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Banking Sector Insight

Wheels slip

1 March 2016

READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

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Executive summary

The Ukrainian banking sector is being transformed in accordance with an earlier plan aimed at boosting solvency and reducing risk. However, interim deadlines have been missed by large margins, with some major issues, such as the fate of Privatbank, remaining open.

Despite running well behind schedule, the NBU is determined to complete the ongoing reforms

Sector reform fails to run to schedule. The IMF programme for the bailout of Ukraine is significantly running behind schedule – and that part of the programme devoted to the reform of the banking sector is no exception. Dealing with two of the most important issues for ensuring the soundness of the banking system, namely, recapitalization and the reduction of insider lending, has been pushed back to a later date. While most state- and foreign-owned banks are on track in tackling both issues, locally owned private banks have not made such progress, according to the regulator.

We consider that such delays are only to be expected, given the scale of the long overdue changes that the Ukrainian banking system faces and the pace at which it is trying to be implement them. At the same time, political risks with regard to the reforms remain high. In particular, the recapitalization of large local banks is beyond the control of the banking sector as it depends to a large extent on the willingness of their shareholders to invest their own money in those institutions, and at present it is questionable just how willing they are to do so.

The current political turbulence is likely to lead to measures being rapidly implemented over several months

From our viewpoint, the year 2016 will be crucial in determining whether the undergoing efforts will reach their logical conclusion. We note that the regulator, the National Bank of Ukraine (NBU), has been determined to see through its reform agenda and recent political turbulence will not undermine the sweeping changes in the Ukrainian financial sector but rather expedite their pace. The current interruption in cooperation with the IMF should encourage the parliament to speed up the reform process so that financing can resume.

Government proposes corporate debt restructuring to kick-start lending. If approved, a new draft law will provide for the faster out-of-court resolution of the restructuring of corporate loans. One-quarter of all business loans issued by Ukrainian banks are eligible for such restructuring and are believed not to involve dodgy borrowers.

However, very little progress has been observed towards improving the protection of creditors' rights, which is one of the important structural benchmarks of the IMF programme. While a significant number of draft laws have been proposed, very few have made it to the floor of the Verkhovna Rada. We expect the passage of legislation on the protection of creditors' rights to be among the parliament's top priorities in the coming months.

Very high level of UAH liquidity. The growth of UAH deposits and the large-scale pay-outs of insured deposits have significantly improved the UAH liquidity of nearly all Ukrainian banks. Even small and medium-sized institutions now carry NBU deposit certificates on their balance sheets – an instrument that is used to absorb excessive liquidity. Nonetheless, a very modest interest rate drop (100 – 150 bps) was observed during the past six months. Lending remains at a low level, constrained by the lack of credible borrowers and their high debt ratios.

Privatbank is expected to raise capital and reduce insider lending, but its willingness and ability to do so is unclear

Containing the expansion of Privatbank. Ukraine's largest bank continues to increase its market share, although both the willingness and the ability of its shareholders to provide additional capital and a cut-back on insider lending remain questionable. The authorities are trying to reduce the bank's importance for the Ukrainian banking system or, at least, contain its expansion. The Deposit Guarantee Fund (DGF) is no longer using the bank, which has the largest network of branches in the country, to pay out insured deposits, while salary projects of state-controlled businesses are encouraged to be taken to state-owned banks such as Oschad.

We see such an approach as the lesser of two evils. By applying non-market instruments, the authorities are trying to limit the potential for damage if the banks' shareholders are unable to meet the regulator's requirements.

State banks empowered. State banks' share in total assets rose from 18.1% in 4Q13 to 28.4% in 4Q15. That figure is lower than we predicted a year ago, but the trend is not yet over, in our opinion. The high level of liquidity of these banks and solid government support are attractive factors for new clients who have little trust to smaller and less stable financial institutions. On the other hand, the authorities are using administrative measures to encourage government-dependent entities to opt for Oschad, Ukrexim and Ukrgazbank. While such actions largely benefit the state banks, providing them with new depositors and improving their ability to repay NBU loans, such practice contradicts the overall intention to decrease the degree of government's intervention in the economy.

The Ministry of Finance has announced its mid-term goal to privatize at least 20% of both Oschadbank and Ukrexim and sell all of Ukrgazbank by 2018. International organizations such as the EBRD and the IFC are considered the most probable candidates to acquire stakes in those banks. We believe the authorities will pursue the stimulation of growth by providing credit facilities to the economy through the above-mentioned state banks. In our opinion, it is crucial that such loans are issued predominantly in hryvnia.

Overview of the banking sector

While the reform of the banking sector is significantly behind schedule, the initial goals to clean up the banking system and restore solvency remain a priority.

The legislative amendments to push forward with the reform of the banking sector are running well behind schedule – as exemplified by the restructuring of FX retail loans. Back in 2014, when the exchange rate was fluctuating around 13-15 UAH/USD, the parliament failed to adopt what we would consider a viable plan for loan conversion into hryvnia. Now, when the market exchange rate is significantly higher, borrowers are demanding terms that are very like to lead to losses – indeed, the situation is significantly worse for Ukrainian banks if compared with the Hungarian example of forced conversion. Ukrainian banks managed to ensure that a bill on loan conversion was vetoed in 4Q15, but no viable solution has been debated in the parliament since then. With the moratorium on mortgage collateral still in place, the banks' loan portfolios are far from having been cleaned up – which is one of the urgently needed goals of the current reforms.

increase in NPLs has resulted from the armed conflict in Donbass and the temporary inability of responsible customers to service their debts

New round of recapitalization under way. Unlike the 2014 assessment of the largest banks (owing to the hostilities in eastern Ukraine it was out of date even before its results were known) the 2015 round of recapitalization posed a significant challenge. The preliminary estimate of the size of the required capital injection (calculated for 18 out of the top 20 banks) was estimated by the NBU at UAH156bn (150% increase over the actual level of regulatory capital in 3Q15). Four banks, including international ones, have a sufficient level of regulatory capital, according to the 2015 assessment, while banks with the Russian capital as well as locally owned state and private banks have the largest capital needs. We restate our previous view that all banks – other than small local private ones, which do not have loans from foreign parent groups to convert into capital – have the capacity to meet the 2015 stress-test capital requirements. According to our estimates, the top 20 banks raised more than UAH16bn in new share capital in December 2015 alone.

Ukraine's top 10 banks are allowed, finally, to recognize the true level of bad debt – and subsequent losses – in 2016. According to the solvency restoration plan, those banks can have a regulatory capital adequacy ratio (CAR) below 5% but above 0% until the September 2016.

Privatbank

The amount of new capital required by Ukraine's largest banks was one of the key issues of the 2015 assessment and is, we believe, partly a political issue. At the time of writing, there has been no official announcement of any clear decision on the amount of recapitalization required by Privatbank having been taken. However, the bank's CEO has said that shareholders will be able to provide the necessary injection in 2017-18.

The share of insider loans in Privatbank's corporate loan portfolio is very large – at least 50%. The performance of those loans may deteriorate significantly should the government take over the bank. But we see a win/win situation for the bank and the authorities if Privatbank's management cooperate with the regulator over recapitalization and reducing insider lending. Given the scale of the problems to be tackled, we do not expect a quick resolution in either case. In our opinion, the most probable outcome is that the bank will gradually reduce its related-party exposure and therefore improve its capitalization. In view of the bank's large market share, we believe the regulator would much prefer the risks faced by Privatbank's to be dealt with slowly rather than its quickly being nationalized.

It is likely that the authorities have a Plan B envisaging taking over Privatbank if no satisfactory progress is made on the issue of its recapitalization. The 2016 state budget allows for up to UAH16bn in government bonds to be issued for bank recapitalizations. Nearly all of that amount have been used to provide a capital injection for two state banks. However, the government is permitted to exceed this budget cap in order to provide required capital to banks. In our opinion, this opportunity will be exercised in case of nationalization.

State banks

The state-owned banks were among the first to approve the recapitalization plans and start recapitalizing. While the smallest of the big three state banks – Ukrgazbank – requires no capital injection, Oschadbank will receive UAH5bn and Ukreximbank UAH9.3bn. As expected, the banks have received newly issued government bonds denominated in UAH and FX-indexed. Considering the level of bad debt, it is most likely that both banks will receive another round of capital in 2017, albeit smaller.

The hidden cost of recapitalizing Oschad and Exim was as much as UAH7bn in 2015

The NBU will not monetize the government bonds issued in the 2016 round of recapitalization, as was the case during the previous (2014) round – owing to monetary policies. From the public debt's point of view, this means the larger real cost of recapitalization. According to our estimates, the previous capital increase of Oschadbank and Ukreximbank combined entailed transfers totalling UAH1bn in the form of interest paid to banks on these bonds and some UAH6bn through the revaluation of FX-indexed bonds in 2015 alone. Further UAH devaluation will lead to a higher UAH cost of supporting banks through increasing government debt.

The fate of the state banks is currently under discussion as the development programme for the state banks is being drawn up. The main prevailing idea is either partial or full privatization of the large state banks. We believe that privatization of Oschad and Exim is not a top priority given the ongoing recapitalization process.

European banks

Ukraine's group of banks with European capital has just lost one gun – Ukrsotsbank – following a deal reached between Unicredit Group and Alfa Group that allows the former to exit the Ukrainian market. The remaining US$0.4bn of the loan from the parent group to Ukrsotsbank will constitute the group's remaining exposure to Ukraine or will be converted into equity before the deal is completed.

Thanks to a still significant amount of quasi-equity – lending from parent banks – Western banks are at low risk in terms of recapitalization. The EBRD has increased its stake in UkrSibbank (BNP Paribas Group) and become a partner of the Raiffeisen Group through the acquisition of shares in Aval. The bank made both investments by purchasing newly issued shares totalling UAH3.3bn and UAH0.5bn, respectively.

European banks are considered the least risky among those financial institutions operating in Ukraine, judging from average interest rates they pay on deposits. They enjoy a spread of several hundred basis points between the cost of hryvnia funding and the 18-20% currently paid on risk-free NBU certificates of deposit (CDs).

Russian banks

Banks with Russian capital became the single largest group of Ukrainian banks by absolute amount of capital injection in 2014-2015. Combined, the parent groups provided UAH40bn, according to our estimates; that represents an increase of 170%. But not all of them have yet met recapitalization targets – for example, Prominvestbank announced but still has not carried out a UAH20bn injection. Like other large foreign banks, the Russians have loans from parent companies that can be exchanged for newly issued shares.

We do not expect further sanctions to be imposed on these banks, nor do we expect nationalization – despite the loud calls for such a move from some activist politicians. Furthermore, we think it unlikely that Russian banks with state capital will record any meaningful growth since they are most likely stuck with poor loan portfolios and will have to concentrate on collection rather than new lending.

The regulator is encouraging faster consolidation of the banking sector

Smaller banks to be assessed. The NBU will conduct an assets quality review for the next 20 largest Ukrainian banks in 2Q16. These financial institutions received much less attention from the regulator in 2014 and 2015 than did the top 20 banks; but this time round, the solvency of such banks will be carefully scrutinized. In February 2016 the NBU abruptly changed the schedule for reaching the minimum required level of both statutory and regulatory capital. Previously that schedule foresaw incremental increases of UAH30m-UAH50m per year until 2024, when the minimum required capital for a newly opened bank will be UAH500m versus the current UAH120m; now small banks will have to increase their capital by up to UAH180m this year in order to reach a minimum of UAH300m by January 2017. As of December 2015, 70 banks were short of that level. Failure to meet the capital requirements will result in the NBU recognizing such a bank as problematic and insolvent if the problem persists for over six months.

Therefore, we expect further consolidation of the banking sector both through M&A and through insolvency proceedings. However, the self-regulated organizations for the Ukrainian banking sector will strongly oppose this decision by the regulator. Alternatively, the NBU may introduce licences for undercapitalized banks that will limit their operations to certain activities, which, in itself, is a form of market consolidation.

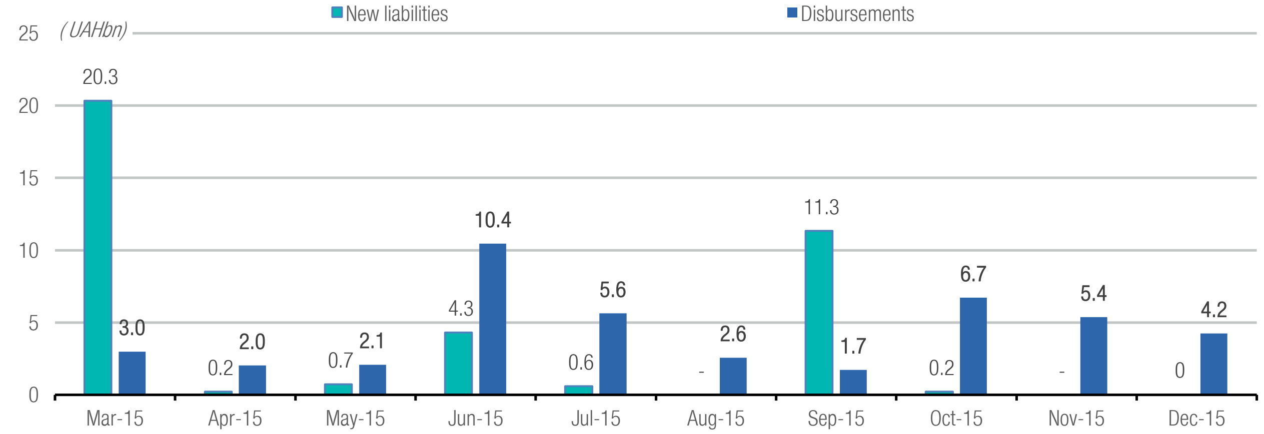
Hryvnia liquidity has been growing

Despite excessive UAH liquidity, the banks are unlikely to resume large-scale lending in 2015

Banks are flush with UAH liquidity. During the last nine months of 2015, most of the solvent banks saw slow but continuous local-currency deposit growth. The pay-outs of insured deposits by the DGF helped the major banks serving as the Fund's agents attract new customers among the recipients of those payments. According to our estimates, up to UAH65bn was returned to customers in 2014-15, of which UAH50bn was paid out in 2015 alone. Around 30 per cent of that amount remains with the DGF-appoint agent banks; the remainder has been either spent / consumed or used to purchase FX. The main point is that the liquidity stays within the banking system. UAH cash outside the banks did not change in 4Q15 – 0.0% YoY.

State-owned banks and most of the top banks, excluding all those with Russian capital except Alfa Bank, have performed the function of paying out insured deposits. Privatbank has been de facto excluded from this process since September 2015. While this step is hardly unbiased, we consider it logical that the authorities exclude banks that have no clear recapitalization plan and remain a high risk.

Chart 1 Disbarment of insured deposits by DGF



Sources: DGF, ICU calculations

The government made advance payment of some social transfers for January 2016 in December of last year. This had an additional positive effect on UAH liquidity, which rose above UAH100bn in January 2016, compared with UAH80bn one month earlier.

The NBU keeps excessive liquidity under control by offering banks its CDs at market interest rates. An overwhelming majority of banks, including the smaller ones, currently have CDs on their balance sheets. The only significant exception to that trend is Privatbank, which historically has avoided investing in government-related securities. Very little of the excessive liquidity is utilized to provide loans to the retail or corporate sector (see the next section below).

Interest rates decline. The inflow of deposits has led to a notable, albeit modest decline in interest rates. We expect continued downward pressure on interest rates during 2016. Excessive hryvnia liquidity will encourage banks to lower rates further. Ukraine's largest bank, Privatbank, has announced another 1ppt rate cut. As we discussed in our previous quarterly banking report,[1] Privatbank has secured a very significant market share of the retail deposit market – one-third, according to our estimates – which is larger than or, at least, comparable to that of peer banks in neighbouring countries. In our opinion, Privatbank enjoys strong market positions owing to its large network of branches and the above market average interest rates it offers. The authorities are likely to favour the containment of the expansion of Privatbank in favour of the state-owned banks. Besides not serving as a DGF agent, the bank could see the number of salary receiving clients decrease as state-controlled entities transfer to other (predominantly state-owned) banks.

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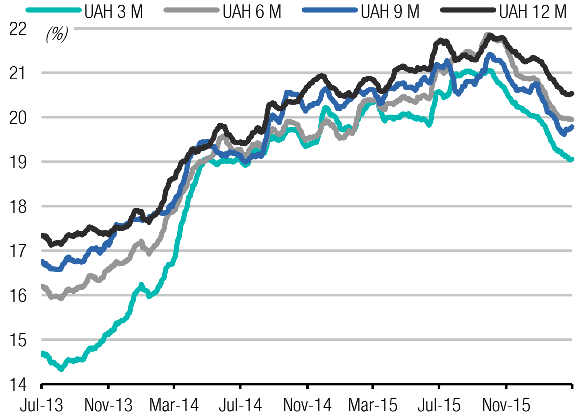
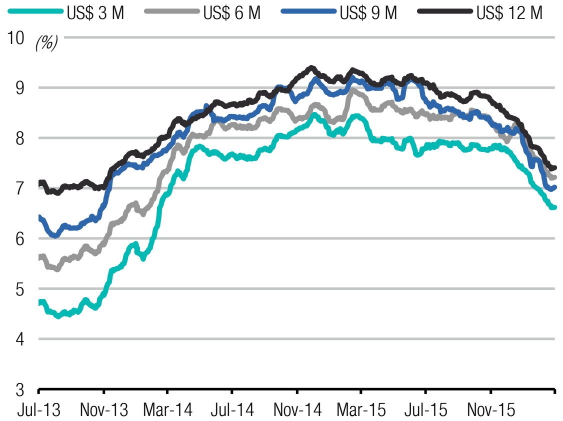
[1] *ICU Banking Sector Insight: Overcoming the challenges*.

Chart 2. Average interest rates on UAH household deposits



Source: NBU, ICU estimates.

Chart 3. Average interest rates on USD household deposits



Source: NBU, ICU estimates

Interbank lending remains very limited. According to newly introduced statistics on interbank lending, the average price of overnight UAH was around 19.1% in 2015, significantly cheaper than the 24% NBU overnight loan facilities which saw little demand in 2H15 and the first six weeks of 2016.

At the moment, short-term (mainly overnight) lending is essentially the only form of interbank lending: the larger banks are not comfortable lending to the smaller ones while the former large have sufficient hryvnia liquidity.

Corporate borrowers: Significant debt restructuring expected

Corporate restructuring to have limited success if FX debts retain their current share

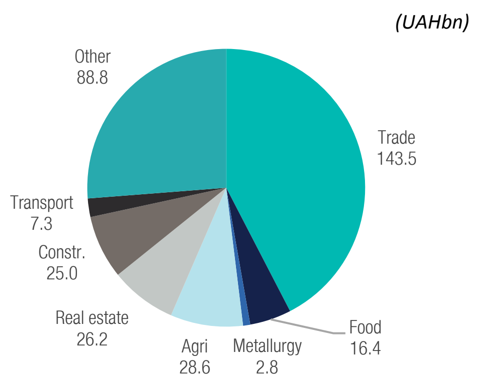
As the share of corporate bad debt on the balance sheets continues to rise, we expect a significant amount of corporate debt restructuring in 2016. The government has proposed a bill to enable faster out-of-court restructuring that includes haircuts. It aims to target viable businesses that are in a financial difficulty. The estimated amount of debt that could be affected by the proposed bill is UAH200bn – almost a quarter of total gross corporate loans.

Capital injections that banks will receive or have already received in response to the 2015 assets quality review will allow them to accept the terms of restructuring without jeopardizing their capitalization level. The temporary decline in the minimum regulatory CAR for large banks will have the same effect.

According to NBU statistics, 19.9% of all corporate loans are past due. Understandably, FX-denominated loans have a much higher overdue ratio (27.9%) than do UAH-denominated loans (9.4%). Therefore, the important question remains of whether the restructuring of FX corporate loans will be successful in the absence of conversion into hryvnia.

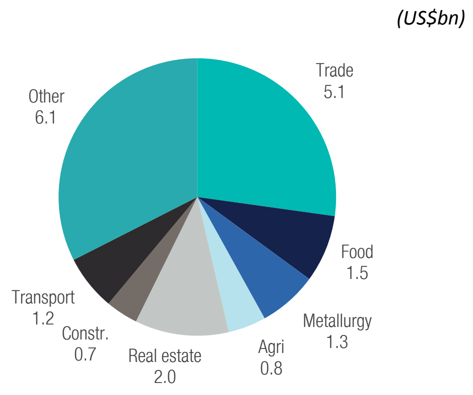
In Charts 3 and 4 below, we have selected industries that jointly account for 70% of the total gross corporate loan portfolio of the Ukrainian banks, according to the NBU's monthly statistics, to show their exposure to corporate debt – in both hryvnia and FX.

Chart 4. Gross corporate exposure per industry – UAH loans



Source: NBU, ICU.

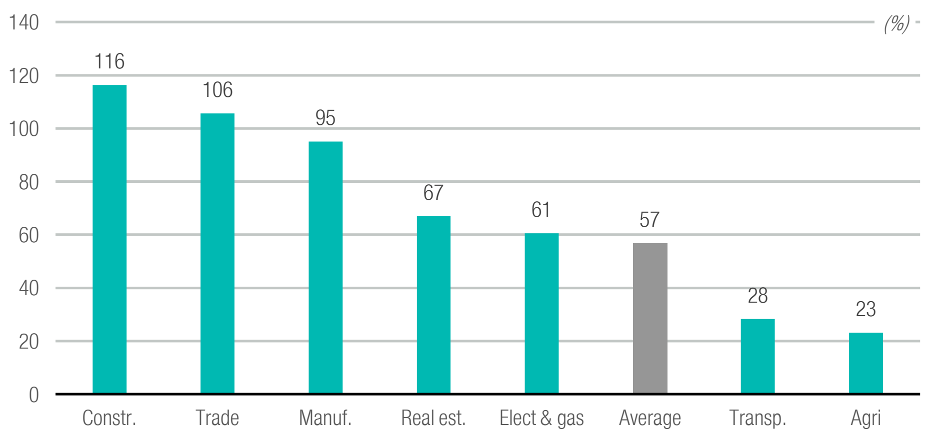
Chart 5. Gross corporate exposure per industry – FX loans



Source: NBU, ICU

Trade companies (wholesale and retail) are currently the main borrowers of Ukrainian banks, accounting for 33.7% of the total gross corporate loan exposure. Manufacturing is the second largest borrower (24.7%); however, we have included two of its largest sub-industries – food production (6.6% of the total gross corporate loan exposure of Ukrainian banks) and metallurgy (4.3%) – as separate categories.

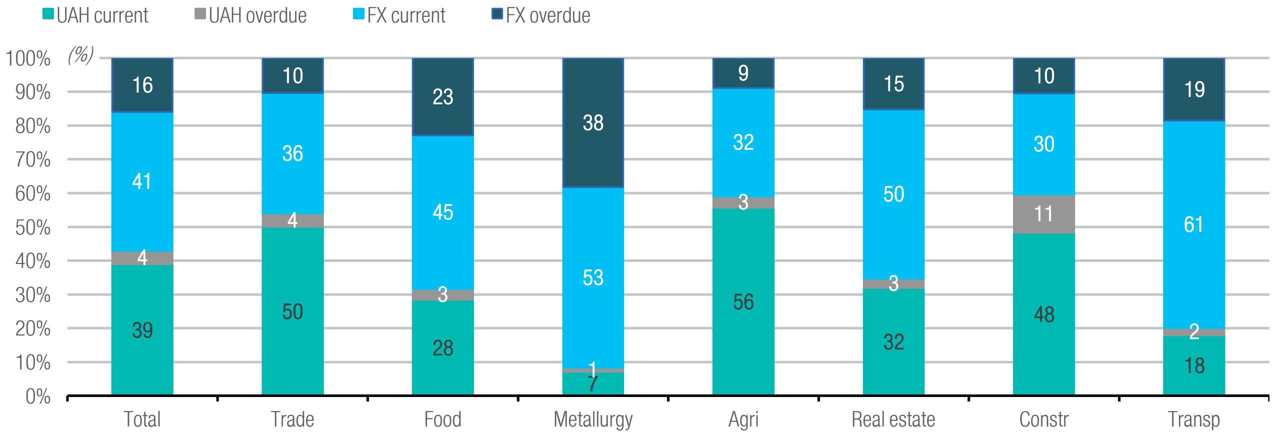
Chart 6. Industry's debt to Ukrainian banks as a percentage of attributable GDP



Source: ICU

If industry's debt to Ukrainian banks is compared in terms of the amount of GDP (last four quarters) generated, the agricultural sector has the lowest debt burden – 23% (see Chart 6 above). The manufacturing industry owes Ukrainian banks the equivalent of a full 95% of its output, compared with an overall industry average of 57%.

Chart 7. Breakdown of loans to non-financial corporates by currency

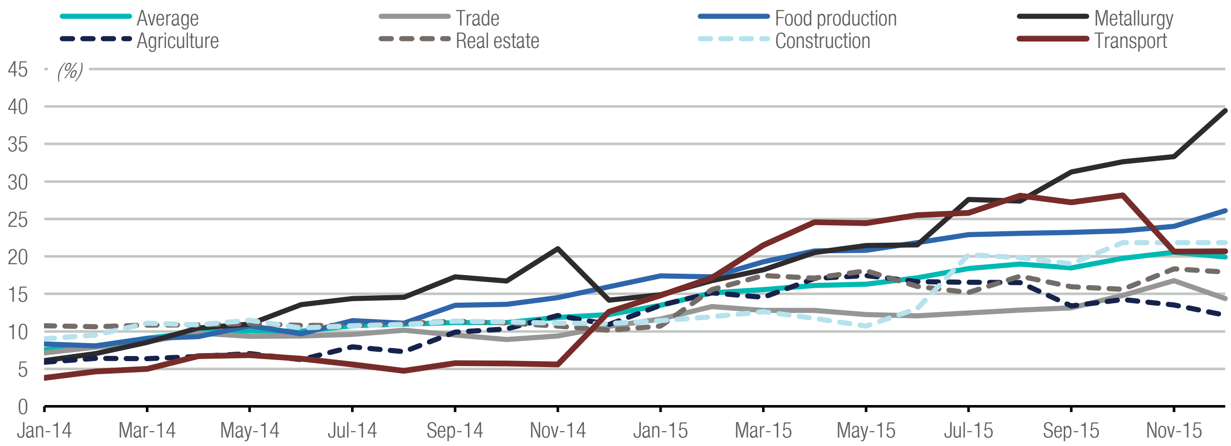


Sources: NBU

The share of overdue loans in the corporate sector fell 0.7ppt in December from the record high of 20.6% in November. However, this was due mainly to changes in loan accounting rather than improvements in payment discipline. We believe that the capital injections received by several large banks have allowed them to form 100% reserves against various uncollectible loans (including those in the occupied areas of eastern Ukraine) and that this has enabled them to write off those assets from their balance sheets.

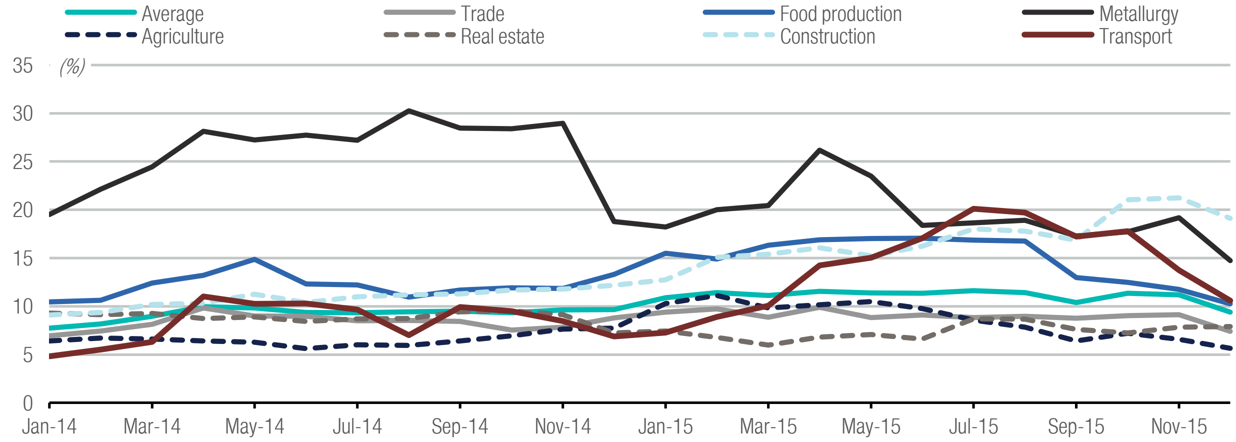
The metallurgical sector is the most problematic borrower among Ukraine's large industries. This is due, above all, to a larger share of FX-denominated debts and the lower prices of commodities in international markets.

Chart 8. Share of overdue loans



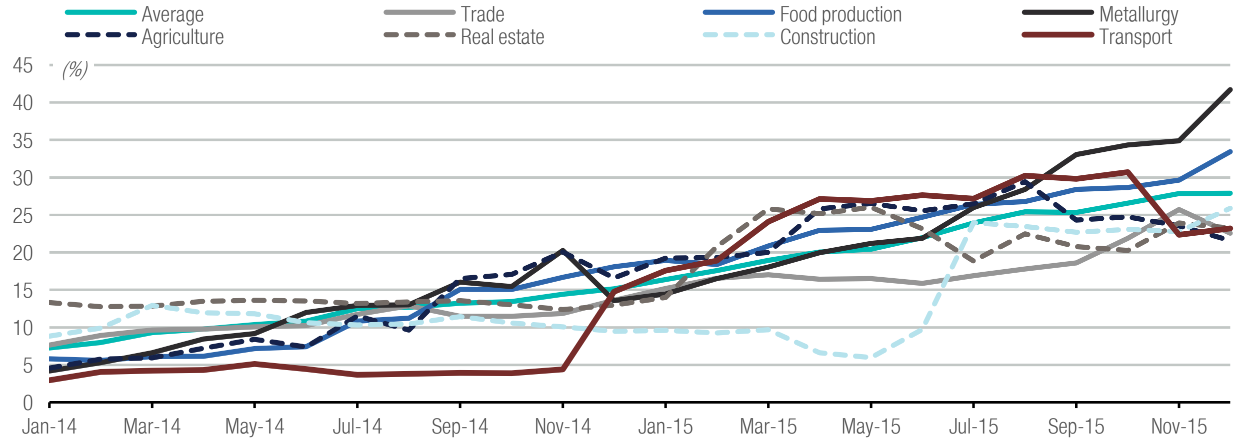
Sources: NBU, ICU

Chart 9. Share of overdue loans – UAH loans only



Sources: NBU, ICU

Chart 10. Share of overdue loans – FX loans only



Sources: NBU, ICU

Disclosures

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This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

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Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

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Sell: Forecasted 12-month total return significantly less than that of relevant benchmark

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