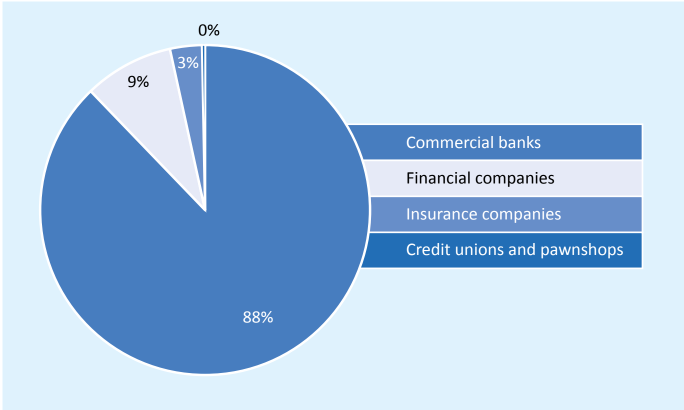
Overview of the financial sector in Ukraine

The financial sector in Ukraine mostly consists of commercial banks with an 88% share in total financial sector assets. The share of financial companies that provide leasing, factoring, and short-term loans to the market is 9%, while the size of other financial institutions such as insurance companies, credit unions, etc. are even smaller and do not influence the overall health of the financial sector. The present analysis will focus on the banking sector.

Figure 1. **The structure of the financial sector in Ukraine, December 2020**



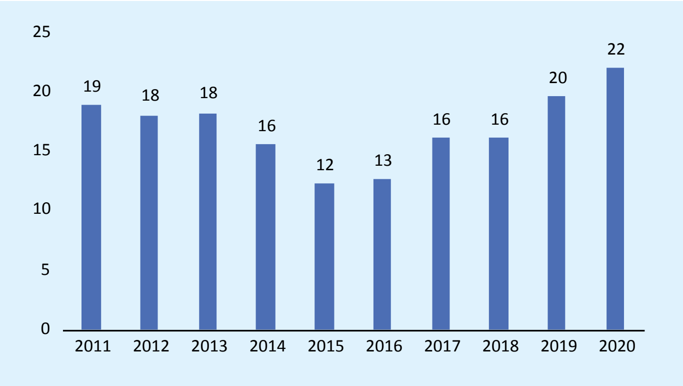
Source: The National Bank of Ukraine

The size of the banking sector shrank considerably relative to the overall economy in the 2014-2019 period. Total assets of the sector dropped from 96% of GDP in 2014 to 50% of GDP in 2019. In nominal local currency terms, the banking sector increased during this period, but since these years were marked with very high inflation and exchange rate depreciation, in real terms and relative to the size of the economy the banking sector shrank significantly. Despite the pandemic, 2020 was the first in the last 7 years when the banking sector grew relative to the economy and by the end of the year total assets increased to 54% of GDP but it is still low compared to BSTDB member countries.

After the exchange rate depreciation and banking crises in 2014-2016, many banks defaulted and were closed eventually. As a result, the number of banks declined from 179 in 2013 to 73 currently. The banking sector in Ukraine is characterized by large state participation, with a 56% share in total banking sector assets. The 4 largest banks in Ukraine are state-owned. The share of foreign ownership, as measured by banking assets, is 29%. Another 15% of total banking sectors' assets are held by domestic private banks. The market concentration in the Ukrainian banking sector is not high. The sector is considered to be competitive as the HHI index of concentration for banks' assets was only at 11% at end 2020.

During the banking crisis of 2014-2016, the capital adequacy ratio declined to 12% of risk weighted assets. Since then banking sector capitalization has increased, and it continued to grow in 2020 reaching 22% by the end of the year. Overall, the banking sector is well capitalized at present. Capital adequacy is above the required minimum for all banks and for large systemically important banks actual capital adequacy exceeds the minimum requirement by a wide margin.

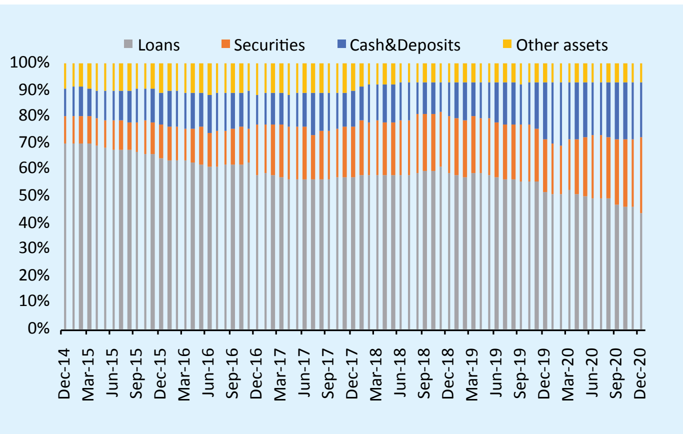
Figure 2. **The size of the banking sector relative to the economy, December 2020 (%)**



Source: National Bank of Ukraine

Almost half of total assets of the banking sector are liquid assets, while loans account for only 44%. Total gross loans of banks equalled 23% of GDP as at end 2020, which is one of the lowest levels among BSTDB member countries and the wider region. Before the crisis in 2014 loans accounted for around 70% of total assets. The decline of loan book of the Ukrainian banking sector is a result of several factors: bank closures and cleaning up of the balance sheet from bad loans on the one hand and lower demand for loans stemming from the economic recession on the other hand reduced the outstanding amount of credit in the sector. The decline of loans continued further in 2020. Deposits are the main source of funding for commercial banks in Ukraine with a 70% share in total liabilities. Around half of the deposits are collected from the retail sector. The importance of borrowing, which used to be a significant source of funding for banks with a 25% share in total liabilities, has declined over the last 6 years and accounted for only 8% of liabilities by the end of 2020.

Figure 3. **Structure of assets of the banking sector**



Source: The National Bank of Ukraine

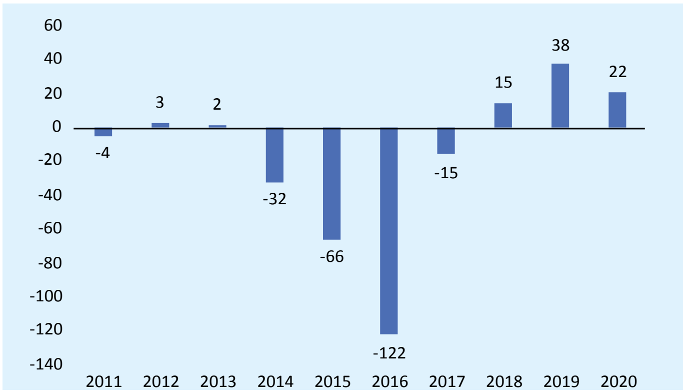
The banking sector in Ukraine maintains large liquidity buffers. In the last two years liquidity in the system increased and in 2020 High Quality Liquid Assets (HQLA) covered around half of the total liabilities. Accumulation of liquidity in this period was supported by the strong growth of deposits. The latter, together with the contraction of the credit portfolio, resulted in the decline of the loan to deposit ratio from 155% in 2014 to 72% by the end of 2020.

Figure 4. **Total (non-interbank) loans to customer deposits (%)**

Source: Financial soundness indicators, IMF database

Before the banking crisis, the profitability of the Ukrainian banking sector was very low with the ROE ranging 2-3%. Following the deterioration of asset quality, banks incurred large losses in the 2014-2017 period, with the ROE in negative territory. As a result the capital of many banks, including large, systemically important banks became depleted and ultimately these banks had to be recapitalized. The authorities nationalized the largest bank accounting for more than one-fifth of banking system assets, for which the capital shortfall amounted to nearly 7 percent of GDP[1]. In recent years, the profitability of the banking sector has recovered and in 2019 ROE reached a high level of 38%, partly due to the very low base effect. Solid profits were reported in 2020 too, with the ROE at 22%, which is in the same range as in countries with similar credit ratings.

Figure 5. **Return on Equity (%)**

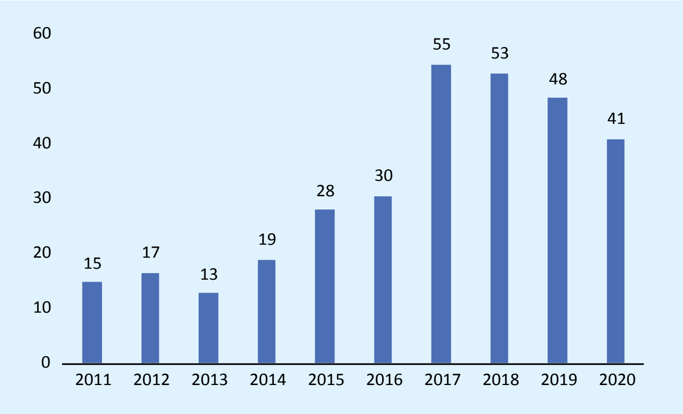


Source: Financial soundness indicators, IMF database

A high level of NPLs is still the biggest challenge for the banking sector in Ukraine. After the crisis, NPLs increased massively and reached 54% of total gross loans in 2017. However, for the last 4 years, the NPL ratio has declined. The decline in the NPL ratio resulted mainly from write-offs of large legacy NPLs. Despite declining further to 41% in 2020, NPLs remain elevated in Ukraine. The current level of NPLs in Ukraine is one of the highest among BSTDB member countries and the wider region. On the positive side, it should be noted that most of the NPLs in Ukraine are provisioned as the NPL provisions ratio stands at 90%.

[1] 2016 Article IV Consultation and third review under the Extended Arrangement, April 2016, IMF

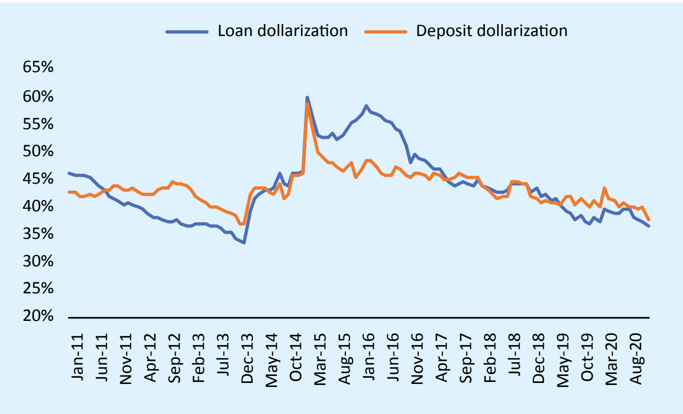
Figure 6. **Non-performing Loans to Total Gross Loans (%)**



Source: Financial Soundness Indicators, IMF database

Before the banking crisis of 2014-2016 dollarization in the banking sector was declining. After exchange rate depreciations and bankruptcies that resulted in a general loss of credibility, dollarization jumped and reached 60% for both loans and deposits. However, the National Bank of Ukraine's credible policies and ability to control inflation in the following years reversed the trend, with dollarization declining again. Despite the pandemic in 2020, dollarization declined further reaching 37% for loans and 38% for deposits. Dollarization is a long-term challenge and, despite improvements in recent years, it is relatively high.

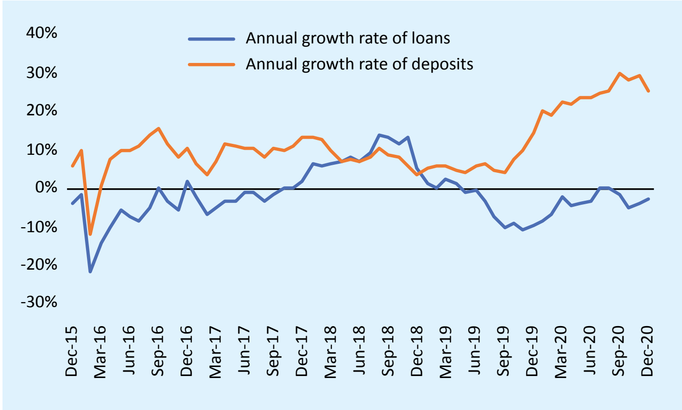
Figure 7. **Evolution of Dollarization in Ukraine banking sector**



Source: The National Bank of Ukraine

The outstanding stock of loans extended by the banking sector has declined by 8% in the last 5 years. The above dynamic was dominated by massive write-offs of bad loans which resulted in the reduction of the stock of loans by almost two-thirds relative to GDP, or from 64% of GDP in 2014 down to 23% of GDP in 2020. The total stock of loans declined further by 2% in 2020, with only consumer loans recording growth. In contrast to loans, deposit growth was quite strong in the last 5 years, averaging 10% per annum. Deposit growth accelerated further in the second half of 2019 and reached 26% in 2020.

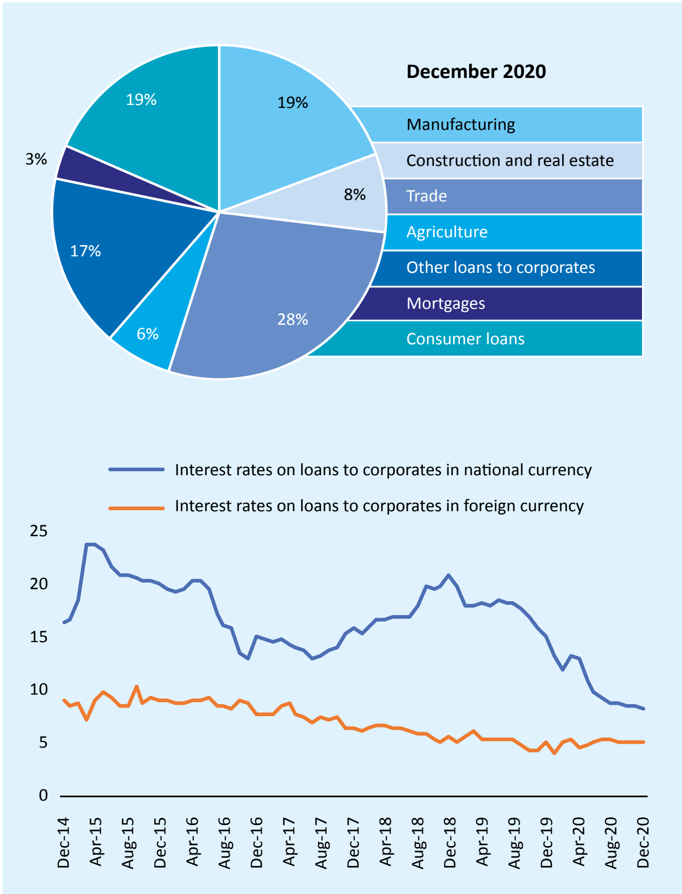
Figure 8. **Growth rate of loans and deposits**



Source: The National Bank of Ukraine

Loans to the corporate sector account for most of the banking sectors' credit portfolio, with a 78% share. The share of consumer loans to household that are granted predominantly in local currency is 18%. The largest portion of corporate lending is in the trade sector with a 28% share and most of these loans, around 83%, are denominated in local currency. Loans granted to the manufacturing sector account for 19% of the portfolio and in this sector loan dollarization is high at 69%. Interest rates for loans in local currency have been high since 2014 as the country went through a high inflationary period. In the last 2 years, however, with the central bank able to bring inflation under control, interest rates started to decline and fell to 8% for loans to corporates by the end of 2020. Interest rates for foreign currency loans also declined in the last 4-5 years and by the end of 2020 they stood at 5%.

Figure 9. **The structure of the credit portfolio and interest rates**



Source: The National Bank of Ukraine

The banking sector in Ukraine went through a major crisis in 2014-2016. A large number of banks defaulted and the system incurred substiantial losses. As a result the capital of the banking sector became depleted and the authorities were forced to intervene and recapitalise the largest bank of the sector. In response to the crisis, the central bank with the help of the IMF undertook a massive cleanup of balance sheet of the banking sector, in order to address the bad loans that resulted in significant losses for the system. Despite being costly, it helped the sector to recover and laid the foundation for potential growth in the future.

In recent years, the performance of the banking sector in Ukraine has improved with both capitalization and profitability increasing. The NPL ratio is declining but remains a major challenge for the banking sector. It is among the highest in the region. After the clean up of the balance sheets of commercial banks, the size of the banking sector shrank and now it is a relatively small sector of the economy. However, due to the current low base, it has strong growth potential once the economy recovers from the pandemic related slowdown. Available large liquidity buffers could potentially support credit growth in coming years. Another challenge for the banking sector in Ukraine is dollarization that has declined recently but still is at a relatively elevated level.