

Ukraine: Struggling banking sector amid substantial political and economic uncertainty

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Introduction: Main findings in a nutshell

- Deep depression + plunge of hryvnia (2014-15)
+ geopolitical tensions & uncertainty

pushed banking sector again deeply into the red

However: Major economic policy anchor: IMF and international support
Fragile macroeconomic stabilization succeeded in H2/2015
Successful NBU intervention to remove smaller problem banks

- Main shortcomings/risks plaguing banking sector:
 - High credit risk
 - Chronic lack of profitability
 - Exchange rate risk
 - Weak rule of law, endemic corruption

↔ Financial intermediation very weak, trough probably reached
Continuing substantial recapitalization needs

Recovery of banking sector/lending will lag recovery of real sector

Overview

- Banking developments from crisis 2008/09 to
- Crisis 2014/15/16 (focus)
- Most significant risks, shock-absorbing factors
- Outlook

Banking sector development since global financial crisis

2 phases dominated by asset growth and decline/ credit cycles

- **Increasingly fragile post-crisis stabilization (2009 to early 2014)**
 - Share of forex loans has traditionally been high in UA (40-50%)
 - Temporary credit spurt to enterprises (2013, connected lending?)
- **Crisis-triggered collapse of fin. intermediation (from early 2014)**
 - Lenders, depositors shocked by deep macroeconomic instability, political uncertainty
 - Delicate re-stabilization tendencies on low level from Q3/2015

Ukraine: Main banking sector stability indicators

	end-09	end-11	end-13	end-14	end-Jun 15	end-15
Commercial banks (number holding banking license)	182	176	179	162	138	119
number of banks not complying with selected banking regulations ¹⁾ :	49	18	14	82	93 ²⁾	.
Total deposits (from resident sectors, excl. interbank, ratio to GDP in %)	36.7	37.8	45.7	43.1	40.9	37.1*
- annual growth (in real terms, exchange rate-adjusted, %)	.	12.8	16.5	-37.6	-47.1	-37.4
- share of forex deposits in total deposits (%)	48.3	43.0	37.0	45.9	48.1	45.3
Total loans (to resident sectors, excl. interbank, ratio to GDP in %)	79.2	61.6	62.2	65.1	61.3	54.4*
- annual growth (in real terms, exchange rate-adjusted, %)	.	4.6	11.2	-30.8	-48.2	-45.7
- share of forex loans in total loans (%)	50.9	40.3	33.8	46.3	52.6	55.8
NPLs (% of total loans, broader definition)³⁾	.	.	23.5	32.0	44.3 ⁴⁾	.
NPLs (% of total loans, NBU definition)⁵⁾	13.7	14.7	12.9	19.0	24.3	25.6*
Ratio of large exposures to capital (%)	169.2	164.5	172.1	250.0	573.2	820.0
Capital adequacy ratio (%)	18.1	18.9	18.3	15.6	9.0	7.1*
Regulatory Tier 1 capital to risk-weighted assets (%)	14.2	14.0	13.9	11.2	5.5	3.5*
Return on assets (ROA, %)	-4.4	-0.7	0.3	-4.2	-12.1	-6.9*
Return on equity (ROE, %)	-33.7	-4.4	1.7	-32.0	-147.3	-80.3*

Source: Natsionalny Bank Ukraini, IMF

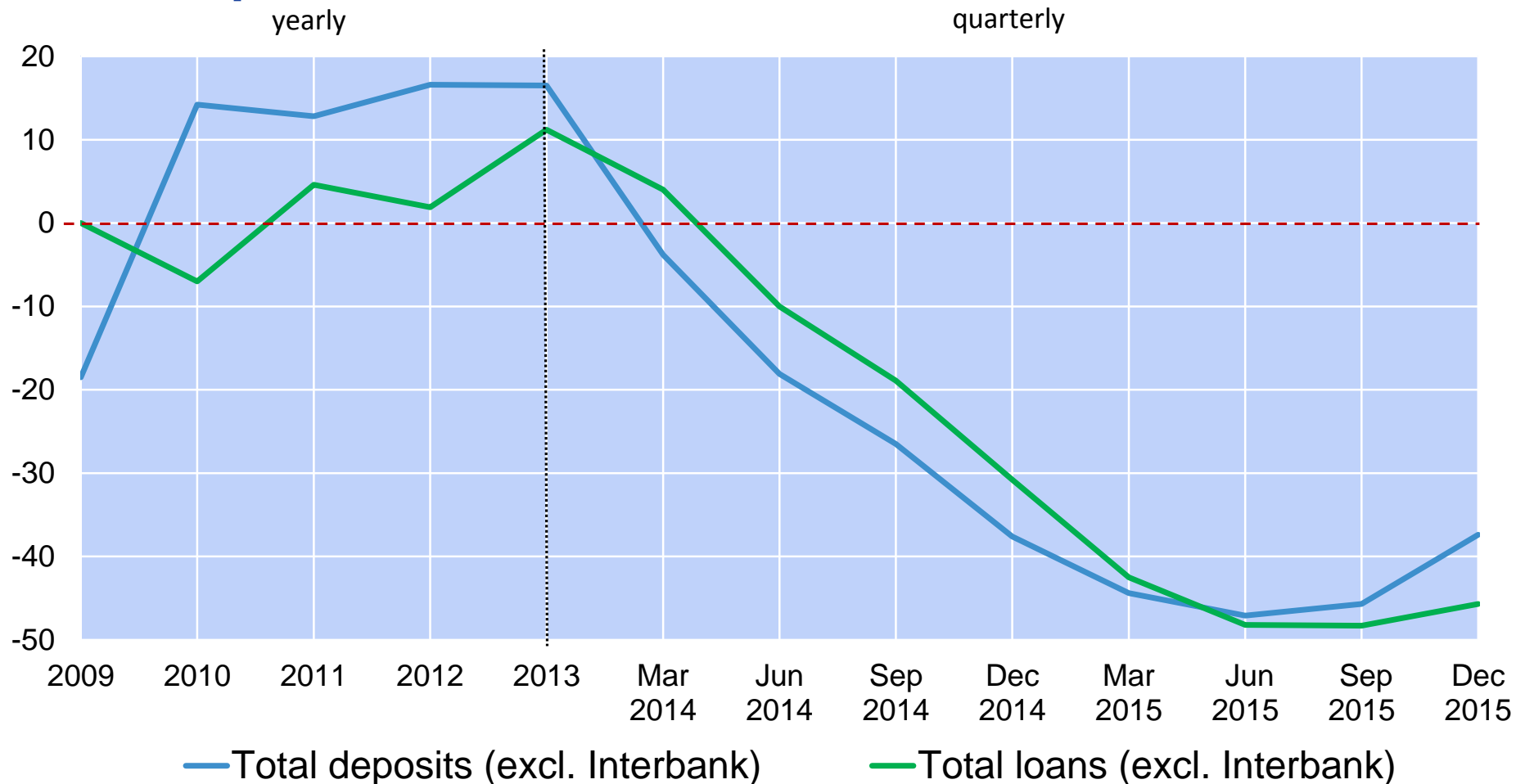
* end-September 2015

¹⁾ Refers to all banks not meeting capital adequacy requirements for Tier 1 capital, prudential regulations and/or reserve regulations. ²⁾ end-April; ³⁾ Includes NPLs that are classified as substandard, doubtful and loss. ⁴⁾ end-May; ⁵⁾ Includes NPLs that are classified as doubtful and loss. From Dec 2012, loan classification adjusted, which results in series break.

From early 2014: New crisis-triggered severe banking contraction

- Strong devaluation and rise of inflation → inflation-depreciation spiral
- Persistent uncertainty, falling real incomes → slide into recession
 - Mounting deposit withdrawals (-18% mid-2014, -47% Jun 15 y-o-y)
 - Share of forex loans rises to record level (56%)
 - Credit quality worsens again (NPLs grow to record 44% and swelling)
 - Capital adequacy plummets (from 18% at end-13 to 7% end-Sep 15)
 - Lending sharply contracts (-10% mid-14, -48% end-Sep 15 y-o-y)
 - Banks' profitability again deeply in the red
- IMF estimate (2014): fiscal cost of bank recapitalization: 9-10% of GDP
 - As of mid-2015, capital of 2.5% of GDP raised
- New diagnostic studies (2015) carried out to identify capital shortages from most recent losses

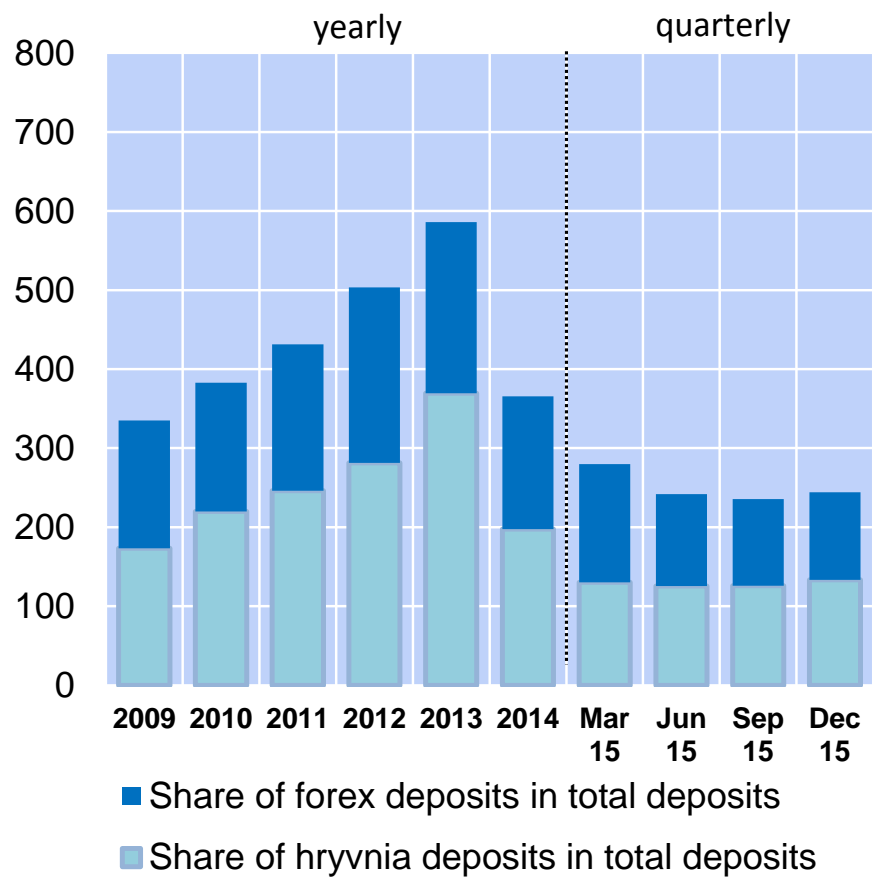
Bank deposits and loans (real growth, exchange rate-adjusted (%))



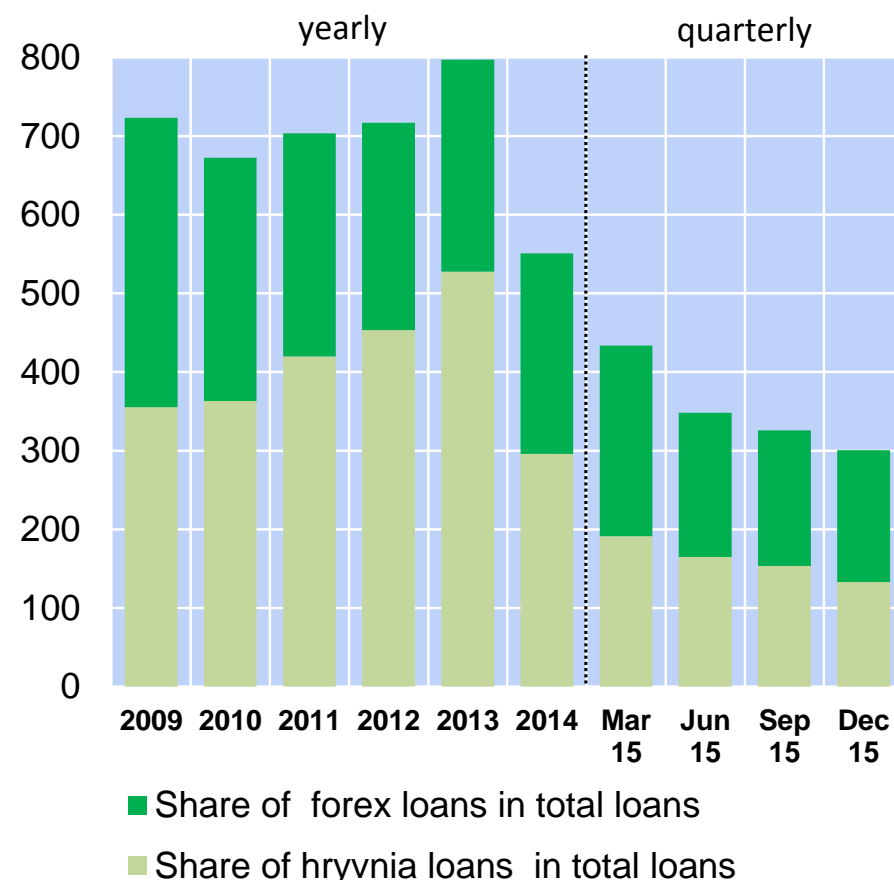
Source: Natsionalny bank Ukraini.

Deposits and loan dollarization in Ukraine

Deposits in UAH billion (excl. rate-adj., deflated)



Loans in UAH billion (excl. rate-adj., deflated)

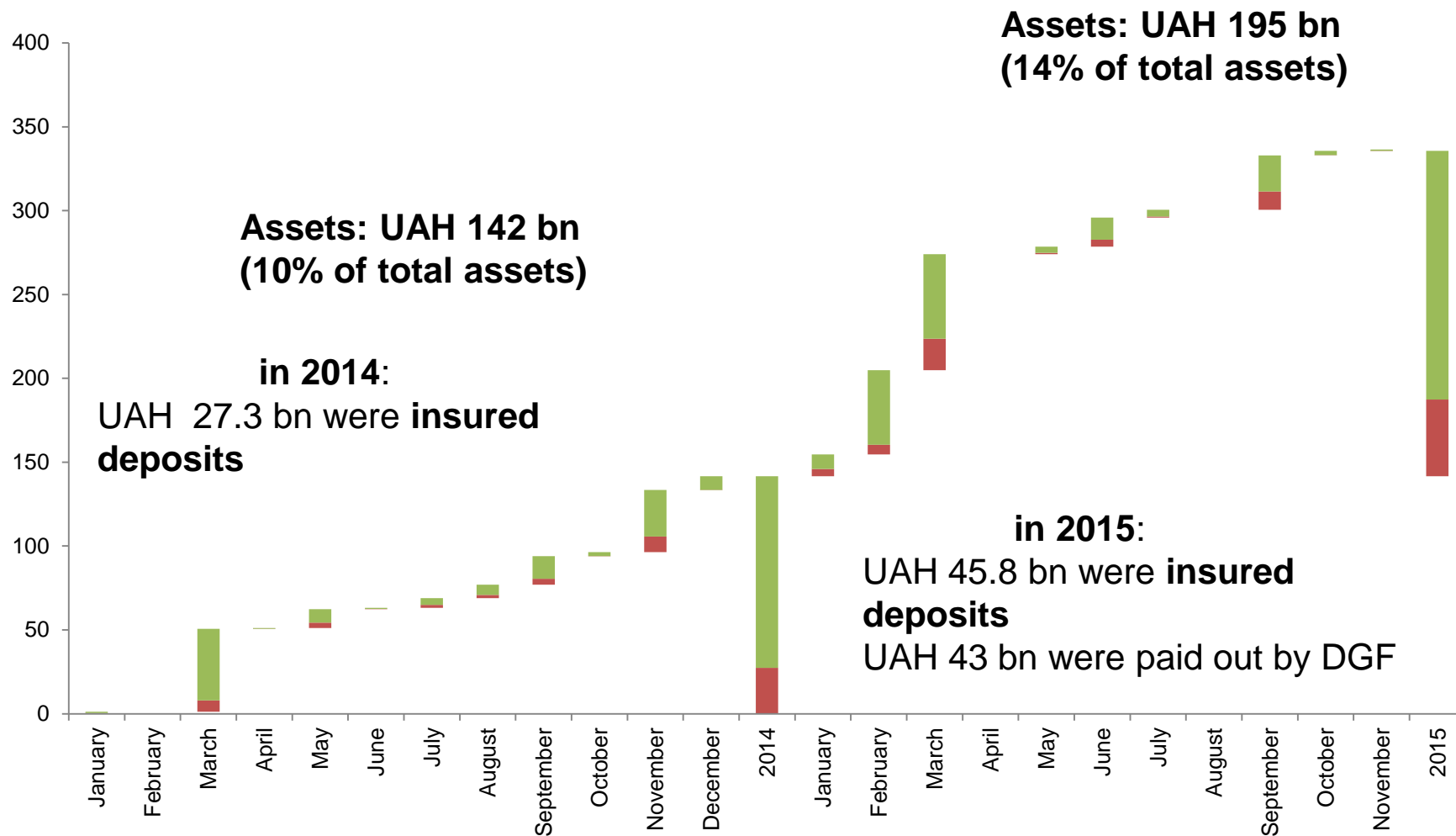


Source: Natsionalny bank Ukraini.

H2/2015: some signs of stabilization at low level

- GDP Q3/15: Slower contraction (y-o-y) and return to weak growth (q-o-q)
- Current account deficit 2015 all but eliminated (ca. 0.2% of GDP)
- From mid-15: Monthly inflation low, considerable slowdown of depreciation
- Therefore: inflation-depreciation spiral interrupted/ stopped
- Deposit withdrawals have slowed down (-37% at end-15 y-o-y)
- Recent distressed debt restructuring agreements for some of largest banks
- NBU: successful cleansing of sector of insolvent pocket banks
effort to rein in connected lending
- **On the other hand:**
 - further deterioration of low credit quality, further swelling losses, eroding capital
 - Serious problems with unhedged borrower-companies

Assets and insured deposits of insolvent banks as of end-2015



Source: National Bank of Ukraine

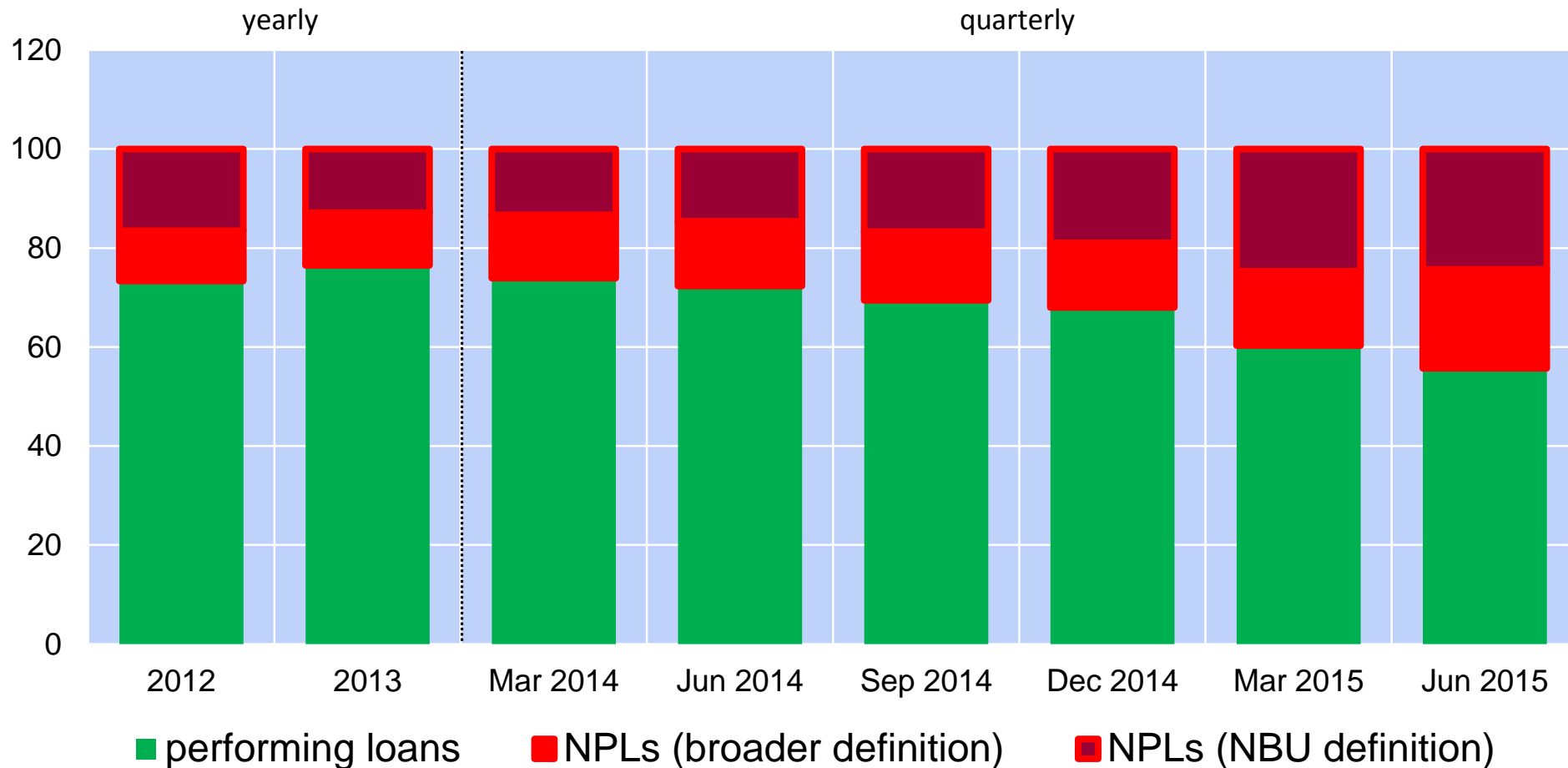
Current Ukrainian banking risks

- **High credit risk**
 - ← Very high NPLs, weakness of economy and hryvnia
- **Persisting negative profitability**
 - ← High provisioning, continued credit crunch
- **Exchange rate risk**
 - ← unstable expectations, capital controls extended, still high infl., high external debt, modest forex reserves
- **Still substantial related-party lending**
 - Largely identified, to be wound down
- **Weak rule of law and creditor rights, endemic corruption**

Shock-absorbing factors

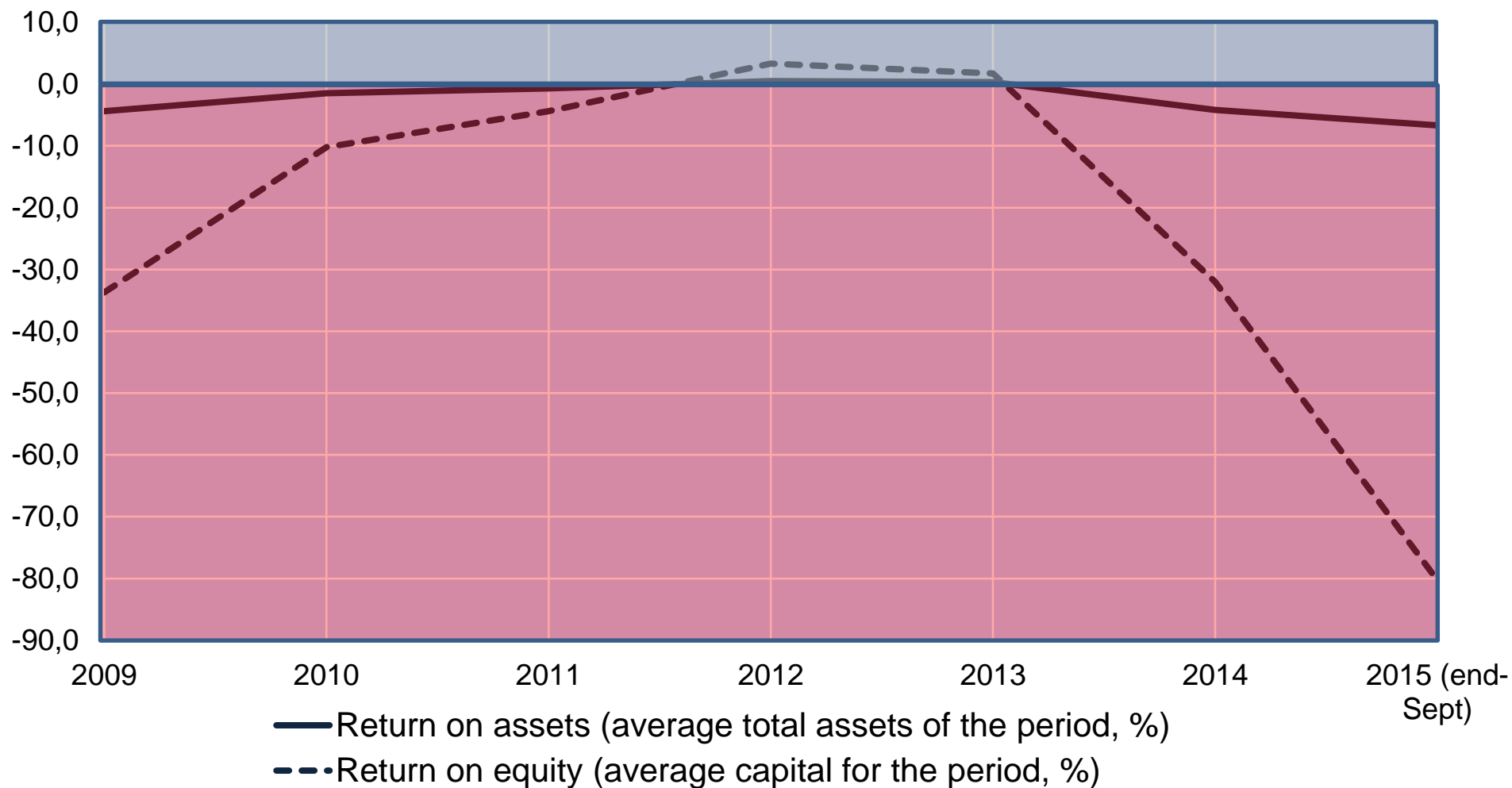
- **Forex reserves** (if still modest: 15% of GDP, 3 import months)
- **Intact IMF financial support (?)** and Western commitment

Non-performing loans (% of total loans)



Source: *Natsionalny bank Ukraini*

Profitability



Source: Natsionalny bank Ukraini

Outlook

- **Fragile recovery of Ukrainian eco. expected from 2016**
- **Recovery strongly influenced by pol. and security factors**
 - Extended domestic political instability/re-escalating geopolitical tensions could put pressure on hryvnia and deposits
- **Turnaround of banking activity will lag real economic recovery**
 - ← Drag of dismal credit quality, lingering uncertainty
 - ↔ Losses probably continuing for some years
- **Authorities grant banks up to end-2018 (forbearance) to fulfill substantial and partly still growing re-capitalization needs**

Danke!