The commissioning of previously built and often sold-out housing continues, while new construction has hardly started, and demand for new properties is extremely low, except in the western regions. The weak supply of housing is likely to lead to its shortages when security risks moderate. Despite the subdued demand, prices have risen slightly since the beginning of the year. The market for retail real estate is growing, while that for office space is still in distress.

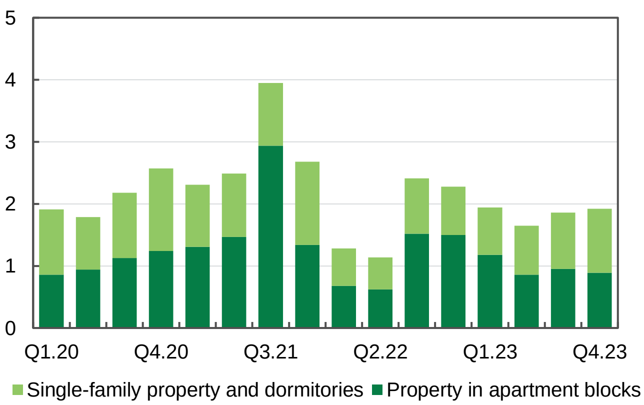
Figure 2.3.1. Housing market activity



Data from the SPFU comprises data on transactions data certified by notaries, under which an obligation to pay personal income tax arises.

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

Figure 2.3.2. Commissioned housing in Ukraine, sq. m millions



Data for 2023 is the estimate based on the number of apartments commissioned over the period.

Source: SSSU.

Demand for housing is slowly growing, driven by the secondary market

Although demand for residential property is slowly picking up, it remains markedly lower than before the full-scale invasion. In Q1 2024, the number of housing purchase agreements certified by notaries was up by one-third from Q1 2023. Over the past four quarters, however, such purchases have gone down by a third compared to the average over the three years prior to the full-scale war. The driver behind the recovery of demand remains the desire to purchase ready-made housing for one's own needs, primarily on the secondary market. Demand has been fueled by higher incomes and better consumer sentiment.

Investment demand continues to be subdued, as does demand for real estate in the primary market. The long duration of construction, the high risk of failure to complete projects, and uncertainty over the protracted war are discouraging people from buying unfinished housing. According to a LUN survey, the number of sales transactions in the primary market last year was only about a fifth of the 2021 level. Almost half of such deals are concentrated in Kyiv, Kyiv oblast, and Lviv oblast.

The share of mortgages in housing purchase agreements is a rather negligible 5.4%. However, this percentage is significantly higher than prior to the full-scale invasion. Almost all mortgage agreements are being concluded under *eOselia*, with demand in certain segments of the housing market increasingly relying on the operation of this program. Mortgage loans made under *eOselia* go to finance the purchase of newly constructed buildings (completed 10 years ago or later) and those in the final stages of construction. Demand is also spurred by other state programs, such as eRecovery[2] and subventions for military personnel and veterans to purchase housing.

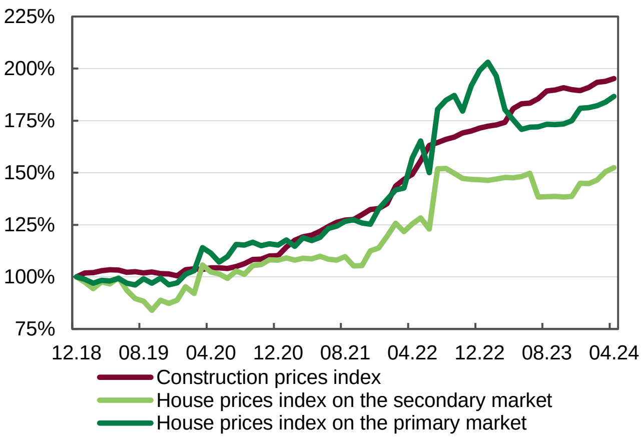
Housing demand is unlikely to surge going forward. It will be driven by government programs and household income growth. Meanwhile, factors that significantly deter housing purchases will persist. Such deterrents are: elevated uncertainty over hostilities, and high security risks.

Housing supply recovery is sluggish

The rate of housing commissioning has been stable, but lower than before the full-scale war. The properties that are being commissioned are primarily ones built previously, or those that were nearing completion when the full-scale invasion started. In practice, however, commissioned

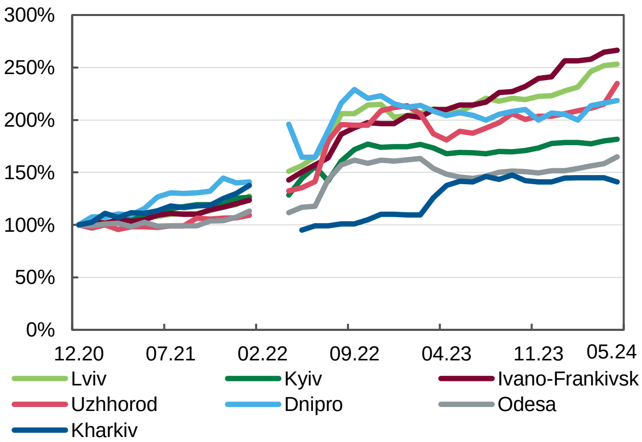
[2] A government aid program for homeowners whose housing has been damaged or destroyed during hostilities.

Figure 2.3.3. **Construction and housing price index, in hryvnia, December 2018 = 100%**



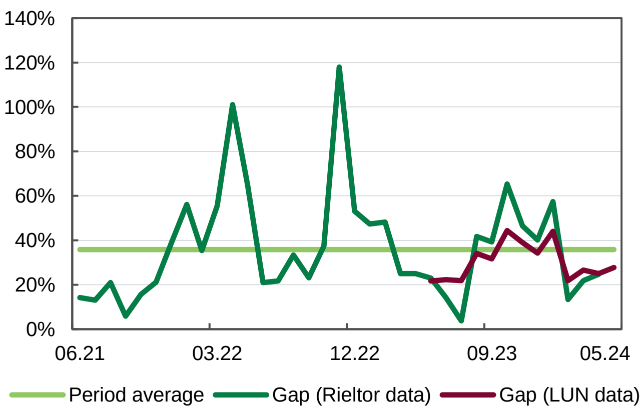
Source: SSSU, real estate agencies, NBU estimates.

Figure 2.3.4. **New housing quoted price index, in hryvnia, December 2020 = 100%**



Source: LUN, NBU estimates.

Figure 2.3.5. **Gap between average quoted prices in all advertisements and in advertisements for apartments that were sold, two-room apartments in Kyiv**



Since May 2024, average quoted prices have been calculated using the LUN database.

Source: Rieltor, LUN.

buildings add little to the total supply of housing, because most of the apartments in such buildings were sold at earlier stages of construction. Old construction is being finalized slowly, and new housing starts are almost non-existent, except for a few isolated projects in the western regions. Overall, the supply of new housing is expanding at a snail's pace. According to LUN, the number of complexes with apartments available for sale at the beginning of May 2024 was 13% less than in early February 2022. However, a significant part of housing offers are for early-construction properties that will most likely find no buyers in the near future.

The flow of new housing into the market is unlikely to pick up. Construction requires considerable resources: prices for building materials are increasing, and there is a large shortage of contractors in the sector due to migration and mobilization. Most developers are reluctant to launch projects at their own expense, and buyers take almost no interest in projects that are far from completion. The current lull in housing construction may lead to a lack of new housing supply after war risks abate and demand increases.

Prices continue to rise, though not always driven by demand

Although housing prices in the secondary market are increasing, this uptrend reflects exchange rate movements rather than changes in fundamental drivers of supply and demand. Market deals are still being made at discounts to advertised prices, though the discounts are declining.

Housing rent rates have continued to rise. The rent increases also apply to already rented housing. The price-to-rent ratio is fluctuating around its long-term average, indicating a stabilization of the secondary market in Kyiv. The average price of an apartment in the capital is currently equivalent to ten years of rental payments for the same apartment.

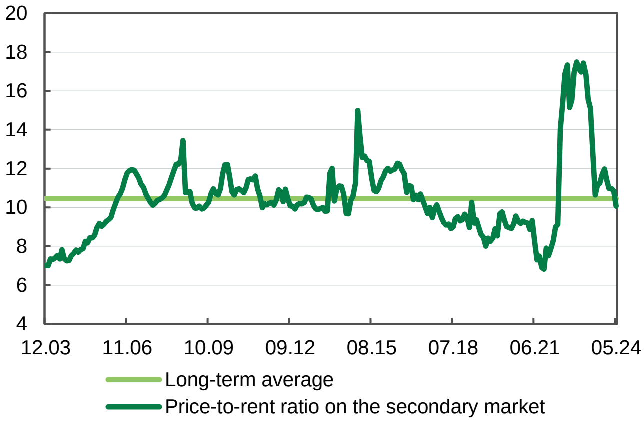
Advertised prices on the primary real estate market are also rising. Since the beginning of the year, housing prices have risen most noticeably in Uzhhorod, by 15%, and in Lviv oblast, by 14%, but by only 2% in Kyiv. The further decline in prices in the primary market has made the price of a square meter of housing comparable to, and in some cases even higher than, the price for housing in the secondary market. Considering the risk of construction going unfinished and the cost of renovations, secondary-market housing offers a significant price advantage.

Seller preferences will support housing prices in future, a pattern that in some segments will be further underpinned by financing from state programs. At the same time, prices for apartments in unfinished buildings at early stages of construction or in less safe regions will significantly surpass levels that buyers find comfortable.

Subsidized mortgages dominate the market, with no alternatives to be found

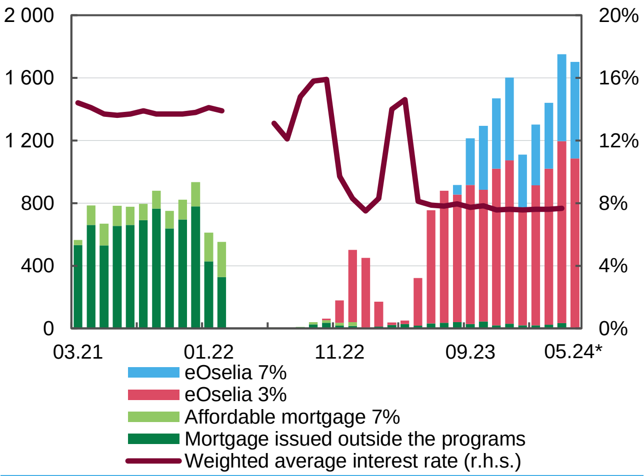
Mortgage lending outside *eOselia* is practically non-existent. Meanwhile, lending under the state program is only picking up. Over 10,000 mortgages worth a total of just under UAH

Figure 2.3.6. **Price-to-rent ratio in Kyiv**



Source: websites of real estate agencies, NBU estimates.

Figure 2.3.7. **New mortgage lending, UAH millions**



eOselia 7% covers loans to broad categories of households.
* Data on mortgages issued outside the program are not yet available for May.

Source: banks' data, BDF, UFHC.

17 billion have been made since the program started. This is almost half of the mortgages issued over the past five years. The program has generated a sustained pace of lending: almost as many loans were made in the first five months of 2024 as in H2 2023. Two-thirds of *eOselia* mortgages are still issued at 3% interest to specific categories of clients: primarily military personnel and law enforcement officers.

The mortgages are most actively provided in Kyiv oblast, where about a quarter of the mortgages were granted since the beginning of the year. A fifth of the mortgages have been issued in the capital itself. The pool of the program's lending banks is not expanding and is dominated by state-owned banks, which make five out of the eight program participants.

Since the beginning of the year, three-quarters of the mortgages have been taken out to purchase housing on the secondary market, 20% of the mortgages – to buy ready-made housing from a developer, and the remaining 5% – to buy housing under construction. A mortgage to purchase real estate under construction can only be granted if the residential complex has been accredited by the banks. The number of accredited buildings is slowly growing. Currently, 48 developers and 104 houses are accredited. According to the public statements and strategy of the UFHC, which is implementing the program, it should focus on financing the primary market in future. However, the mechanisms for overhauling the program have yet to be finalized. In addition, the UFHC in late May once again faced a lack of liquidity to finance the program's work. This means lending will slow.

Some banks are looking to revive their mortgage products as the real estate market gradually recovers. However, their products currently cannot compete with publicly available mortgages from *eOselia*. The program's design should not impede the development of market-based non-subsidized mortgage lending.

The market for retail real estate is growing, while that for office space remains in distress

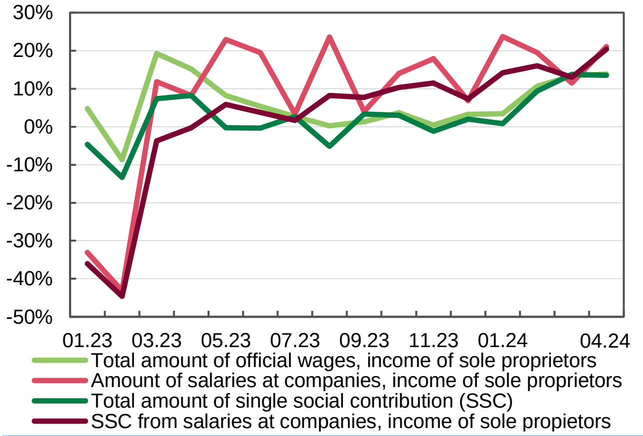
The retail real estate market is growing. The vacancy rates of large shopping malls in oblast center cities continue to decline. The flow of customers to shopping malls has stabilized. Lease conditions are approaching pre-war ones: the market is offering fewer and fewer discounts, and the fixed and variable parts of tariffs have returned. Rental income is rising: landlords are collecting higher payments as sales increase. Most shopping malls are equipped to cope with power outages. However, no one is willing to invest in the construction or purchase of a shopping mall.

The market for office space is still in distress. Short-lived spikes in demand are alternating with slumps in businesses' economic expectations and delays in rental decisions. The office vacancy rate remains high, but not uniform. Prime offices account for most of the space filled by businesses. A stable power supply, the availability of an air raid shelter, and the building's location remain key factors in office rental decisions. Landlords are still ready to reduce rent, accepting less money to have at least some of their offices filled. Construction of new business centers has all but halted.

2.4. Households and Related Risks

Real household incomes are growing markedly, fueled by a decline in unemployment and higher wages. Higher incomes contribute to improved consumer sentiment and stimulate demand for loans. At the same time, rising welfare ensures that the overall debt burden of the households is low. Continued inflows of income to households' accounts will ensure an ongoing comfortable inflow of funding for the banks. However, the list of savings instruments popular among households is gradually widening.

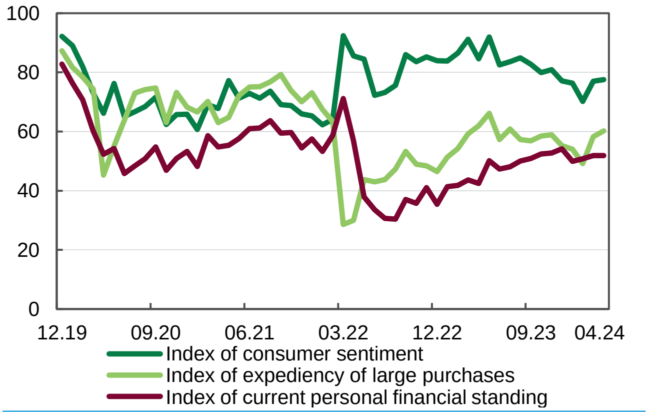
Figure 2.4.1. Estimated monthly real household income*, yoy



* Amounts of wages and incomes of sole proprietors come from bank reports. PrivatBank's data were adjusted to include only wage payments.

Source: Pension Fund of Ukraine, STSU, banks, NBU estimates.

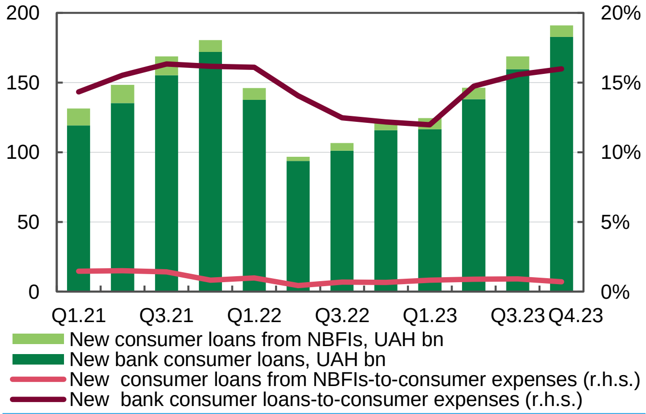
Figure 2.4.2. Households' consumer sentiment*, points



* The index readings below 100 indicate that society mostly considers the situation to be negative.

Source: NBU, Info Sapiens, monthly surveys of households (respondents aged 16+).

Figure 2.4.3. New consumer loans and their impact on consumption



Source: SSSU, NBU estimates.

Growth in real household incomes is accelerating

The growth in real household incomes accelerated in 2024. Wages, their main component, are rising more rapidly, primarily in the private sector. This is being driven by a further recovery of economic activity. On the other hand, the average wage is being driven upward by increased competition for workers. The average monthly salary in Q1 2024 increased by 22.5% yoy. Businesses continue to face a shortage of skilled workers. More than half of the employers surveyed by the Ministry of Economy and the International Organization for Migration (IOM) in February–March said that finding workers was their main difficulty. Finally, the gradual increase in the minimum wage at the start of the year and in April had a positive impact on incomes.

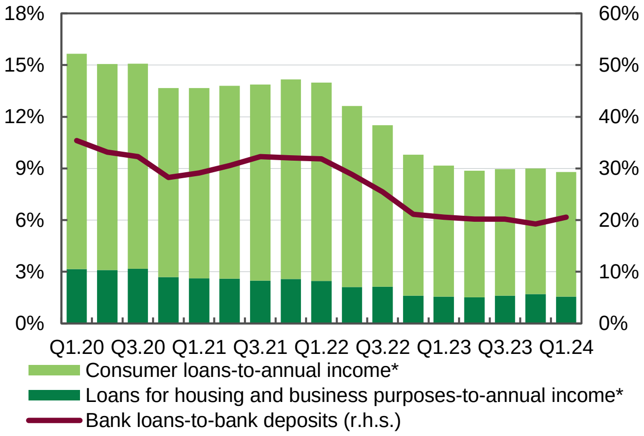
The overall growth in household incomes is being fueled by an increase in wages at public institutions, as well as in the salaries of military personnel. Due to the resumption of additional payments in February–April 2024, nominal payments to the military increased by 10% yoy. Pension payments also continued to grow due to indexation. Another important factor behind the growth in real incomes is the significant slowdown in inflation.

Despite the persistence of security risks and the destruction of energy infrastructure, the economy will continue to grow. Business activity will help reduce unemployment. Competition for skilled workers among employers will continue to drive up wages. According to a survey of companies held by the NBU in Q1, 77% of respondents plan to raise wages in 2024. In addition, the government intends to raise pay for military personnel. However, the acceleration of inflation will somewhat slow the growth in real incomes.

The role of loans in financing consumption is growing

In recent months, households have been improving their assessments of their current financial situation, as indicated by an Info Sapiens survey. The index of expediency of large purchases also increased, although it remained below the pre-war level. This is likely to be the result of the rise in household incomes and higher employment. Real consumer spending has been growing since the start of Q2 2023. At the same time, demand for consumer loans is growing even faster. This can be seen from both the findings of the Bank Lending Survey and the rapid growth in the portfolio, which has lasted for more than a year. In Q4 2023, the ratio of new bank consumer loans to household consumption reached a historic high of 16% – a level last seen in 2021. For non-bank loans, this figure does not exceed 1%. Although the impact of lending on consumption is still not decisive, its contribution is gradually increasing. Demand for consumer loans is

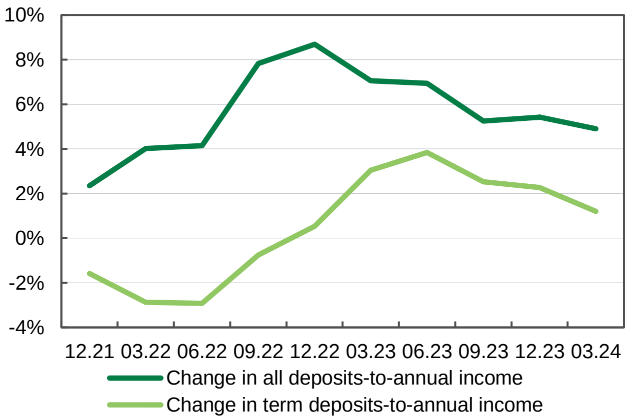
Figure 2.4.4. Household debt burden



* Amounts of wages and income of sole proprietors come from bank reports, and amounts of pensions from the data of the Pension Fund of Ukraine.

Source: Pension Fund of Ukraine, banks, NBU estimates.

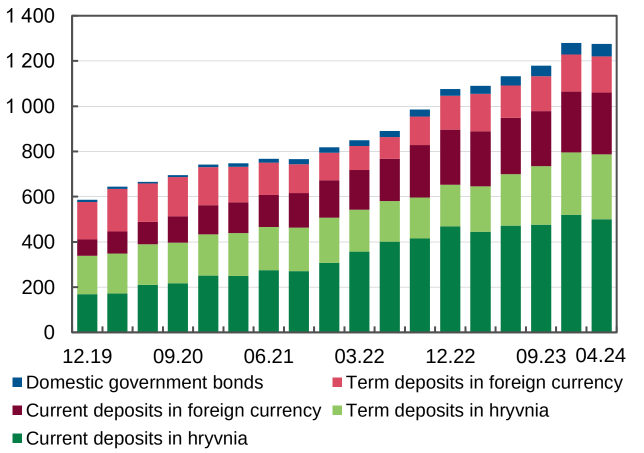
Figure 2.4.5. Ratio of change in hryvnia retail term deposits to annual income*



* Amounts of wages and income of sole proprietors come from bank reports, and amounts of pensions from the data of the Pension Fund of Ukraine.

Source: Pension Fund of Ukraine, banks, NBU estimates.

Figure 2.4.6. Main financial savings instruments, UAH billions



Source: NBU estimates.

expected to remain strong, fueled primarily by rising incomes and consumer sentiment.

The total debt burden of households remains low

The rapid growth in the loan portfolio is commensurate with changes in household income. Therefore, the total debt burden of households is consistently low. The ratio of net loans to income is about 9%. According to an Info Sapiens survey, less than a quarter of households have taken out loans. The banks continue to assess households' debt burden as being at a record low, as evidenced by the NBU's bank lending survey.

The debt burden of bank borrowers continues to vary by the level of income: lower-income households generally have a larger debt burden. Although the banks offer them lower credit limits, credit limit utilization rates are higher. The role of the *eOselia* state program in shaping the debt burden is becoming increasingly important. Increasing numbers of individuals with lower incomes are able to afford to purchase housing on credit due to affordable downpayment requirements and low interest rates. In July, the expanded Credit Register will be launched, with information on loans of UAH 50,000 and more being submitted not only by the banks but also by finance companies. This will allow the banks to more fully assess the debt burden and risks of a bank's client.

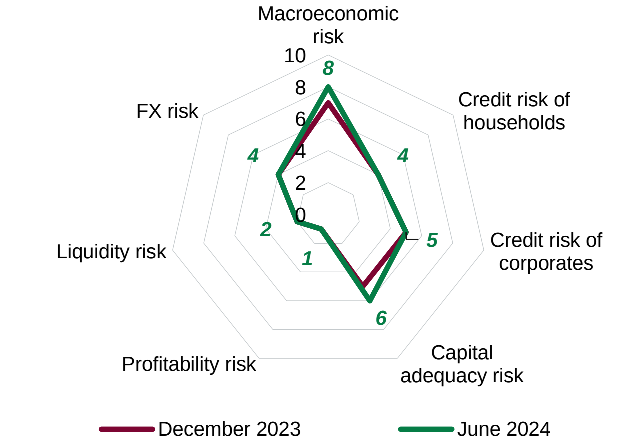
The propensity of households to keep savings at banks has been maintained

In view of rising incomes, households continue to deposit money at banks. As before, more than a third of hryvnia deposits rest on term deposits. The actual and projected inflows of wages and other official incomes to bank accounts are steady, and will thus ensure account balances remain at comfortable levels for financial institutions. Competition for hryvnia term deposits is expected to rise going forward. Investments in domestic government debt securities are currently more attractive than deposits as they allow high yields to be locked in, while coupons are not subject to taxation. Currently, few banks offer households to buy domestic government debt securities, and available offers are limited. This restrains the flow of deposits into domestic government debt securities. Given the easing of restrictions on foreign currency exchange for households, savings in cash foreign currency have increased.

Part 3. Banking Sector Conditions and Risks

3.1. Financial Sector Risk Map

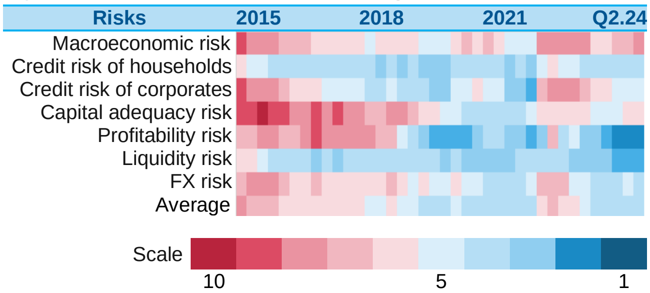
Figure 3.1.1. Financial sector risk map*



* The NBU assesses risks on a scale from 1 to 10, with 1 being the lowest level of risk, and 10 the highest. The assessment reflects the outlook for the next 12 months. The methodology for building the risk map has been adjusted to factor in data availability.

Source: NBU estimates.

Figure 3.1.2. Financial sector risk heatmap



Source: NBU estimates.

Description:

- Macroeconomic risk indicates the level of threats arising in the rea economy, the external sector, and the fiscal area.
- The credit risks of households and corporates reflect expecte changes in the share of non-performing loans in bank loan portfolio and the need for extra provisions for those loans.
- Capital adequacy risk measures the ability of banks to maintain a adequate level of capital.
- Profitability risk measures the ability of banks to generate net profit.
- Liquidity risk is a measure of the ability of banks to meet their liabilitie to depositors and creditors in full and on time.
- FX risk is the risk that foreign exchange market trends will affect the resilience of banks.

Macroeconomic risk: increased

Macroeconomic risk remains the most significant risk for the financial sector. Economic recovery has slowed, primarily due to the damage done to the energy sector. The ratios of the state budget deficit and external debt to GDP remain high. In addition, risks are growing due to a widening of the current account deficit of the balance of payments and an increase in public debt relative to GDP. Significant international financial assistance mitigates these risks.

Credit risk of households: unchanged

The credit risk of households is moderate. The share of significantly overdue loans has decreased further. In addition, the banks have improved their expectations for their retail portfolio quality. However, households' economic expectations have deteriorated slightly.

Credit risk of corporates: unchanged

The level of corporate defaults has been gradually declining. The banks' assessment of the future quality of their corporate loan portfolios has also improved. The financial stance of companies is satisfactory, and their debt burden is reasonable. However, their expectations for future changes in business activity have deteriorated.

Capital adequacy risk: increased

The banks' capital adequacy ratios have declined slightly due to tightening capital requirements, in particular, capturing operational risk in full. At the same time, the sector's capital position continues to be strong thanks to high profitability and restrictions on capital distribution. Therefore, capital adequacy risk remains moderate.

Profitability risk: unchanged

Profitability risk remains at historically low levels. The banks remain profitable, supported by high net interest income, low loan loss provisioning, and strong operational efficiency. Despite declining interest rates, the risks to bank profitability are low.

Liquidity risk: unchanged

Liquidity risk is low. The inflow of client deposits to the banks is continuing. The LCR ratio is more than three times higher than the required level. According to surveys, the banks assess liquidity risk as moderate.

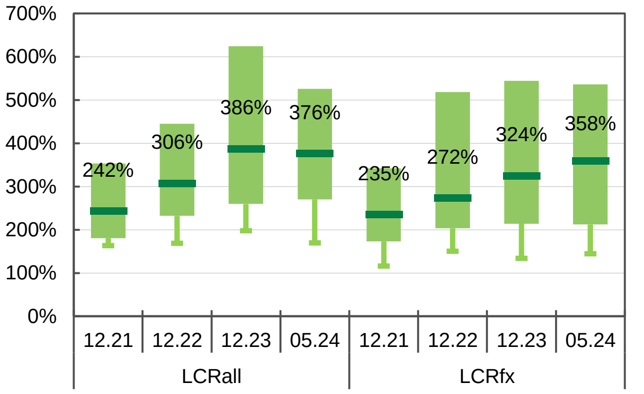
FX risk: unchanged

FX risk is moderate. The volatility of the UAH/USD exchange rate has slightly increased. Accordingly, the banks' assessments of FX risk have deteriorated. At the same time, the risk to the banks was mitigated by a decrease in the net open foreign exchange position of the banks. In addition, larger international reserves provide comfort in the FX market.

3.2. Liquidity and Funding Risk

The banks' liquidity remains ample, albeit unevenly distributed, the share of high-quality liquid assets is high, and the banks retain a margin of safety to withstand potential risks. Inflows of client deposits to the banks are sizeable and stable, primarily in the hryvnia, so the banks do not need funding from other sources. After a seasonal decline in client deposits at the start of the year, their inflows have recovered. The share of hryvnia retail term deposits has stabilized, and de-dollarization has come to halt.

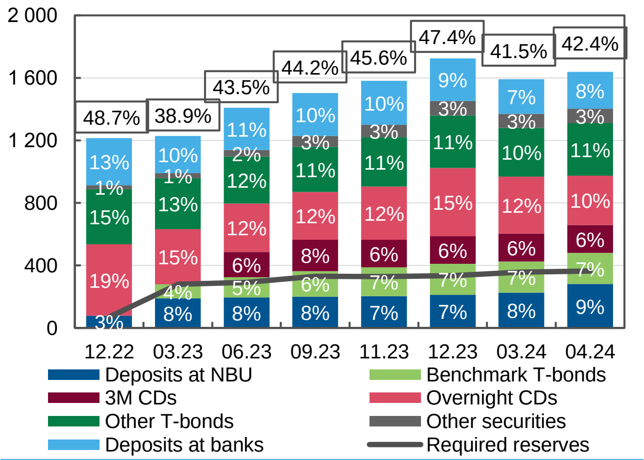
Figure 3.2.1. Liquidity coverage ratios in all currencies (LCRall) and in FX (LCRfx)



The upper and lower edges of the rectangles correspond to the distribution's first and third quartiles. The dashes inside the rectangle show the median. The lines extending below the rectangles indicate minimum values. The regulatory ratio is 100%.

Source: NBU.

Figure 3.2.2. High quality liquid assets in all currencies, UAH billions, and their share in net assets



At banks that were solvent at each reporting date. The percentage indicates the share in net assets. Benchmark government debt securities indicate nominal value.

Source: NBU.

The banks retain high liquidity

The banking system remains highly liquid. This is due to steady inflows into clients' accounts and a structure of the banks' assets that is favorable for liquidity. The LCR ratios for most banks continue to be more than three times the minimum required. At the start of the year, there was a short-term decline in the banking system's liquidity as the banks made large transfers to the budget. They paid a record amount of income tax at an increased rate, and state-owned banks also paid significant dividends. For the whole of 2023, the banks paid almost UAH 77 billion in income tax. Most of these funds were paid at the start of this year. Dividends from state-owned banks amounted to around UAH 32 billion.

The share of high-quality liquid assets (HQLAs) in the sector's net assets remains large, at 42%. The banks retain a sufficient safety margin to withstand liquidity risks that may materialize in wartime. Foreign banks hold the largest liquidity stock, their HQLA share reaches a half of net assets, while at state-owned and private banks the share is close to 40%. The banks' HQLA structure remains almost steady: domestic government debt securities and NBU certificates of deposit dominate in hryvnia HQLAs, while FX HQLAs mainly comprise funds in correspondent accounts with foreign banks. The share of the latter is decreasing as correspondent accounts with banks are gradually being phased out from HQLA in line with European standards (currently, they may account for no more than 60% of total HQLA).

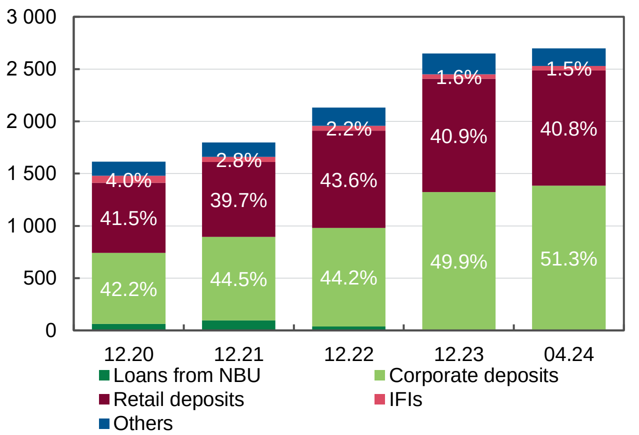
The banks continue to be almost entirely funded by client deposits

For funding, the banks continue to rely primarily on client deposits: retail and corporate ones. Their share of liabilities is over 93%. Therefore, the financial institutions have little need for funding from other sources. Thus, only a few small private banks have outstanding refinancing loans from the NBU. At the end of last year, for the first time since the start of the full-scale war, the banks' debt to IFIs increased slightly due to Ukraine receiving funding from the EBRD and the World Bank. These funds are mainly being used for lending support programs. However, the decline in the debt to IFIs resumed this year. As a result, the share of loans from international organizations in the sector's liabilities fell again, to 1.5%.

Businesses accumulate funds on their accounts

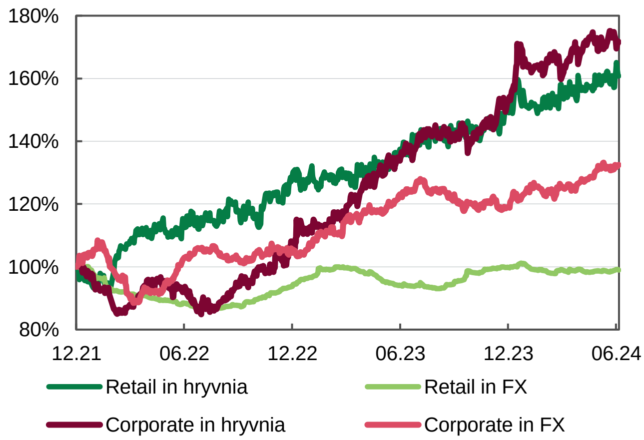
Hryvnia deposits with the banks are continuing to grow rapidly. Corporate deposits are growing faster than retail ones. Businesses are also increasing their FX deposits. The accumulation of funds on accounts reflects higher incomes at most companies and the limited ways in which they can be used: moderate working capital needs and the lack of investment projects. Businesses traditionally deposit almost

Figure 3.2.3. **Structure of banks' liabilities, UAH billions**



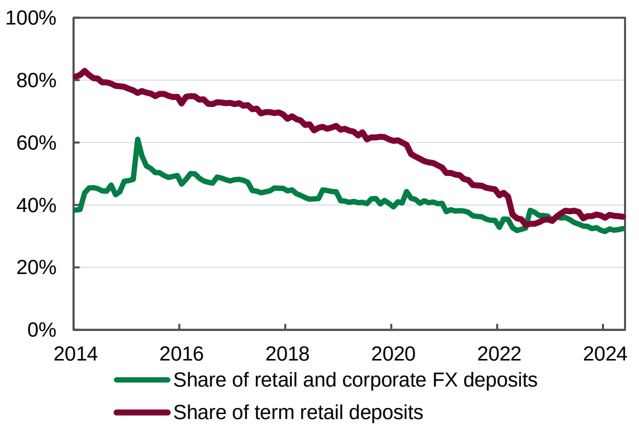
The share in liabilities is indicated as a percentage.
Source: NBU.

Figure 3.2.4. **Deposits of retail and corporate clients, 1 January 2022 = 100%**



Source: NBU.

Figure 3.2.5. **Dollarization rate of retail and corporate deposits and the share of term deposits in retail deposits**



Source: NBU.

all of their funds on current accounts. The recent easing of FX restrictions by the NBU is expected to result in a partial redirection of accumulated funds to external payments, primarily to repay loans and distribute dividends. At the same time, these outflows will be offset by inflows from companies' operations, so the banks' liquidity will not come under pressure.

Funding from retail clients continues to grow

The hryvnia savings of households continue to grow steadily, with the usual seasonal fluctuations. This growth is driven by the rapid growth in nominal household incomes and the retention of trust in the banks. Both the number of deposits and the average size of bank deposits are increasing. The average deposit amount has risen by 18% since last April, reaching around UAH 12,000. At the same time, larger deposits are growing much faster than smaller ones, increasing the concentration of retail deposits. Over the past year, the volume of deposits exceeding UAH 600,000 has grown by over 40%, and their share in the total deposit portfolio is more than a third. In terms of quantity, such deposits account for only 0.2%.

The volume of hryvnia retail term deposits is growing, albeit somewhat slower than total retail deposits. Despite the cut in the key policy rate, the banks have been cautious in adjusting the rates on retail term deposits. This is driven by maintained regulatory incentives to attract term deposits, such as required reserve requirements and 3-month certificates of deposit. As a result, the share of term deposits hovers around 36%.

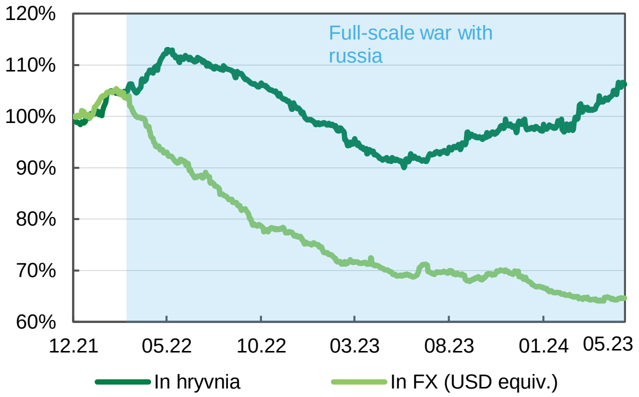
De-dollarization of deposits slows

Due to the easing of currency exchange limits, the exchanging of hryvnia for foreign currency for subsequent placement on deposit has ceased to be in demand. As a result, retail FX deposits declined. Due to the statistical effect of the hryvnia depreciation in recent months and an increase in FX corporate deposits, the downward trend in the share of FX deposits was interrupted. The share of FX deposits in client deposits is hovering at around 32%, which is low by historical standards. The banks remain reluctant to attract FX deposits, as ways to invest these funds are extremely limited. Given the high rates on FX instruments, the banks will occasionally earn additional income even if they keep these funds in low-risk instruments, such as deposits at foreign banks and investment-grade bonds. However, in the longer term, expected key rate cuts in the advanced economies will weaken these opportunities. Therefore, the banks will continue to have little incentive to encourage their clients to invest in foreign currency.

3.3. Corporate Lending Risk

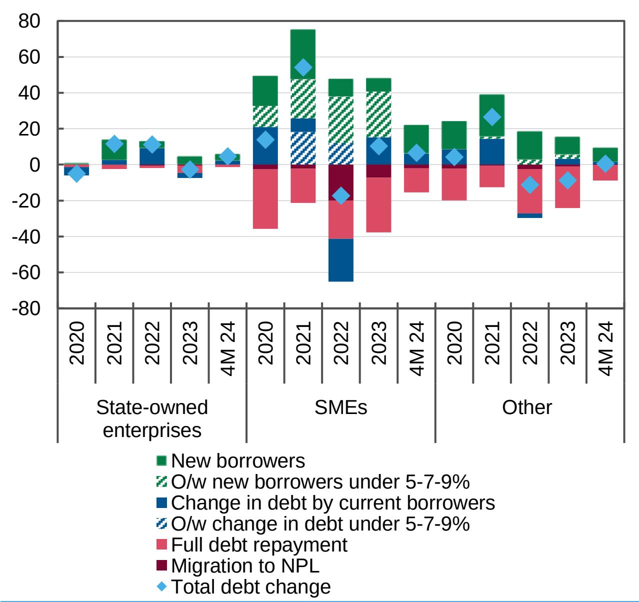
The banks continue to lend and increase their loan portfolios in line with the plans in their business models. This is facilitated by lower loan rates and the use of guarantees, in particular from IFIs. Loans to small and medium-sized businesses are growing the fastest. The role of unsubsidized lending is rising. Going forward, the implementation of the Lending Development Strategy will boost the revival of lending. The quality of the corporate loan portfolio has improved: the default rate is declining, and the debt burden of clients is acceptable.

Figure 3.3.1. Net corporate loans, December 2021 = 100%



Source: NBU.

Figure 3.3.2. Change in performing hryvnia corporate loans, UAH billions



Source: NBU, BDF (data as of 1 January 2024).

Loan portfolio is gradually growing

The net hryvnia corporate loan portfolio is continuing to grow. At the beginning of May, its growth rate was almost 12% yoy. This figure is generally in line with the banks' expectations, as they planned to grow their portfolios by about 15% in 2024. However, the hryvnia corporate loan portfolio has only recently returned to the level of February 2022. Since then, the share of loans in bank net assets has fallen by 10 pp, to 17%. Therefore, there is significant room for further portfolio growth.

Acceptable macroeconomic conditions and controlled security risks are creating the basis for more active lending. The banks are increasing their risk appetites and expect corporate lending to grow, as they report in NBU surveys. Declining inflation and credit risks, as well as intense competition for solvent clients, are encouraging the banks to cut their loan rates. Over the year, the cost of new hryvnia loans has decreased by 4 pp, to around 16%. The banks are also more willing to issue longer-term loans, with the share of loans with a maturity of more than a year in newly disbursed loans has increased by 8 pp since May last year.

At the same time, the risks that constrain lending remain high. The destruction of the energy infrastructure and interruptions in electricity supplies, notable uncertainty over the prospects for ending the war, and a lack of qualified personnel limit businesses' investments in development. The latest Lending Survey shows that demand for loans is growing slightly only among small- and medium-sized companies.

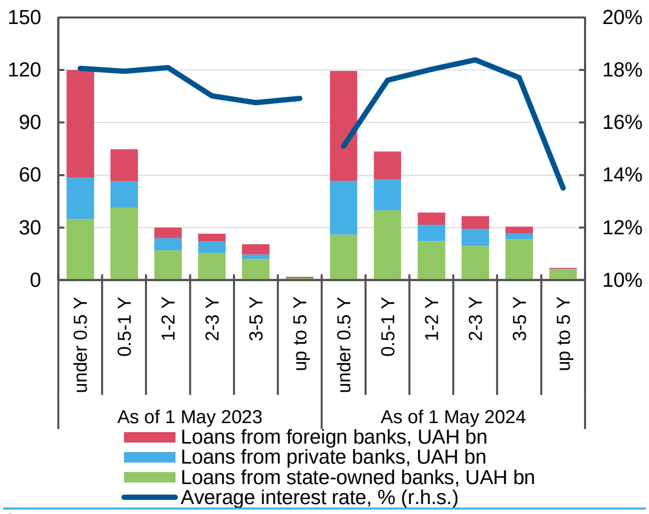
Unlike hryvnia lending, FX lending continues to stagnate due to low demand and significant risks. Since the onset of the full-scale war, net FX loans have fallen by a third. There are still no signs of a revival in demand for FX loans from businesses.

Small business remains the driver of the portfolio growth

Banks of all groups are increasing their hryvnia loans at a commensurate pace. This indicates a systemic improvement in lending conditions, and fuels competition. The main recipients of new financing over the past year have been trading and food industry companies. Since the end of 2023, agricultural companies have mostly been repaying previously received loans. A relatively new phenomenon is the lending by banks to the state financial company Ukrfinzhytlo for the further implementation of the state *eOselia* program.

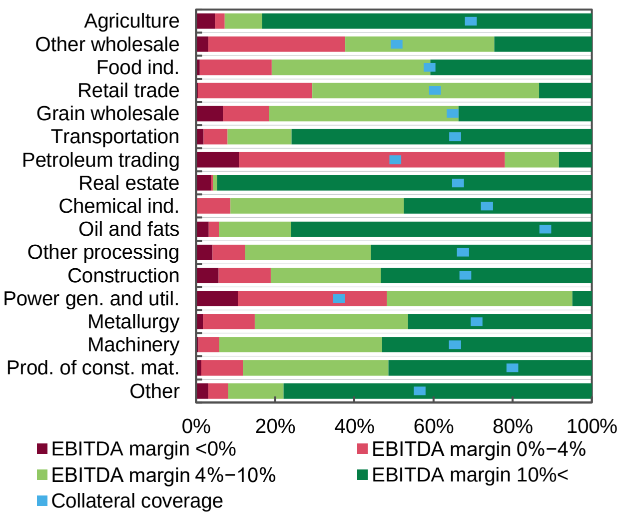
The emergence of new borrowers is an important factor in the revival of lending. In May, about 35% of all borrowers were businesses that had not been clients of banks a year ago.

Figure 3.3.3. Bank corporate loans in hryvnia by maturity and their cost



Source: NBU.

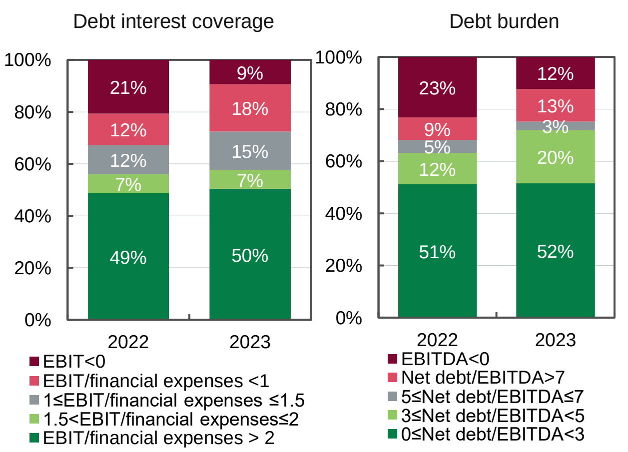
Figure 3.3.4. Profile of working corporate borrowers with hryvnia loans



Loans exceeding UAH 2 million. Excluding state-owned enterprises.

Source: NBU.

Figure 3.3.5. Breakdown of performing corporate loans by debt metric, as of 1 May 2024



Loans exceeding UAH 2 million. Excluding state-owned enterprises.

Source: NBU.

State-owned banks are the most active in attracting new customers. The new clients are mainly small companies, three out of four of which applied to financial institutions for subsidized loans under the *Affordable Loans 5-7-9%* program. Despite the difficulties in the program's current operation (see *Box 1. The Affordable Loans 5-7-9% Program Requires Sweeping Change*), perhaps its most significant achievement is that the banks have started lending to new micro-, small-, and medium-sized enterprises (SMEs). The portfolio of hryvnia loans to SMEs is growing faster than the total one: growth has accelerated to 21% yoy. The share of SME loans has already reached 60% of hryvnia corporate loans.

Resumption of lending is a key priority

As the economy continues to recover and lending conditions improve, the banks will meet the demand for loans from operationally profitable companies on market terms. Both during the war and in the post-war period, this will be facilitated by credit risk-sharing instruments, primarily from IFIs.

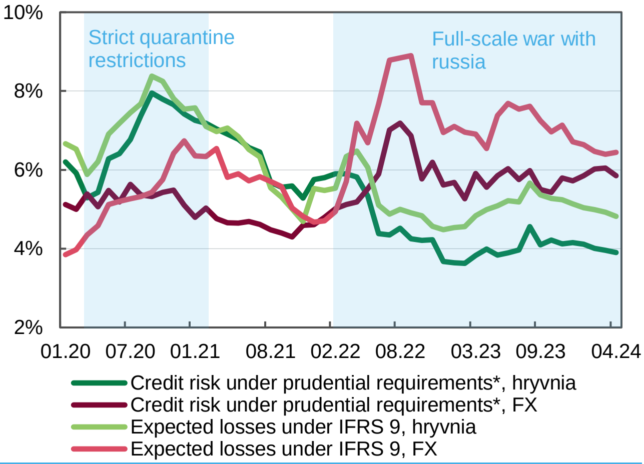
Despite the positive lending trends over the past year, it is too early to say that the banks have fully restored this respective function. The ratio of bank net corporate loans to GDP is now slightly below 8%. A comprehensive analysis of this problem and ways to reduce barriers to lending are set forth in the Lending Development Strategy, which the NBU developed in cooperation with concerned ministries. The strategy has two focuses: stepping up lending during the war, and developing credit market infrastructure. One of the NBU's first steps in implementing the strategy is to establish temporary approaches to measuring credit risk from specialized loans for the period of martial law. This will boost the launch and implementation of new infrastructure projects with loans. State subsidies for loans under the *Affordable Loans 5-7-9%* program will remain available for companies implementing investment projects that are critical to maintaining infrastructure, or operating in areas of high security risk. However, for businesses that do not fall into these categories, the amount of subsidized loans will be reduced.

Credit quality is acceptable

The prudent lending policy of the banks in previous years ensured high portfolio quality. Borrowers with performing loans maintain satisfactory debt metrics. The weighted average ratio of operating profit to financial expenses for 2023 improved slightly, to 1.6x. The average ratio of net debt to EBITDA decreased to 4.5x. Although the average debt burden is acceptable, it is still too high in the real estate, construction, and energy sectors. Agricultural companies, the loans of which account for about a fifth of the portfolio, have seen their debt burden increase noticeably.

The stable macroeconomic environment is conducive to the normalization of credit risk. In early 2024, for the first time since the beginning of the full-scale war, the banks reported in surveys expectations of an improvement in the quality of their corporate portfolios. Default rates on hryvnia loans continue to decline, reaching around 5% by number of borrowers. This is commensurate with periods of

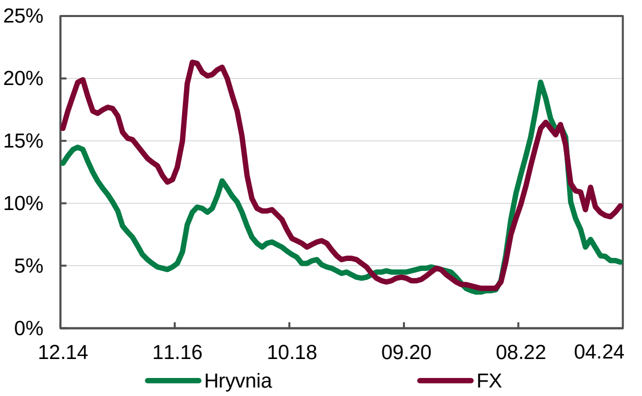
Figure 3.3.6. **Provision coverage of performing corporate loans**



* Credit risk according to Regulation No. 351.

Source: NBU.

Figure 3.3.7. **Default rate of large borrowers* over a 12-month horizon, smoothed data**



* Credit risk according to Regulation No. 351.

Source: NBU.

macroeconomic stability. At the peak of the war-related crisis, the default rate was 20%. Defaults on FX loans are almost twice as common, although this figure is also gradually declining. Given the moderate default rate and portfolio growth, the share of non-performing corporate loans has stabilized at around 44%. NPLs are being slowly resolved (see *Box 2. NPL Quality Recovery Is a Non-systemic Phenomenon*).

The coverage of performing hryvnia corporate loans with financial provisions (according to IFRS) and prudential provisions fluctuate at around 4% to 5%. The banks' loan loss provisions continue to be minimal. New loans are issued in a prudent manner. However, the banks should be prepared for the fact that the destruction of energy infrastructure and difficult security conditions could lead to new episodes of credit risk materialization.

Table 1. **Corporate loan portfolio as of 1 May 2024**

No.	Industry	Gross performing loans			Loan migration* to NPLs over 12 months		NPL ratio**, %	Interest coverage ratio (EBIT/financial expenses)*		Debt burden (net debt to EBITDA)*		Structure of loans, 5-7-9%, % (out of UAH 127 bn total)
		total, UAH bn	of which SMEs, UAH bn	credit risk coverage ratio, %	by quantity, %	by loan amount, %		2022	2023	2022	2023	
1	Agriculture	94	78	3.4%	6%	8%	17%	2.2	1.8	3.3	4.0	50.9%
2	Wholesale trade in grain	22	7	4.0%	11%	11%	41%	1.2	1.6	6.2	5.9	1.8%
3	Trade in petroleum products	12	6	7.5%	6%	37%	32%	2.3	1.7	3.7	4.3	1.7%
4	Other Wholesale trade	61	45	3.9%	4%	5%	16%	1.6	2.1	5.2	3.7	16.7%
5	Retail trade	21	5	3.1%	5%	6%	22%	1.2	1.5	4.3	3.0	4.3%
6	Food industry	31	17	3.8%	6%	6%	26%	2.0	2.1	3.9	3.7	6.0%
7	Production of vegetable oil and animal fats	15	7	2.3%	3%	8%	15%	0.9	1.9	6.9	4.8	0.7%
8	Mining	3	1	5.8%	8%	5%	39%	1.7	1.6	4.1	3.7	0.3%
9	Metals industry	7	5	3.0%	3%	6%	53%	2.1	2.0	3.3	3.7	1.7%
10	Mechanical engineering	7	4	2.6%	6%	5%	46%	2.2	2.3	4.2	2.9	1.6%
11	Chemical industry	7	6	2.2%	6%	6%	24%	1.8	2.3	5.2	3.4	2.7%
12	Production of constr. materials	4	2	2.7%	9%	26%	30%	1.8	1.8	6.1	4.7	0.9%
13	Light industry	2	2	4.5%	7%	3%	18%	1.2	1.7	7.9	3.3	0.5%
14	Other processing	8	5	2.6%	4%	2%	17%	2.1	2.6	4.0	3.7	2.8%
15	Electricity supply and other public utility services	6	4	6.7%	16%	24%	59%	2.0	2.2	6.8	6.6	0.3%
16	Green energy	12	8	3.8%	14%	15%	63%	0.7	1.2	7.2	7.0	0.6%
17	Real estate transactions	10	7	7.7%	31%	55%	56%	0.2	0.9	9.1	7.2	0.3%
18	Commercial real estate	8	6	4.1%	25%	20%	85%	1.8	1.4	4.5	5.1	0.2%
19	Transportation	13	9	2.7%	7%	6%	25%	2.3	2.4	2.4	2.5	2.6%
20	Construction	4	3	4.6%	16%	18%	72%	2.2	2.3	3.4	7.1	1.8%
21	Financial services	6	6	0.8%	24%	42%	29%	0.5	0.6	3.4	2.3	0.0%
22	Other	19	6	2.6%	10%	18%	32%	1.6	2.0	3.7	2.6	1.7%
23	State-owned companies	70	7	3.8%	6%	0%	8%	0.6	0.8	7.5	6.1	0.0%
	Total	**442**	**248**	**3.7%**	**7%**	**9%**	**32%**	**1.5**	**1.6**	**5.2**	**4.5**	**100%**

* The ratio of the number or amount of debt of borrowers whose loans have migrated into NPLs over 12 months, in accordance with the requirements of Regulation No. 351. ** The calculation of the NPL ratio does not include PrivatBank loans granted to companies linked to former shareholders and related parties. Taking into account that data, the total NPL ratio is 44%.

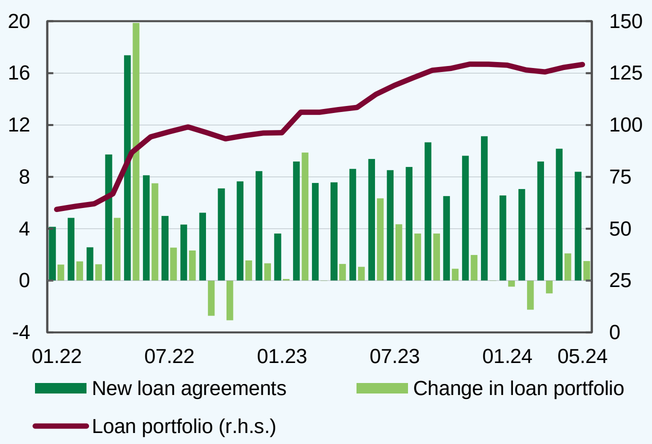
Source: NBU.

Box 1. The Affordable Loans 5-7-9% Program Requires Sweeping Change

The *Affordable Loans 5-7-9%* State Program played an important role in supporting clients during the most critical periods, in particular in 2022, after the start of the full-scale russian invasion. However, its scope exceeded the state's capabilities, resulting in a significant debt to the banks. The uncertainty of the debt repayment prospects is holding lending. If the program remains widely accessible, its debt to the banks will continue to grow. One-off measures cannot solve this problem. The program needs focus and fundamental changes that will correct the accumulated imbalances.

In the first year of the full-scale war, the *Affordable Loans 5-7-9%* Program (the program hereinafter) played a critical role in supporting businesses. It made bank financing available to new and existing clients. In 2022, despite the deep economic crisis, lending continued thanks to government support. Over 2022–2023, the government amended the program 16 times, mostly by raising credit limits and expanding the list of lending areas. Since then, a wide range of borrowers have been able to receive state support, regardless of their actual needs. The portfolio of loans subsidized by the program has more than doubled since the beginning of the full-scale invasion, amounting to UAH 129 billion in early June 2024. The cost of loans for clients remained extremely low even during the period when market rates were rising. So the program was becoming increasingly expensive for the state. The program's budget was not designed for such dynamics. The debt on compensation to banks exceeded UAH 7 billion at the beginning of 2024. Since then, the debt to banks has only slightly decreased, falling to UAH 5.8 billion in early June.

Figure B.1.1. Loans under the Affordable Loans 5-7-9% program, UAH billions



Source: Business Development Fund.

Periodic delays in the program's funding have created uncertainty for the banks and borrowers participating in the program. The banks are in no hurry to lend under the program because of the existing debts they are owed. Borrowers are not eager to enter into lending agreements outside the program, hoping to take advantage of its favorable terms. As a result, the conclusion of new agreements and the prolongation of old ones have been suspended, and lending has slowed down.

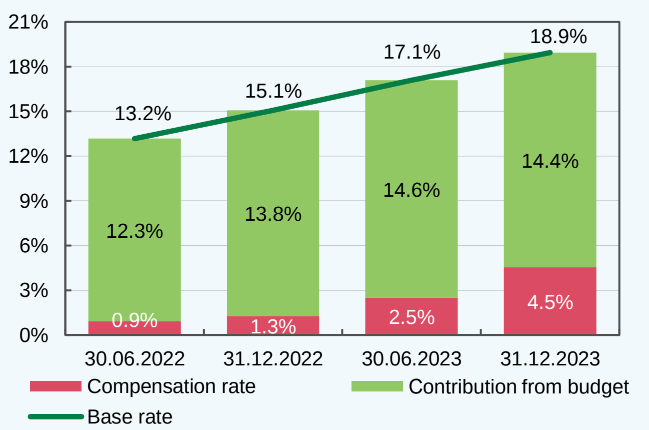
The speed of loan disbursement has become a factor of competition between the banks participating in the program

It is easier for the banks to find clients under the program than outside of it because of the cheapness of the loans and the unification of loan terms. Borrowers do not need to compare loan terms from different banks. So when taking out a loan, clients often prefer banks that make decisions faster. This prompted the banks to simplify the procedures for approving loans under the program. As a result of this simplification and because of the preferential payment terms, sometimes less attention is paid to assessing a borrower's ability to repay the loan. At the same time, banks with high lending standards may lag behind in terms of portfolio growth. Some banks have generated more than 50% of their net hryvnia corporate portfolio through the program, while the system average is about a third. In future, the balance between the speed of decision-making and the quality of risk assessment should be improved.

The program restrains the banks' price competition for clients

The mechanism of the program has not changed since its inception. A bank sets a base rate on the loan, which is the sum of the 3-month Ukrainian index of retail hryvnia deposit rates (UIRD) and a spread set by the program. The base rate is reviewed quarterly if the UIRD changes. The borrower pays a fixed rate – a compensation rate that is lower than the base rate. The Business Development Fund (BDF) pays to the bank the difference (the base rate less the compensation rate) at the expense of the budget.

Figure B.1.2. Weighted average interest rates under the program



Source: Business Development Fund, NBU estimates.

After the onset of the full-scale invasion, compensation rates for borrowers declined, and significant volumes of loans were provided at 0% for a long period. In addition, the government raised the permissible spreads to enable the banks to cover the credit risk, which increased during the war. What is more, in 2022–2023, the cost of funding and, accordingly, the UIRD grew. Therefore, the program's base rates continued to rise. By the beginning of 2024, they had reached an average of 18.9%. The average compensation rate under the program was 4.5%. Thus, the burden on the state has increased – the state paid the banks an average of 14.4% per annum for each hryvnia of loans granted.

Since the beginning of 2024, market loan rates have declined significantly. This is the result of cheaper funding and lower credit risks due to improved security conditions and economic recovery. However, the base rates on loans under the program did not decline in line with the interest rates on loans outside the program. The reason is that banks do not need to compete for clients in the program: clients paying a fixed compensation rate are not sensitive to the base rate.

In February, the NBU surveyed 40 banks about lending conditions within and outside the program. According to the survey, the banks set base rates for clients in the program almost 3 pp higher on average than for loans outside the program. In addition, the banks reported that they were ready to cut interest rates for SMEs outside the program by another 2 pp. So at a certain stage, the program began to subsidize not only clients but also participating banks. It restrained price competition and discouraged the reduction of loan rates by banks.

Table 2. Interest rate on SME working capital loans in Q4 2023

Loan rates	Average weighted	Min	Max
Outside the program	**20.1%**	14.6%	27.3%
Under the program (base rate)	**22.9%**	20.0%	27.0%
Minimum interest rate at which a bank is willing to lend outside the program	**18.4%**	13.0%	27.0%

A survey of 40 banks participating in the *Affordable Loans 5-7-9%* program conducted in February 2024.

Source: NBU.

Participation in the program does not increase the operational efficiency of companies

In 2023, the program covered companies that account for about 13% of the total revenue of enterprises. According to an analysis of financial statements for 2022–2023, the main effect of the program for borrowers is an increase in net profit due to savings on financial expenses. In fact, these companies receive more net profit thanks to state subsidies. The average net margin of corporate borrowers in the program is 2 pp higher than that of borrowers outside the program.

The operating efficiency of most industries shows no noticeable difference between the average operating margin of program participants and the rest of the companies. Only the operating margin of agricultural companies that received subsidized loans was 2 pp higher than that of companies that received loans outside the program. This excess has been observed since 2022 and has not increased over time. There is no confirmation that this is a consequence of the program.

In general, there is no evidence that the program has contributed to the higher operational efficiency of companies that received subsidies, which is one of the stated goals of the program.

Banks should assess loan quality more critically

Overall, the solvency of borrowers in the program is satisfactory. The share of non-performing loans for the period of the full-scale war has increased from less than 1% to 8%. This figure was higher for borrowers outside the program. Another 6% of loans are debts of operationally unprofitable companies that have not yet been recognized as NPLs. Companies do not pay interest on a third of this debt – the compensation rate is zero. These clients will most likely not be able to repay the debt in the future, but the state will continue to bear the burden of servicing the loan for these borrowers. Very low or zero compensation rates on loans in the program, and the right to extend the principal, have allowed a number of clients to disguise their insolvency for a long time. Under the terms of the program, the banks stop receiving interest compensation if the client violates the terms of the loan agreement. Sometimes, financial institutions are interested in not recognizing a loan as bad for as long as possible.

Despite progress in improving the program, it needs more focus

Budgetary constraints and a number of imbalances in the program have prompted a change in its design. In particular, in April, the use of the program for subsidized loans to replenish working capital was limited – the limits for non-priority areas were reduced from UAH 60 million to UAH 5 million. The banks' permissible margin above the UIRD index was also reduced by 3–5 pp. These changes have the prospect to decrease the burden on the budget, but they will not solve all of the problems. To further improve the program, the following steps are necessary:

- Gradually focus mostly on investment projects.
- Provide working capital loans only to certain categories of clients: for example, viable businesses, the financial indicators of which do not allow servicing the loan on market terms due to war-related losses.
- Require the banks to regularly assess clients' eligibility under the terms of access to the program and to pay increased attention to assessing clients' solvency during loan extensions.
- Consider setting a general limit on the size of the loan portfolio in the program, taking into account the budget allocated for it.

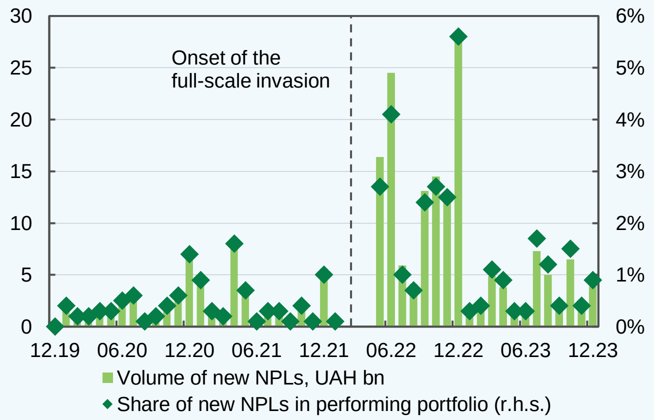
These steps will focus the program and return it to its original format.

Box 2. NPL Quality Recovery Is a Non-systemic Phenomenon

The increase in NPLs since the beginning of the russian full-scale invasion again requires significant efforts from banks to resolve bad loans. Given the length and complexity of court proceedings, the banks mostly opt for voluntary settlements. This usually involves extending the terms of the loan principal repayment and introducing a grace period for interest payments. For the largest loans, the banks are even willing to significantly reduce the interest rate. But despite all such efforts, the recovery of borrowers' solvency is still rare.

The materialization of credit risk and further growth of non-performing loans (NPLs) are common consequences of economic crises. The full-scale war was a shock to Ukraine's economy. It resulted in a number of borrowers becoming insolvent. Therefore, despite the banks' longstanding efforts to resolve NPLs, their ratio has increased over the past two years. In May, NPLs amounted to about 44% of the gross corporate loan portfolio, which was more than 12 pp higher than before the full-scale aggression. One third of the total corporate NPLs are so-called "war" NPLs that arose during and as a result of the russian invasion (see *Causes of Business Defaults during Full-scale War*, December 2023 FSR). The peak of war credit losses has already passed, but the default rate is still higher than before the invasion. At the same time, the banks have not stopped working on recovering NPLs, even during the full-scale invasion. They have sufficient tools for the task, which they are actively using.

Figure B.2.1. Migration of corporate loans to NPLs



No data available for March-May 2022, all migrations for the period are reflected in June 2022.

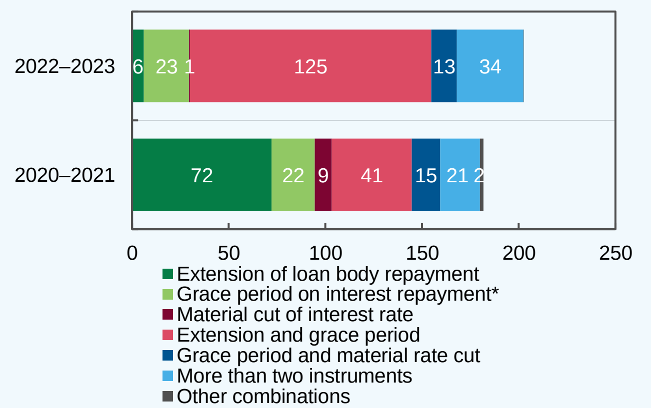
Source: NBU estimates.

45% of the banks' total NPLs are loans to Privatbank's ex-owners. Due to the non-market nature of this portfolio, the only way to compensate for losses is through legal action. The respective court proceedings are going on successfully for Privatbank in many jurisdictions, although no final rulings have yet been made. However, instances of banks successfully defending their rights in court are still rare as a market practice. Given the ineffectiveness of litigation, the banks have been trying to use other tools.

Out-of-court restructurings are the most common tools used by the banks to deal with NPLs. They aim to mitigate a client's debt burden and enable them to restore their solvency. The banks have restructured about half of all of their corporate NPLs that currently remain on their balance sheets. Excluding loans to Privatbank's ex-owners, this share exceeds 90%. Further down in the text, the box analyzes the conditions and effectiveness of restructurings conducted since 2020.

Prior to the full-scale invasion, the most common concession to clients with NPLs was a debt extension. Financial institutions applied this tool alone to about 40% of the restructured corporate NPL portfolio. In another quarter of cases, the banks combined debt extension with a grace period on paying interest on the loan. During the full-scale war, the banks became more flexible. In order to leave more funds for clients to restore their financial stance faster, the banks combined several instruments at the same time. The share of restructurings where banks combined loan extensions with a grace period for interest payments increased to 62%. Most often, the concessions applied for short periods of time: three to six months. Given the economic uncertainty, longer-term restructurings are almost impossible due to the difficulty in making forecasts. Meanwhile, short-term restructurings keep banks flexible in their further work with clients. Most often, a couple or more consecutive relatively short restructurings are applied to NPLs, often with each subsequent one having a longer term than the previous one. At the same time, banks seldom reduce interest rates.

Figure B.2.2. Application of restructuring instruments to corporate NPLs (except for those restructured under the Law of Ukraine *On Financial Restructuring*), UAH billions



Loans exceeding UAH 2 million, at the exchange rate as of 1 January 2024.

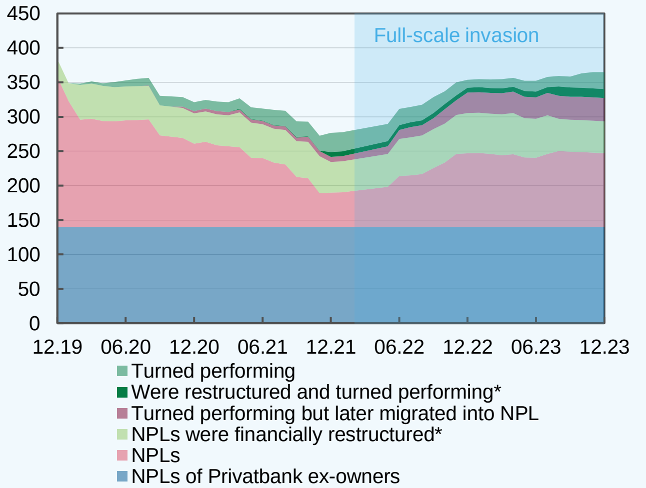
* The classification of instruments is based on changes in contractual terms other than the grace period for interest payment. The grace period is considered to be the accumulation of accrued non-overdue interest on a loan of more than 10% compared to the previous month, for three consecutive months.

Source: NBU estimates.

A special approach to dealing with NPLs is restructuring in accordance with the Law *On Financial Restructuring* (the Law). The Law, adopted in 2016, introduced a mechanism of voluntary and comprehensive restructuring for companies in critical financial condition that have the potential to resume operations. Since then, eight banks have conducted restructuring procedures under the Law for 47 borrowers. Their loans accounted for 29% of corporate NPLs, excluding loans to Privatbank's ex-owners. State-owned banks carried out the largest number of restructurings under the law from 2017 to 2021. Restructurings covered primarily borrowers from large business groups. A common feature of most of these clients was their poor financial health at the time of loan origination, and the excessive debt burden after the loan was disbursed. These loans were often significant relative to the banks' capital. In the course of the restructurings, the banks often agreed to very lenient terms: extension of the loan for more than ten years, and a reduction of the interest rate to non-market levels (often less than 1%), with its very slow increase in the future. According to the banks' estimates, foreclosures or sales, in most cases, could recover less than a third of the debt.

Despite all the concessions, restructured NPLs still rarely restore to performing. For loans restructured under the Law, the debt to the banks has decreased by only 8% since the restructuring. About a fifth of the loans that underwent the financial restructuring procedure migrated to the performing category.

Figure B.2.3. Corporate NPL portfolio, UAH billions



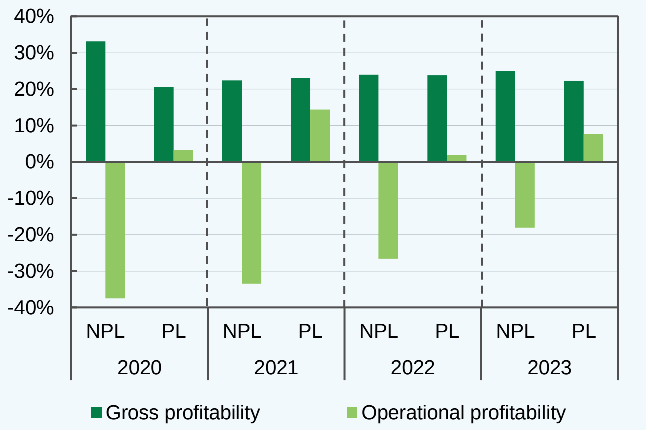
Loans exceeding UAH 2 million, at the exchange rate as of 1 January 2024.
* Financial restructurings under the Law of Ukraine *On Financial Restructuring*.

Source: NBU estimates.

Overall, the banks are currently receiving only minor payments, primarily interest, on the vast majority of corporate NPLs (excluding loans to Privatbank ex-owners). For more than two-thirds of the portfolio, the principal is not being repaid. The longer a loan remains non-performing, the less likely it is to recover in the future. Even clients who have resumed debt servicing remain an elevated-risk group for banks. About half of their loans eventually migrate back to NPLs. These are mostly loans to state-owned banks, whose quality deteriorated again during the full-scale war.

In general, the financial health of clients with NPLs is much worse than that of clients with performing loans. The main symptoms are negative EBIT margins and the respective lack of operating income to pay interest.

Figure B.2.4. Financial performance of corporate borrowers

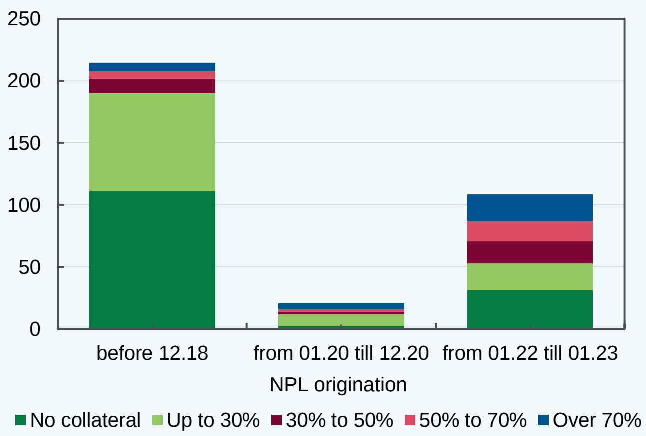


PL – performing loans. The indicators are weighted by gross loan debt as of the first day of the following year. All borrowers with loans exceeding UAH 2 million that submitted annual financial statements for the relevant year.

Source: Open data portal, NBU.

The last resort measure to recover NPLs is the foreclosure and sale of collateral by the bank. The most common types of collateral are real estate (65%) and equipment (16%). Taking into account liquidity ratios (reflecting the risk of collateral losing its value due to the length of foreclosure and sale procedures), gross NPLs are only 35% covered by collateral. The war NPLs are better collateralized than the old portfolio, which, among other things, reflects the more prudent lending standards of recent years. However, in general, the low collateral coverage rates of loans makes voluntary work-out measures even more important for banks.

Figure B.2.5. Coverage of new gross corporate NPLs with collateral (by date of origination), UAH billions



Loans exceeding UAH 2 million, at the exchange rate as of 1 January 2024.
Excluding loans to Privatbank's ex-owners.

Source: NBU.

Box 3. Changes in Regulatory Requirements for Defining Non-Performing Assets

To further harmonize national requirements with the European ones, the NBU has expanded the category of non-performing exposures (NPLs) and tightened the requirements for derecognizing NPLs. These changes will slightly increase the NPL ratio, but will not affect the banks' capital. Their main objective is to make domestic statistics more transparent and comparable with international approaches, as well as to enhance the system of NPL management.

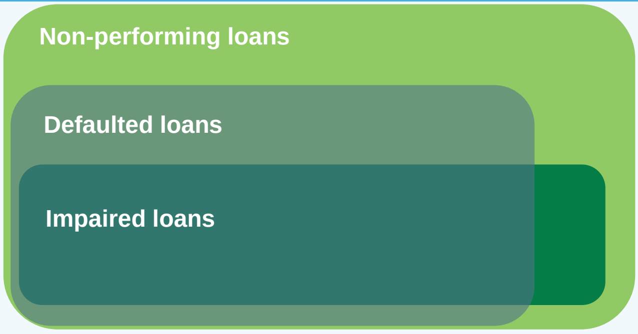
Proper recording of the quality of bank assets is a strict requirement in international practice. Without it, correctly diagnosing the state of the banking system is impossible. Also, without the timely detection of a deterioration in asset quality, it is impossible to restore it effectively. Global practice has two approaches to asset quality classification:

- the accounting approach (under IFRS 9), which implies that if events occur that lead to an actual or expected shortfall in cash flows from assets, then the assets are recognized as impaired. These are assets that are assessed at the third stage or as purchased (originated) credit-impaired financial assets (POCI) according to IFRS 9 classification. This standard has been fully implemented in Ukraine. However, it contains mostly soft indicators of impairment based on relevant principles. The recognition of impairment thus depends largely on the judgments of the banks. For impaired assets under IFRS 9, the banks make increased financial provisions, which are reflected in their expenses and, accordingly, in capital (read more in the December 2018 FSR, *Expected Bank Losses under IFRS 9*). The recognition of financial provisions under IFRS 9 has a direct impact on the banks' losses and capital;
- the prudential approach, which, on the other hand, relies on the concept of default. According to this approach, a bank recognizes that a debtor is in default if the debtor has a debt that is overdue by more than 90 days or is unable to meet its liabilities without foreclosing on collateral. An asset of a debtor in default is the asset in default. In Ukraine, the criteria of a default event are defined by Regulation No. 351, and are generally in line with the EU acquis (CRR). Prudential provisions determined under this regulation reduce a banks' capital if their amount exceeds the amount of provisions under IFRS 9.

The categories of defaulted and impaired loans are not mutually exclusive. In practice, in most cases, if a loan falls into one category, it also falls into the other. Moreover, in Ukraine, impaired loans assessed under IFRS 9 at the stage three are recognized as defaulted.

However, in international practice and, accordingly, in EU acquis, there is an even broader category of non-performing loans. It includes loans classified as impaired and defaulted under both the accounting and prudential approaches, respectively. In addition, it may also include other loans that are unlikely to be repaid to a bank. The stylized intersection of these three approaches is shown in Figure B.3.1.

Figure B.3.1. Stylized interrelation between different problem asset categories



Source: NBU.

In Ukrainian practice, the category of non-performing exposures was introduced in 2019 by Regulation No. 97. This category includes almost all loans in default under Regulation No. 351. A bank must take measures in order to resolve and restore the timeliness of the servicing of these loans. Moreover, Regulation No. 97 defines a category of potential problem loans that should be watched closely.

In May 2024, Regulation No. 97 was amended to bring the definition of NPLs closer to the one provided by the CRR. From now on, NPLs will include:

- almost all of the assets recognized as defaulted under Regulation No. 351. The banks will be allowed not to recognize only a few categories of defaulted assets as non-performing, based on a reasonable judgment, if the loans are not impaired or there are no grounds for recovering collateral or restructuring the debt. These are primarily loans that are identified as defaulted due to the absence of financial statements or due to the recognition of the borrower's default by another bank (information from the Credit Register), and non-impaired loans recognized as defaulted due to provisioning of more than 50% under IFRS 9 for them. These characteristics do not constitute a clear sign of default under EU rules either;
- POCI assets, which are a separate category of assets that are impaired under IFRS 9 from the date of their recognition. This is a novelty, and in the future these assets will be classified as NPLs even if they are not defaulted exposures;
- restructured assets that a bank has repeatedly restructured or that are overdue for more than 30 days after being derecognized as non-performing – this is another novelty.

The amendments also tighten the requirements for derecognition of exposures as non-performing, especially those that have been restructured. From now on, in order to derecognize a restructured asset as non-performing:

- at least 365 days must pass from the date of restructuring (previously, 180 days from the elimination of the signs of default were required to derecognize an NPL);
- none of the debtor’s liabilities should be overdue for more than 30 days (this condition is already in effect);
- a bank must form a judgment about the debtor’s ability to meet its liabilities, which is confirmed by the payment of the overdue debt or debt that has been written off as a result of a restructuring (this is a novelty).

The current requirements provide for keeping a loan that is no longer NPL on the list of potential problem exposures – the watch list. In the future, in order to remove loans from the watch list, a set of requirements will need to be met:

- at least 730 days must have passed since the loan was included in the list (double the current period);
- the debtor must have been servicing the debt on time under the terms of the restructuring for at least a year. The debtor must also pay a substantial portion of the debt to the bank after the loan is derecognized as an NPL;
- none of the debtor’s liabilities can be overdue for more than 30 days.

These changes bring the definition and classification of NPLs into line with European requirements. This will make NPL statistics more transparent and will more clearly define the perimeter of the bank’s work on the resolution of exposures for which credit risk has materialized. Tightening the requirements for derecognizing loans as NPLs and for removing them from the watch list of potentially problem exposures will prevent the banks from being overly optimistic when they start paying less attention to clients at the first sign of improved debt servicing. In practice, this shortcoming in the risk management system leads to a significant share of repeated client defaults on former NPLs (see Box 2. *NPL Quality Recovery Is a Non-systemic Phenomenon*).

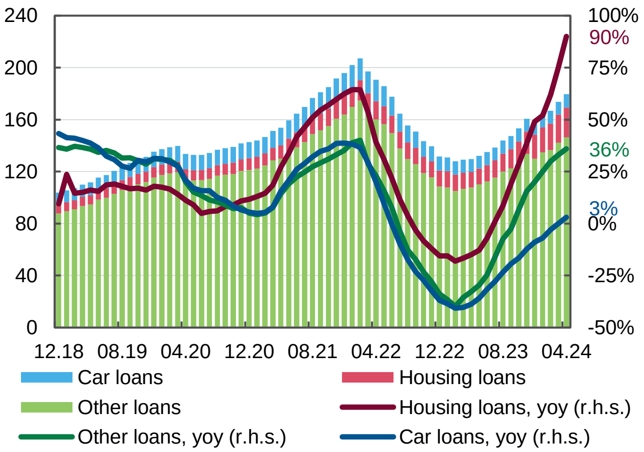
These changes will take effect from the start of 2025. The changes will have a moderate impact on the NPL ratio, which will increase by less than 1 pp. The NPL volume will increase primarily due to the inclusion of POCI assets in this category.

At the same time, the likely increase in NPLs will not affect the banks’ capital, as it does not affect the amount of prudential provisions (credit risk under Regulation No. 351). Currently, the total amount of NPLs is covered by 86% with prudential provisions and by almost 84% with financial provisions under IFRS 9.

3.4. Retail Lending Risk

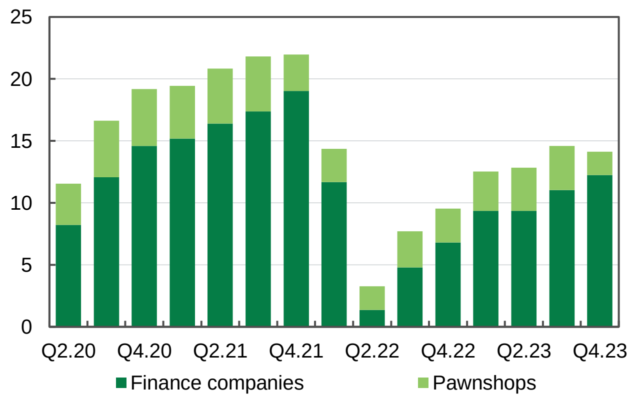
The retail loan portfolio has been recovering rapidly over the past year. The main driver of this growth is consumer demand, including that for large purchases. Mortgages have almost doubled over the past year thanks to the government program. Lending standards for subsidized loans are more lenient than those for pre-war loans, which were mostly unsubsidized. Unsecured loans are increasing due to more active lending to new clients. The quality of the retail portfolio is gradually improving, but the banks remain conservative and maintain adequate provisions.

Figure 3.4.1. Net hryvnia loans to households, UAH billions



Source: NBU.

Figure 3.4.2. Loans issued during the quarter by finance companies and pawnshops, UAH billions



Source: NBU.

The retail loan portfolio continues to grow rapidly

In April, the net hryvnia loan portfolio grew by 38% yoy. As before, most of it was made up of unsecured consumer loans. The volume of these loans increased by about a third over the year. However, mortgages are growing the fastest – they almost doubled compared to last year's figures – but their share in the retail loan portfolio is still small, at about 13%. Such high growth rates are explained by a very low comparison base. The car loan portfolio has been growing gradually since January, but now it is only slightly higher than a year ago. The revival of consumer demand remains the main reason for the growth in the loan portfolio. In the latest Lending Survey, the banks said they expected further growth in demand, primarily for consumer loans. The revival in lending was reflected in a slight increase in the net retail loans-to-GDP penetration rate, to 2.6%, in Q1. However, in general, this figure remains very low. The portfolio accounts for less than 6% of the banks' net assets.

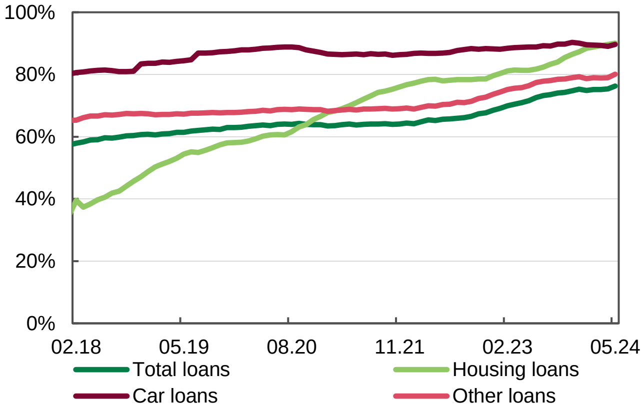
Non-bank financial institutions are gradually increasing their loan portfolio. However, this portfolio is still 15% below their pre-war levels. The portfolio growth rate is much lower than that of the banks. Despite there being consumer demand, growth is held back by market transformation. Some major players were withdrawn from the market for violating consumer protection laws. Lending standards in the segment are also changing due to the legislative restriction at the end of last year on the maximum interest rate on consumer loans of 1% per day and tighter financial monitoring requirements. Therefore, in the future, microfinance institutions are likely to lower their risk appetites because of the narrower lending margins. All these steps will reduce predatory lending, i.e. lending that produces an excessive debt burden for clients. The penetration rate of non-bank retail loans to GDP is only 0.3%.

The consumer lending market remains segmented, while its concentration is growing

The profiles of bank and non-bank borrowers remain distinct, with no clients drifting between the markets. Concentration is growing in the banking sector. The two banks with the largest portfolios already account for more than half of total retail loans, compared to 37% before the full-scale war. Only two or three banks continue to dominate each market segment, and it is becoming increasingly difficult for the rest to compete with them. At the same time, the non-bank market remains highly competitive. The five largest companies provide a quarter of new loans, as was before the war.

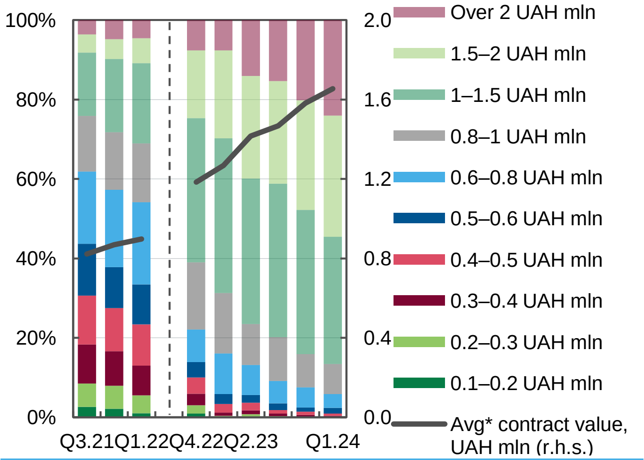
In recent years, concentration has increased the most in the mortgage segment. Banks that have suspended market lending since the start of the full-scale invasion have not yet

Figure 3.4.3. Share of the five banks with the largest portfolio by segments



Source: NBU.

Figure 3.4.4. New mortgages distribution by principal



* Average, weighted by the number of loans issued.
Source: NBU.

resumed offering products. Almost all mortgages since then have been granted under the *eOselia* program, and mainly by state-owned banks. The program's favorable terms leave little room for unsubsidized market lending. The low margins in the program do not attract a wider range of banks. That said, as the real estate market is gradually recovering, more and more banks are considering reintroducing mortgage products. The planned focus of *eOselia* on the primary market may provide more room for the further development of unsubsidized mortgages.

As before, banks with convenient and multifunctional mobile applications still have a competitive advantage in card lending. Another success factor is the expedient credit decision-making. It is easier for banks that already have an advanced IT infrastructure to find clients, so they are growing faster than others. The financial institutions are working to increase their outreach to potential clients, and having found solvent and disciplined ones, they are gradually expanding their credit limits. Interest rates on unsecured loans have remained practically unchanged for about a decade and do not affect competition in the card segment.

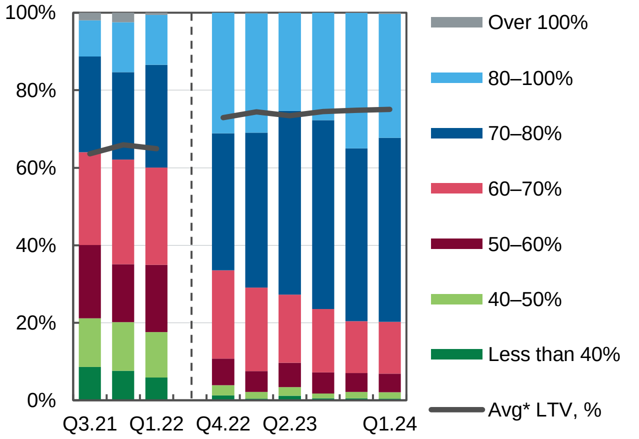
The banks are easing requirements for client selection

In general, the standards for approving loan applications, primarily those for approving unsecured loans, have been easing over the past year. In the latest lending survey, the banks said that this trend would last, mainly due to stronger competition from other financial institutions. The banks' risk appetites are also rising due to macro risks being under control. The banks are using an increasingly diverse range of information sources and methods, including artificial intelligence and machine learning, to assess creditworthiness and select clients. Given the need for quick decision-making in the unsecured lending segment, lenders hardly ever require official documents, including income statements. At the same time, the banks use all available sources of information, including credit bureaus and account transaction histories, to verify the submitted data. The list of high-risk lending factors for banks has also changed over time, for example, financial institutions are more willing to lend to migrants and military personnel than at the beginning of the full-scale war. Given the extremely low level of lending penetration, the potential for portfolio growth is very significant. The portfolio may continue to grow rapidly if the economy recovers. To control risks, the banks must adhere to prudent lending standards and lend responsibly.

The profiles of mortgage clients have changed significantly during the full-scale war

Until 2022, four out of five mortgages were granted without subsidies, despite the presence of a government support program. Accordingly, lending conditions were determined by banks, and these conditions were moderately conservative (read more in *Mortgage Lending Survey Findings* in the NBU FSR, December 2021). In particular, the banks maintained the debt-service-to-income ratio (ROA) at an average level of about 50%, taking into account official income. Average rates trended towards 14%. Due to high loan rates, clients tried to reduce loan sizes by making substantial downpayments on housing. Almost two-thirds of mortgages had loan-to-value

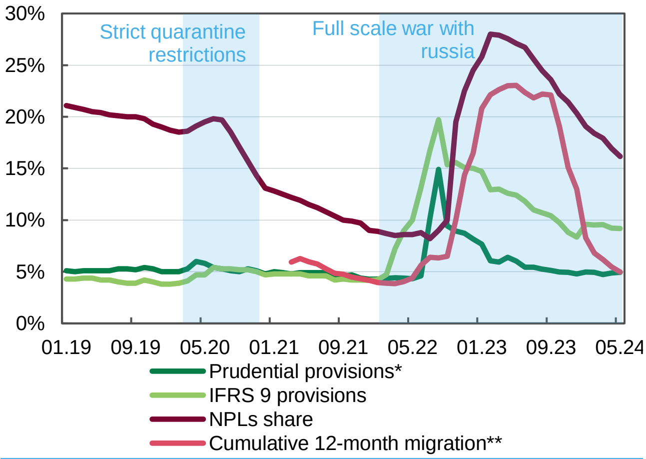
Figure 3.4.5. New mortgages distribution by LTV at origination



* Average, weighted by the volume of loans issued.

Source: NBU.

Figure 3.4.6. Provisions for performing, share of NPLs and migration into NPLs for hryvnia retail loans



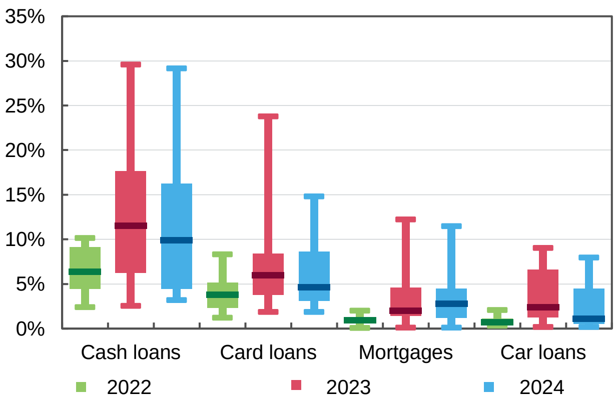
Provisions equal the ratio of provisions to gross loans.

* Credit risk, as measured according to Resolution 351.

** Migration to stage three under IFRS 9, % of loans at stages one and two.

Source: NBU.

Figure 3.4.7. Distribution of expected losses on hryvnia retail loans at stage one under IFRS 9 as of 1 January of the respective year



The faces of the rectangles correspond to the distribution's first and third quartiles. The dash inside the rectangle is the median. The lines above and below the rectangle indicate the maximum and the minimum.

Source: data for 18 banks from surveys conducted in January 2022, 2023 and 2024; NBU estimates.

(LTV) ratios below 70%. The average term of a mortgage was about 15 years in late 2021. Mortgages were most often issued to borrowers aged 35-45, who had a stable income.

After the full-scale war began, mortgage lending continued almost exclusively under the *eOselia* program. Mortgages are provided at a preferential rate of 3% or 7%. Cheaper mortgages and higher housing prices encouraged borrowers to take out loans for ever larger amounts. The average LTV ratio is approaching 80%, the maximum possible level under the terms of the program–. Borrowers take out mortgages for longer terms. The number of borrowers under the age of 30 has increased. As a result, lending standards have eased, although this risk is offset by the moderate average debt burden of clients. Identification of the potential level of credit risk of a new portfolio takes time. For banks, the credit risks of the new portfolio are mitigated by the possibility of transferring credit risks to Ukrfinzhytlo after three years of the loan's life.

Portfolio quality is improving, but the banks remain prudent in their provisioning assessments

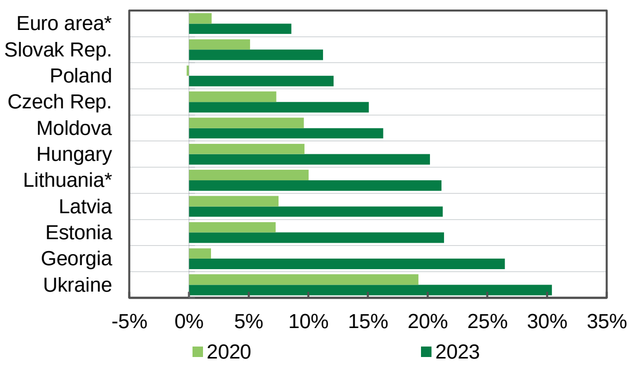
The quality of the portfolio continues to improve. The migration of loans to stage three under IFRS 9 has decreased and has already reached its pre-war level. The coverage of the portfolio with prudential provisions, measured in accordance with Regulation No. 351, corresponds to the 2021 level of 5%. The share of non-performing loans in the retail segment is rapidly declining due to the low default rate of new loans, growth in the new portfolio, and write-offs and sales of non-performing loans.

At the same time, financial institutions remain conservative in assessing the quality of their retail portfolios. The parameters for measuring expected losses under IFRS 9 for loans that are not past due only moderately improved at the beginning of 2024. The financial provisions-to-debt ratio is twice as high as before the war and as the prudential provisions coverage ratio. The banks will be able to use the provisions they built to cover credit risks arising from the new war portfolio, the risks of which may materialize over time. The likelihood of credit risk materializing unexpectedly remains high in wartime.

3.5. Profitability Risk

The banks continue to generate large profits due to high net interest margins and as most banks do not need to make additional provisions to cover their exposures. Yields on assets declined slightly, while the cost of liabilities stabilized. The decline in yields on assets is likely to continue. Nevertheless, net interest margins will remain high by historical standards. Net fee and commission income will remain depressed for some time to come. The ratio of administrative costs to net assets has decreased, so a possible increase in expenses in the future does not pose a threat given the banks' high efficiency.

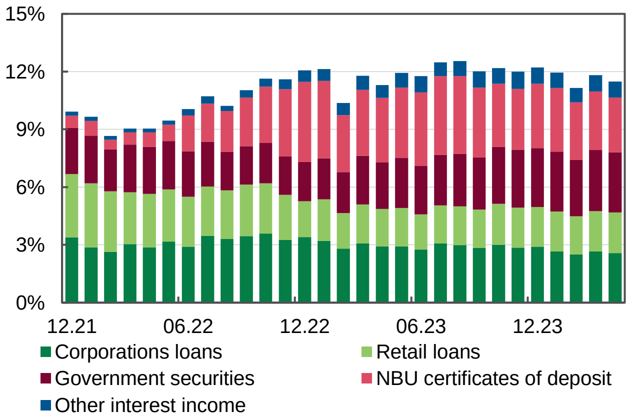
Figure 3.5.1. **Banks' return on equity**



* ECB provisional data for 2023.

Source: IMF, ECB.

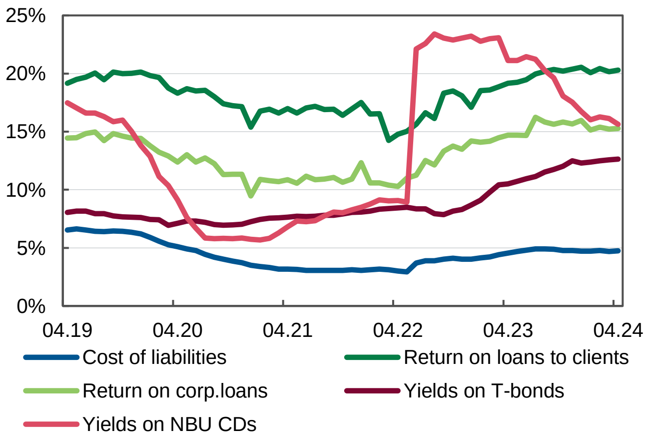
Figure 3.5.2. **Interest income components, % of net assets**



Annualized data. Other interest income includes income from interbank loans, loans to authorities, and other minor sources.

Source: NBU.

Figure 3.5.3. **Return on assets and the cost of liability**



Calculated against the net balance sheet value of the portfolio.

Source: NBU.

The banks are profitable and operationally efficient

Ukrainian banks remain operationally efficient and profitable. In 2023, even after deducting income tax at the increased rate of 50%, the average return on equity in the sector was about 30%. In 2024, the tax rate was halved and the net profitability of financial institutions increased accordingly – in the first four months of this year, the return on equity amounted to 49%. During this period, only nine institutions reported operating losses. These are institutions with largely inefficient business models and a number of legacy problems, which are unrelated to current market conditions. High interest margins remain key to the sector's profitability. In addition, improved macroeconomic conditions reduced the pressure on provisions.

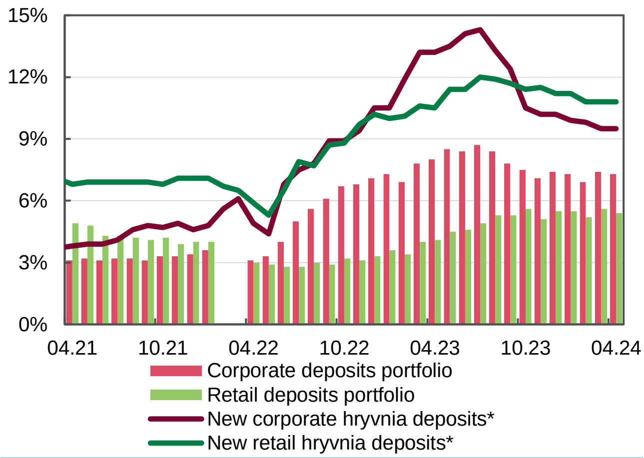
The growth in the banks' profitability in recent years is not a situation peculiar to Ukraine alone, but a Pan-European trend. The COVID-19 of 2020 crisis resulted first in a liquidity increase in the financial system, and then in a hike in key policy rates to tame inflation. It is higher interest rates, coupled with high liquidity, that have led to a rise in net interest margins and, accordingly, the overall profitability of the banking business.

Asset yields declined slightly

Yields on assets remain high by historical standards. Over the past six months, the decline in market rates following the key policy rate cuts has only slightly reduced asset yields. First of all, interest rates on NBU certificates of deposit decreased. Interest rates on new corporate loans also trended down, although due to the longer maturity of these instruments, the loan portfolio's yields are taking longer to change. Interest rates on new issues of domestic government debt securities are also declining, but remain higher than the average yield on the existing portfolio of government securities. The latter includes older issues of domestic government debt securities with much lower coupons, including capitalization securities of state-owned banks. Replacing gradually maturing instruments with securities that have higher interest rates is maintaining the yield of the portfolio as a whole.

The cycle of declining interest rates is increasingly encouraging the banks to invest in longer instruments to lock in yields. Accordingly, the banks are expanding their domestic government debt securities and loan portfolios. This will continue to support the banks' high profitability, despite the decline in interest rates. In contrast, the volume of certificates of deposit has slightly decreased since the beginning of the year.

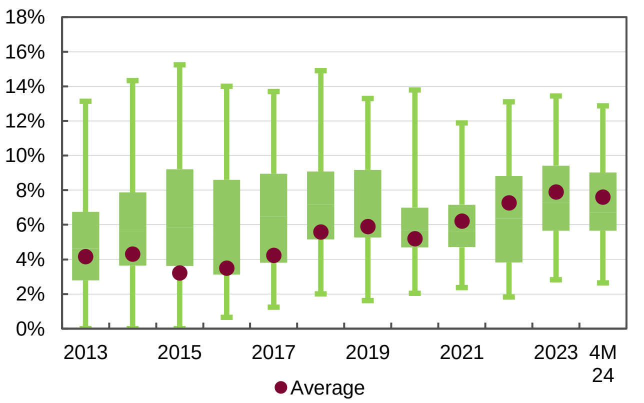
Figure 3.5.4. Interest rate on corporate and retail funding in hryvnia, % per annum



No data was submitted on the cost of the deposit portfolio and liabilities for February–March 2022. * Without loan rescheduling or any other changes in contractual terms.

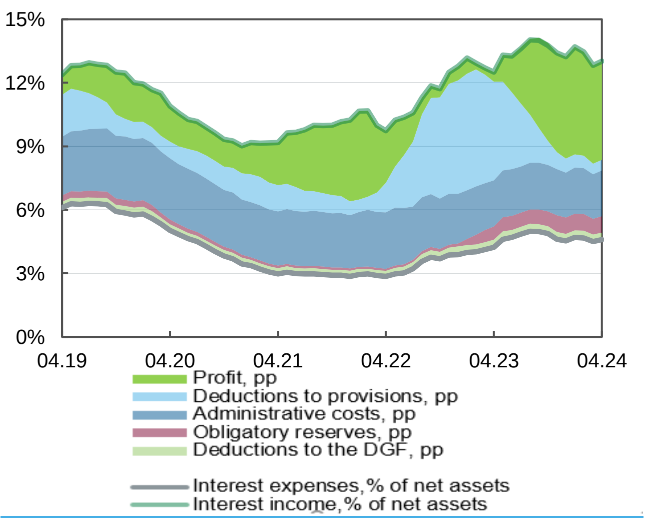
Source: NBU.

Figure 3.5.5. Net interest margin of banks



Source: NBU.

Figure 3.5.6. Decomposition of the net interest margin of banks



Three-month trailing average. Calculated as the ratio of interest expenses / income to the average volume of net interest-bearing assets for the past three months. Administrative costs are taken into account proportionally to the ratio of net interest income and net fee and commission income, taken as an average for the past 12 months. Provisioning includes provisions for credit risk and debt securities and provisions for debt securities, taken as an average for the past 12 months. Profit is estimated on a residual basis. At banks that were solvent as of the reporting date.

Source: NBU.

The cost of funding has stabilized

Interest rates on retail and corporate deposits are slowly heading downward, with those on corporate deposits moving faster. However, in general, the cost of funding remains practically unchanged. In the corporate segment, the reason behind this is the variety of individual borrowing conditions due to competition, especially for deposits of large corporates, and the persistently high interest rates in the economy. In the retail segment, the reason for the unchanged cost is the higher share of term deposits and longer deposit maturities. Corporate deposits are generally more expensive for the banks than retail ones, because, unlike for corporate deposits, the banks hardly pay any interest on retail current accounts. This results in a much lower total cost of funding for retail banks, compared to corporate ones. In the banking system as a whole, the cost of hryvnia funding from clients has stabilized over the past six months at a level below 7% per annum.

Net interest margins are resilient to changes in macro-conditions

The banks went through a period of sharp key policy rate cuts from the end of 2023, maintaining a high interest margin of more than 7.5 pp. The existing margin space gives the banks considerable leeway in the face of possible future interest rate changes. Market rates are expected to continue to decline, responding with delay to previous monetary policy easings. However, further interest rate cuts will be slower, thereby reducing risks for financial institutions. Net interest income will remain the main driver of profitability, with its share in the sector's operating income growing to 72%, up from 60% in 2022.

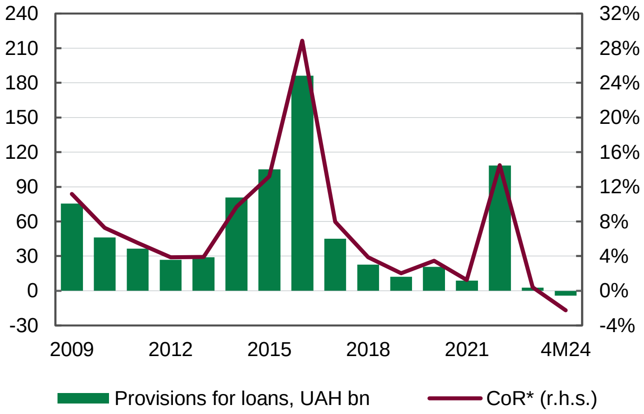
The sector requires practically no provisioning due to the better quality of the loan portfolio

The banks' provisioning is almost entirely driven by the increase in loans and securities. At the same time, thanks to positive economic expectations, the banks are gradually reducing their estimates of expected credit losses. The large-scale materialization of credit losses is rather a rare occurrence. Therefore, over the first four months, the banks even released their loan provisions somewhat. The cost of credit risk and, accordingly, provisioning expenses are gradually normalizing to their average levels before the full-scale war. However, high net interest margins can more than adequately cover these costs.

Net fee and commission income remains depressed, net trading income contracts

The revival of consumption and the corresponding growth in domestic payments contributed to the increase in net fee and commission income. At the same time, the volume of customer card transactions abroad decreased slightly this year compared to Q4 last year, narrowing the revenue base. The lower-than-pre-war tariffs for card payments are also hindering its growth. Therefore, the growth of fee and commission income is rather slow. In the first four months of the year, it grew by 6.4% yoy. The banks lost more than a third of their fee and commission income relative to their net assets compared to 2021. The role of fees and commissions in total banking income has been declining over time, with

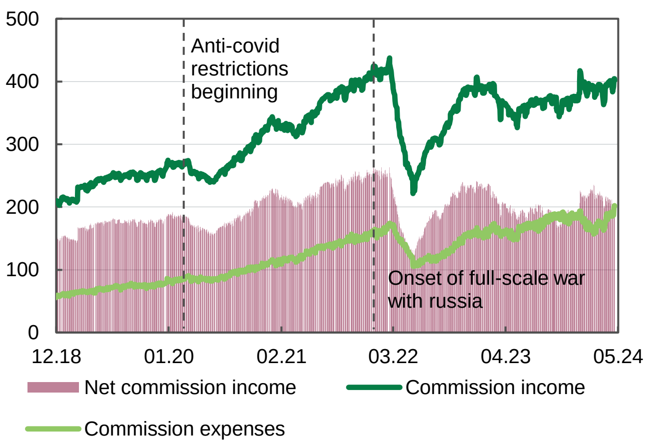
Figure 3.5.7. Cost of risk (CoR)



* Ratio of provisions for loans in the respective period to the net loan portfolio.

Source: NBU.

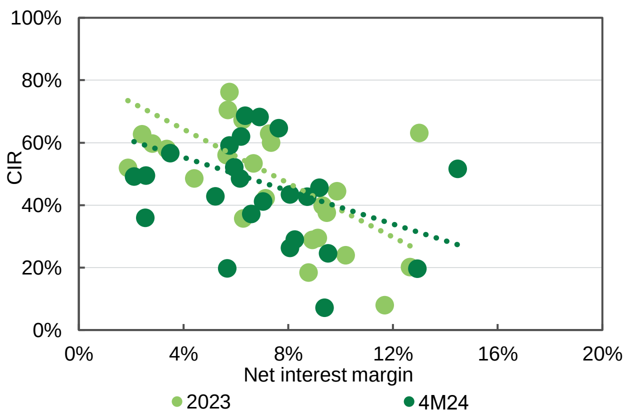
Figure 3.5.8. Banks' fee and commission income and expenses per day*, UAH millions



* By daily balances; 60-day trailing average.

Source: NBU.

Figure 3.5.9. Operational efficiency of 25 largest banks



Source: NBU.

fees and commissions currently covering about half of administrative expenses. The banks' profits from buying and selling foreign currency fell by a third year-on-year, as exchange rate spreads narrowed. The share of profits from currency trading in the operating income of banks fell to the pre-war level of about 5%.

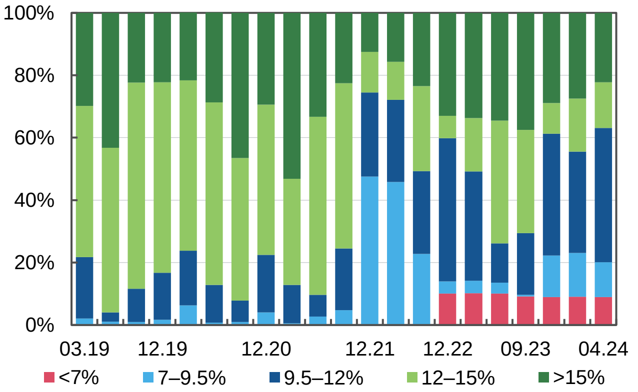
Operating costs increase without jeopardizing operational efficiency

The banks are restoring their operating expenses after the crisis cost-cuts of the past few years – by 13.4% in the first four months of the year compared to the same period last year. That said, the banks remain prudent – the average cost-to-income ratio (CIR) remained below 40%, with the median value at around 60%. Administrative expenses were primarily driven by an increase in labor costs due to staff shortages and competition for qualified employees. Since the beginning of 2022, solvent banks have lost almost a fifth of their staff. At the same time, the average wage in the sector has grown considerably over this period. The banks cite the quality of human capital in the sector as one of the biggest sources of systemic risks, so they are expected to continue to increase expenses on their staff. Financial institutions have also invested in fixed assets and intangible assets, in particular to modernize payment infrastructure and develop online services, as well as to maintain uninterrupted operations of branches during power outages. Although the costs of maintaining and developing their businesses are growing, the current high returns guarantee the banks' profitability even if costs continue to rise.

3.6. Capital Adequacy Risk

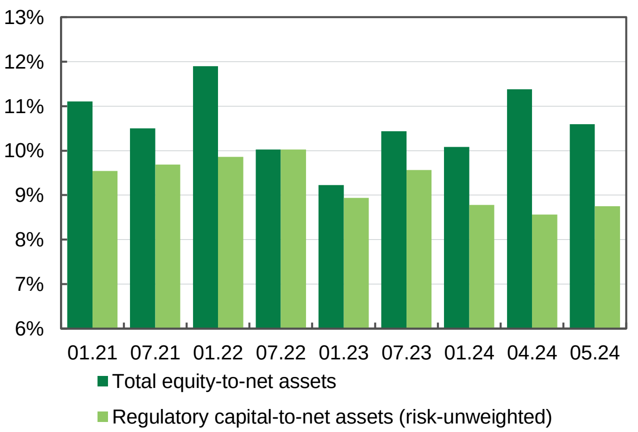
The banks' profitability is supporting their capital, and the ratio of the banks' equity to net assets is recovering from the shock of the first year of the war. This sets favorable conditions for the further enhancement of capital adequacy requirements. From August, the banks' capital will cover all key risks: credit, market and operational ones. In addition, a new capital structure will come into effect. The NBU has proposed a transitional period for these innovations to ensure that the banks can smoothly adapt to the new requirements and maintain their ability to expand their loan portfolios. Next year, the NBU will conduct a resilience assessment also under adverse scenario. Based on its outcomes, a plan for implementing further capital requirements will be developed.

Figure 3.6.1. Distribution of core capital adequacy ratio by banks' shares of total assets



Source: NBU.

Figure 3.6.2. Banks' ratios of capital to net assets



Source: NBU.

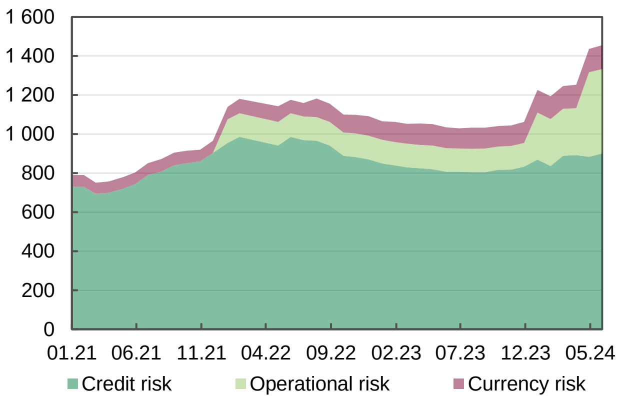
Capital is growing and covering a wider scope of risks

The regulatory capital adequacy of Ukrainian banks remains high, averaging more than double the minimum requirements. The banks' capital is being constantly replenished by their profits. They are maintaining high profitability, while profit distribution is temporarily prohibited. The ratio of the banks' equity to net assets exceeds 10%, having almost recovered from the crisis in 2022. Capital growth is rapid, despite a significant increase in the tax burden: profit taxation at 50% last year and 25% afterwards. Thus, the banks have enough of their own funds to cover the risks of their operations and are continuing to build up the stock.

The banks' profitability creates preconditions for the further introduction of capital adequacy requirements in line with EU standards. Thus, since the beginning of the year, the banks have been taking into account 100% of operational risk when calculating their capital. Since May, after a three-year pause, they have been updating the calculation of this risk in their current financial statements. Due to the combined effect of these two factors, the banks' estimated capital requirements to cover operational risk increased fourfold compared to the end of 2023. Its share in the equivalent of the banks' total risk-weighted assets has approached one third. Starting in August, the requirements for calculating the amount of capital to cover market risk will be expanded. Currently, only one of its components, currency risk, is taken into account in the adequacy ratios. According to test calculations, full consideration of market risk would increase capital requirements by about a third relative to the current amount of currency risk. As a result, the share of market risk in the equivalent of total risk-weighted assets will only slightly exceed 10% on average. Finally, the need for capital to cover credit risk is at its highest, with the share of these risks now slightly exceeding 60%. Minor changes to the approaches to calculating credit risk weights are planned to be introduced next year, but these changes are not expected to affect capital requirements. Thus, the requirements on risk-weighted assets in Ukraine will in the future be in line with European standards.

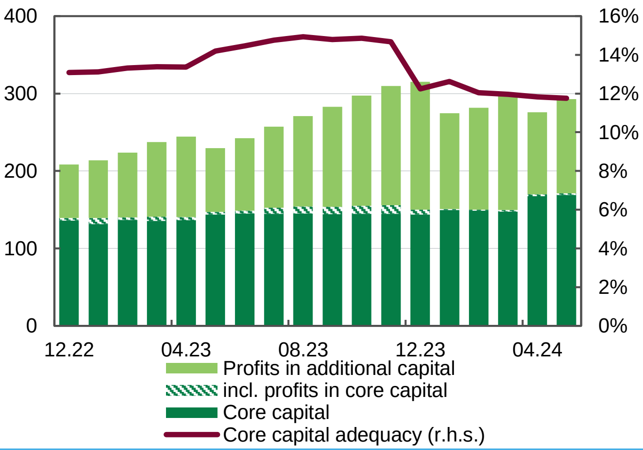
Stricter requirements for risk assessment increase the banks' resilience to adverse events. After all, financial institutions will hold more capital to cover unexpected losses, primarily from the possible materialization of three key risks: credit, operational, and market ones. At the same time, the banks' capital adequacy ratio is technically declining, given the increase in the denominator of the indicator. Nevertheless, all of the banks but one are continuing to meet the minimum requirements. Ukreximbank, which has been violating capital

Figure 3.6.3. Equivalent of banks' risk-weighted assets, UAH billions



Source: NBU.

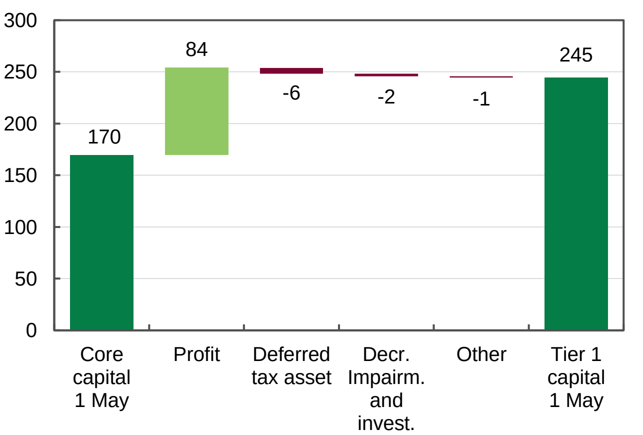
Figure 3.6.4. Core capital and distribution of banks' profits between capital tiers, UAH billions



The profits shown in this figure are included in additional capital within the general limit of 100% of the core capital.

Source: NBU.

Figure 3.6.5. Transition of core capital elements into Tier 1 capital as a result of the new structure implementation, UAH billions



Source: NBU.

adequacy standards since 2022, has drawn up and is implementing a capitalization program to bring its indicators to the minimum requirements in accordance with the terms stipulated by the resilience assessment (see *Peculiarities of Bank Resilience Assessment in 2023*, in the June 2023 FSR).

Transition to a new capital structure will bolster the banks' ability to ramp up lending

The next step is to change the requirements for calculating the amount of regulatory capital and its structure. Starting from August this year, the banks will finally switch to a three-tier capital structure in line with EU standards (see *Reforming Capital and Liquidity Standards* in the December 2017 FSR). Following the changes, capital will be divided into three components instead of two: common equity Tier 1, additional Tier 1 capital, and Tier 2 capital. Each of the components will have a separate adequacy requirement: 5.625%, 7.5%, and 10% respectively. Thus, the total regulatory capital adequacy requirements will be maintained.

The changes will lead to a redistribution of capital components between capital tiers. The best-quality capital component, common equity Tier 1, the closest equivalent of which is the current core capital, will increase significantly for banks in all groups. This will be primarily facilitated by the possibility of including profits (except for those that the bank plans to distribute through dividends) in this component. Currently, profits are mostly part of additional capital. The inclusion of profits will compensate for the effects of capital reductions from other innovations. The key ones of those are the deduction of tax assets and impaired securities from common equity Tier 1.

To ensure that the banks have enough time to accumulate profits and easily comply with the updated requirements, the NBU has proposed transitional rules, the key ones being:

- a phased schedule for meeting a regulatory capital adequacy ratio of 10% by 1 July 2025,
- the inclusion of interim profits for 2024 without an auditor's review on the financial statements and without approval from the NBU.

Such measures will preserve and even boost the banks' ability to grow their loan portfolios. Even in the case of violations of the requirements, the banks will be able to submit a capitalization plan. If it is fulfilled, no enforcement action will be taken against the banks.

The harmonization of capital requirements with European standards will continue

Despite significant progress in the implementation of capital requirements, there are still a number of elements that will need to be taken into account over time. First of all, the NBU should develop requirements for capital coverage of counterparty credit risk (CCR) and risk of a credit valuation adjustment (CVA). However, given the insignificant amounts of the banks' investments in derivatives, the NBU does not expect these requirements to have a substantial impact on capital adequacy. Moreover, approaches to setting additional capital requirements based on the results of a supervisory assessment (Pillar II) are still being developed. Finally, the

Table 3. Prioritization of uses for the banks' accumulated profits

Order of priorities:	
1	Coverage of unexpected losses from risks realized during the war
2	Fulfillment of deferred requirements for capital coverage of risks: ▪ for operational risk (applicable in full), ▪ for market risk (requirements are expected to be implemented from August 2024), ▪ 100% risk weights for FX domestic government debt securities (taking into account adjustment coefficients, the current risk weight is 50%).
3	Fulfillment of new requirements (to be approved in 2024–2025) for: ▪ the updated regulatory capital structure (to be introduced from August 2024), ▪ updated credit risk weights of individual asset categories, ▪ the leverage ratio.
4	The building up of the capital conservation buffer and the systemic importance buffer.
5	Distribution of dividends

Source: NBU.

NBU plans to activate the capital conservation and systemic importance buffers in future.

The minimum capital adequacy requirements in Ukraine are higher than those in the EU (the regulatory capital adequacy ratio is to be 10%, compared to 8%). As long as the capital adequacy requirements do not include all the components required by EU law and as long certain temporary reliefs are in place, this approach will hold. This is justified, among other things, by the increased risks to banks in times of war. In future, after the capital buffers are activated and the banks build them up, the minimum capital ratios are likely to be revised, and restrictions on dividend distribution may be relaxed or lifted.

Eventually, the NBU plans to introduce leverage ratio. It reflects the ratio of Tier 1 capital to all assets and off-balance sheet liabilities. This requirement will ensure that capital is available to cover risks other than those included in the minimum capital adequacy requirements.

New capital requirements will enhance the banks' resilience

The best way to assess the adequacy of the banks' capital to cover unexpected losses in a crisis is through stress testing. Following a pause this year, the NBU plans to conduct another stress test in 2025. It will include an assessment of the banks' financial sustainability under both baseline and adverse macroeconomic scenarios, while the auditors will assess asset quality. The results of the assessment will inform the NBU about the optimum time for the further introduction of regulatory requirements.

Box 4. How Ukrainian Banks Assess Climate Risks

Ukraine's post-war reconstruction will largely be "green", in line with donor approaches and EU acquis. The financial sector is also expected to change. Ukrainian banks are aware of the impact of climate risks, but are still at an early stage of incorporating them into their risk management systems.

Climate change has a significant impact on the economy

More than twenty years have passed since a joint publication by the United Nations and a number of the world's leading financial institutions drew attention to the importance of environmental, social, and governance (ESG) factors in the activities of financial institutions. Since then, the impact of climate change on financial markets has been one of the most discussed and researched among these factors. Climate risks are broadly defined as the probability of financial losses due to climate change. According to the approach agreed upon in 2016 by the G20, climate risks are divided into physical risks and transition risks. The Basel Committee also uses this classification. Physical risks are potential damage and losses caused by the direct impact of climate change, such as natural disasters. Transition risks are the threat of losses incurred by economic agents or a shortfall in their income due to the need to adapt to climate change or transition to a greener economy. For example, transition risks arise from restrictions on certain types of activities or the introduction of taxes on non-environmentally-friendly production. Climate risks threaten the operations of both financial institutions and their counterparties. In the latter case, climate risks will exacerbate classical financial risks, such as credit or market risks.

EU acquis is the benchmark for climate risk management in Ukraine

Given the significant impact of climate risks on the economy, they are a constant focus of the EU and many IFIs. In 2019, the EU launched the European Green Deal. It reflected a coherent understanding of the harms of climate change and ways to neutralize them, in particular by limiting harmful production. There are no direct bans on the financing of certain industries, although banks may draw up their own lists of activities undesirable for lending. For this purpose, a classification of environmentally harmful and beneficial activities – the taxonomy of sustainable activities – was approved. Financial institutions are also contributing to the Green Deal. Regulators require them to collect and disclose information on the environmental profile of their clients and products. In addition, the ECB and the EBA have provided EU banks with guidelines for assessing, monitoring, and managing climate risks. The ECB is preparing to fine banks for failing to assess climate risks. Tools for measuring climate risks, including stress tests, are being developed at the EU level. The EU's approaches to climate risk management are a guide for Ukraine as a candidate country.

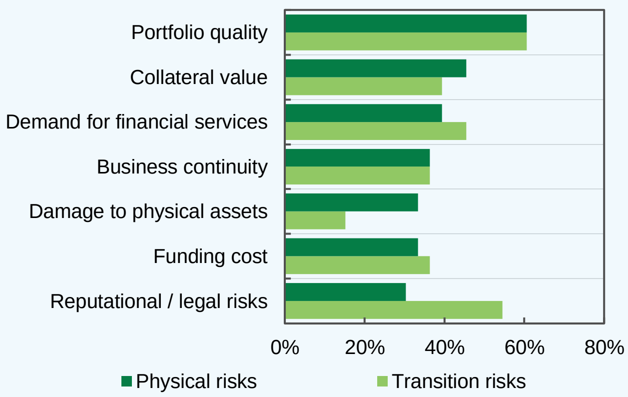
Ukraine will take steps to green its economy

Ukraine has already joined a number of international initiatives to combat climate change. As part of the EU's Ukraine Facility financial assistance program, Ukraine has to integrate environmental elements into its reforms in the energy sector, agriculture, and small- and medium-sized business policy, and implement measures for a green transition. Implementing these reforms will unlock significant amounts of financial support, and bring Ukrainian production and climate risk management practices closer to the best European standards. The Ukraine Facility foresees not only general commitments but also specific steps, with clear timeframes for their implementation. To this end, in the near future the Business Development Fund and the Partial Credit Guarantee Fund in Agriculture, which implement state lending support programs, plan to introduce requirements for the compliance with ESG standards for banks participating in these programs. This requires the rapid preparation of such standards based on the experience of the EU and the banks themselves. Going forward, the government, following the EU's example, should play a leading role in promoting the green transition. In particular, a taxonomy, reporting requirements for companies, and incentives for green production are needed.

Ukrainian banks are aware of the impact of climate risks on their operations

Ukraine currently has no specific regulatory requirements for banks to manage climate risks. When developing this function, financial institutions should follow the general requirements for building a risk management system. A number of banks have already developed their own policies in this area and integrated them into their overall risk management system. This was confirmed by the results of an NBU survey on approaches to climate risk management conducted with 33 major banks in April.

Figure B.4.1. Share of surveyed banks that noted an impact of climate risks on specific aspects of their operations

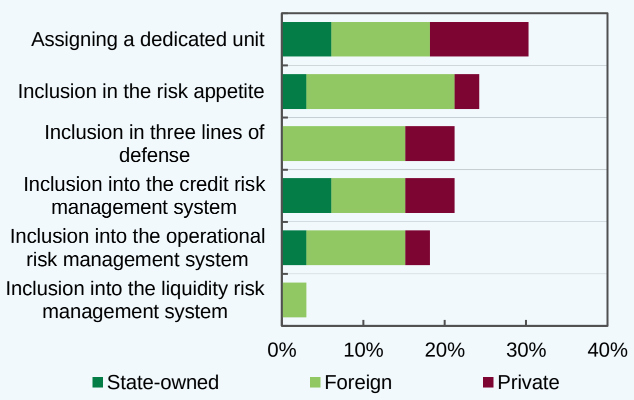


Source: bank survey.

Almost three quarters of the banks surveyed indicated that climate change is already affecting their operations (according to another survey on systemic risk, around a third of the financial institutions consider climate risks as high or medium). The banks expect the impact of both physical and transition risks to persist in the medium term. Most financial institutions note the impact of climate risks on loan portfolio quality and collateral value. About half of the respondents believe that climate risks affect the demand for financial services, with transition risks having the strongest impact. One third of the responding banks reported that climate change would affect their property and business continuity in the short term, primarily through physical risks. The financial institutions are also aware of the potential adverse impact of climate risks on their reputation and compliance, as legislation and regulatory requirements in this area will continue to tighten.

About a dozen of the banks surveyed have made good progress in managing climate risks. Most are banks belonging to international groups, incentivized to analyze climate risks in more depth by policies of their parent banks developed to meet regulatory requirements of the respective jurisdictions. The leading banks already have climate risk management practices with three lines of defense, and integrate these risks into their assessments of other types of risks. Two financial institutions identify climate risks as being significant for them. Most often, climate risks are assessed as elements of credit and operational risks. One third of the surveyed banks have assigned units to deal with climate risks.

Figure B.4.2. Share of surveyed banks that reported inclusion of climate risks into their risk management system



Source: bank survey.

Banks most often analyze climate risks while assessing credit risk

Around a fifth of respondents have set climate-sustainable lending targets – a certain desired percentage of sustainable projects in their portfolio. These banks are already "climate scoring" their clients when issuing loans. Large companies, including those that operate in external markets or that have foreign counterparties, are themselves interested in complying with ESG standards. Therefore, they can provide banks with high-quality information for the scoring. Smaller clients often need support. This encourages the banks to hire climate risk assessment experts

Climate scoring primarily checks the client’s business activity against the exclusion list of the bank – activities deemed harmful to the environment. Examples include deforestation, the production of asbestos, and trade in endangered plants and animals. One third of the surveyed banks have their own exclusion lists. A client on such a list will be denied a loan. For borrowers with a high level of climate risk, the financial institutions offer measures to reduce it in the future.

At the same time, there have been no moves as yet to fully integrate climate risks into lending decisions: Ukraine’s financial institutions hardly ever incorporate the impact of climate risks into credit risk parameters such as the probability of default and value or liquidity of collateral. Therefore, the “greenness” of a borrower rarely affects lending terms, including interest rates. Less than a third of the banks surveyed offer any green products that imply special financing terms for sustainable production. At the same time, half of the banks see potential opportunities from climate change in the future, in particular through the development of green products for borrowers wishing to reduce their carbon footprint.

Table 4. Consideration of climate risks in the lending process, share of surveyed banks

Process	Legal entities	Households
Loan approval	39%	3%
Regular credit review	15%	-
Setting interest rate	3%	-
Assessment of PD or LGD	-	-
Assessment of collateral eligibility	6%	3%
Assessment of collateral value	9%	3%

Source: bank survey.

Climate risks are also taken into account in the context of operational risks

A quarter of the banks surveyed measure their carbon footprint, which is the impact of their own operations on climate change. The majority of them limit themselves to assessing the direct environmental impact of their operations: the level of emissions they produce themselves, for example, by using cars and power generators, or emissions produced while generating energy consumed by the bank. Half of the respondents indicated that they are taking measures to reduce their carbon footprint, such as reducing paper use, switching to electric cars, installing automatic lighting systems, and retrofitting buildings. At the same time, banks consider climate risks to be a source of operational risk. Half of the surveyed banks have included events related to physical climate risks in their business continuity plans. Moreover, almost a quarter of the respondents insure against physical risks. Some banks have even included climate risks as an element of operational risk in their ICAAP. In some cases, the banks believe that climate risks may affect liquidity risk. Some banks expect climate change to affect funding costs in the short term. Climate factors have not yet been integrated into the market risk management system.

Recommendations

Coordinated efforts and close coordination of all financial market players – banks, NBFIs, the NBU, and other market regulators – and the effective cooperation of state authorities are needed to safeguard financial stability in difficult wartime conditions. The NBU makes recommendations to the government authorities and financial institutions, and communicates its near-term priorities.

For government institutions

Maintain the momentum of reforms envisaged by agreements with the EU, IMF, and with other donors and partners

In the context of the ongoing war, the inflow of external financing remains key to macroeconomic stability. Thanks to the joint efforts of state authorities, Ukraine has gone through four reviews of the IMF program without delay. The implementation of the Ukraine Facility with the EU has begun. Further implementation of the reforms set out in the programs will help bring the necessary financing to the country and facilitate European integration and post-war development.

Passing required financial sector legislation:

This mainly concerns draft law No. 11043, which is aimed at improving regulation in the financial services markets. The main novelties of the draft law are:

- allowing finance companies, pawnshops, and credit unions to provide payment services on the basis of existing licenses, without having to obtain a separate license for the provision of financial payment services
- granting the right to the NBU to set requirements for the adequacy, components, and calculation of the regulatory capital of non-bank payment service providers, and
- introducing remote inspections.

Implement the lending development strategy

In June, the Financial Stability Council approved the Lending Development Strategy, which was drawn up by the NBU jointly with the Ministry of Finance and the Ministry of Economy. The Strategy contains a list of necessary steps on the part of state authorities that will help revive lending and promote sustained economic recovery. The strategy has two focuses: stepping up lending during the war, and developing credit market infrastructure for the market's long-term growth. The document contains a list of priority lending areas under martial law: the defense industry, the energy sector, the manufacturing industry, as well as projects in de-occupied territories and areas close to the frontline, the "resilience" areas. The strategy includes an action plan to help address NPLs. The development of the Strategy was envisaged by a Memorandum with the IMF.

Further refine the focus of government lending support programs to encourage unsubsidized lending

Since the introduction of the *Affordable Loans 5-7-9%* state support program, the program's scale has exceeded the state budget's appropriations, resulting in the accumulation of a substantial debt to banks. In April, the government limited the size of working capital loans and reduced the margins of banks participating in the program. However, the changes introduced are not enough to balance the needs of the program and the available budget. Therefore, the program needs further changes, including focusing on investment projects, limiting working capital loans to certain categories of clients, and controlling the size of the portfolio.

Government support also includes lending in the mortgage segment. However, wide access to the program makes it difficult for the banks to launch products outside the program. Therefore, the design of the program should be adjusted in the future.

Recommendations for financial institutions

The banks should adapt to the new rules for calculating capital adequacy and managing non-performing assets

The NBU continues to bring its requirements for banks in line with European standards. New requirements for the structure of regulatory capital, market risk capital coverage, and revised capital adequacy ratios will be introduced in August. Recently, the banks have been offered new transitional rules, the key ones of which are:

- a phased schedule for meeting a minimum regulatory capital adequacy ratio of 10% by 1 July 2025
- allowing the banks to include their interim profits for 2024 in their common equity Tier 1 without prior approval of the NBU and an auditor's review.

These rules ensure that the banks can feel more comfortable complying with the revised requirements without impairing their ability to lend to the economy.

Also, starting next year, the banks will have to classify loans as non-performing and potentially impaired on the basis the new rules.

Providers of non-bank financial services to meet the regulator's requirements, in particular:

- Insurers are required to meet the solvency and minimum capital requirements by the end of June, taking into account the revised asset eligibility criteria. In July, insurers will also need to submit to the NBU a detailed report on the methods and results of an auditor's analysis of their asset quality. The purpose of the report is to increase confidence in the proper quality of insurers' assets.
- Credit unions should bring their internal regulations into line with the revised prudential capital and liquidity requirements by early July. The full transition to the new requirements will take place at the beginning of next year.
- Finance companies are required to meet equity adequacy requirements by the beginning of July. The minimum amount of equity is calculated by taking into account the types and number of services a finance company provides, as well as the leverage requirement.
- Finance companies and credit unions that will become members of the Credit Register in July should exchange information on the status of loan servicing in other financial institutions.
- All non-bank financial services providers should submit regulatory reports in accordance with significantly revised requirements by 27 July 2024.

NBU's Priorities

Assess the banking sector's resilience in 2025 and continue to implement EU regulatory standards

Starting in 2025, the NBU plans to return to assessing the banking sector's resilience. This assessment will involve external auditors to check asset quality and include stress tests under baseline and adverse scenarios. Assessment results will inform decisions on the further implementation of regulatory requirements that meet European standards. Future planned innovations include the introduction of a leverage ratio, systemic importance buffers, and capital conservation buffers. The implementation of these changes will ensure that banks have sufficient capital to cover risks under martial law and prepare for European integration.

Continue work on establishing a war risk insurance system

The NBU, together with the Ministry of Economy and the Ministry of Finance, is finalizing a draft law that will set up a war risk insurance system. The proposed model envisages the gradual introduction of compulsory insurance of various categories of objects and additional coverage of risks through voluntary insurance. The model envisages the participation of local insurers, international reinsurers, and a newly established state agency (or another institution as determined upon discussions). It is expected to protect a wide range of economic entities from direct war-related losses, and thus help raise investment for economic development.

Abbreviations and Terms

The Report presents data for banks that were solvent as of 1 June 2024 unless stated otherwise.

War, invasion	Full-scale russian invasion to Ukraine since 24 February 2022
Pre-war	Before the full-scale invasion
5-7-9%, 5-7-9% state program	State program *Affordable Loans 5-7-9%*
AQR	Asset quality review
BDF	Business Development Fund
CD	Certificate of deposit
CIR	Cost-to-income ratio
CoR	Cost of risk
COVID, COVID-19	Coronavirus disease 2019
CPI	Consumer price index
CRR	Capital Requirements Regulation (EU) No. 575/2013
DGF	Deposit Guarantee Fund
EBA	European Banking Authority
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes, depreciation and amortization
EIB	European Investment Bank
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
eOselia	State program of affordable housing lending
EU	European Union
FSR	Financial Stability Report
FX	Foreign currency/exchange
G7	Group of Seven
G20	Group of 20
GDP	Gross Domestic Product
HQLA	High quality liquid assets
ICAAP	Internal Capital Adequacy Assessment Process
IFI	International Financial Institutions
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
HQLA	High-quality liquid assets
LCR	Liquidity coverage ratio
LGD	Loss given default
LTV	Loan-to-value
SMEs	Small and medium enterprises
NBFI	Non-bank financial institution
NBU	National Bank of Ukraine
NSSMC	National Securities and Stock Market Commission
NFC	Non-financial corporations
NPE/NPL	Non-performing exposure / loan
OPEC	Organization of the Petroleum Exporting Countries
o/w	Of which
PD	Probability of default
Regulation No. 351	Regulation of the NBU of 30 June 2016 No. 351 approving Regulation on credit risk calculation by Ukrainian banks
Regulation No. 97	Regulation of the NBU of 18 July 2019 No. 97 (with amendmends)
ROE	Return on equity
SMEs	Small and medium-sized enterprises
SSSU	State Statistics Service of Ukraine
STSU	State Treasury Service of Ukraine
T-bonds	Domestic government debt securities
UFHC	Ukrainian Financial Housing Company
UIRD	Ukrainian Index of Retail Deposit Rates
UK	United Kingdom of Great Britain and Northern Ireland
U.S.	United States of America
w/o	without

bn	billion
mln	million
sq. m	square meters
EUR	euro
UAH	Ukrainian hryvnia
USD	US dollar
USD eq.	US dollar equivalent
pp	percentage points
yoy	year-on-year
mom	month-on-month
r.h.s.	right hand scale
H	half of a year
Q	quarter
M	month
Y	year