Financial Stability Council
Report on Activities

(August 2021 – July 2022)

Kyiv 2022

Foreword

Since August 2021 through July 2022, the Financial Stability Council (Council hereinafter) held four meetings. At each meeting, the Council discussed systemic risks for the financial sector and current issues of its development. For instance, the Council focused on progress in winding down the nonperforming loan (NPL hereinafter) ratio, in October 2021. In particular, it reviewed the advance of state-owned banks in implementation of NPL reduction strategies. At its October meeting, the Council also concentrated on results of the work of the Deposit Guarantee Fund (DGF hereinafter) on recovery of losses from former owners and managers of failed banks.

The full-scale russian invasion into Ukraine became the key challenge and shifted the Council's focus. At its meetings in April and June 2022, the Council reviewed rising domestic and external risks caused by russian aggression for financial sector of Ukraine and economy in general and discussed a range of anti-crisis measures for mitigation of these risks. In particular, the Council concentrated on risks of monetary financing of state budget and endorsed key actions aimed at narrowing its deficit. At the same time, the Council Members agreed to make efforts to raise official financing from international partners at favorable terms, and to stick to the highest possible saving mode for budget funds and international reserves under the martial law.

Another key issue on June agenda of the Council was the development of government programs for lending support. Government program Affordable Loans 5-7-9% became the major lending driver during the wartime. Lending under government programs accounted for over a half of hryvnia loan portfolio growth in the wartime. Given the prospect for loan portfolio growth and increasing market interest rates, the Council backed intentions of the Ministry of Finance of Ukraine together with Entrepreneurship Development Fund to update development plans for government programs for lending support in order to promote further Ukrainian business and properly meet obligations to banks on interest rate compensation.

CONTENT

Composition of the Financial Stability Council[1]

Co-chairpersons of the Council:

Sergii **MARCHENKO**	– Minister of Finance of Ukraine
Kyrylo **SHEVCHENKO**	– Governor of the National Bank of Ukraine (NBU)

Members of the Council:

Yuriy **DRAGANCHUK**	– Deputy Minister of Finance of Ukraine for European Integration
Yuriy **HELETIY**	– Deputy Governor of the NBU
Ruslan **MAGOMEDOV**	– Head of the National Securities and Stock Market Commission (NSSMC)
Yaroslav **MATUZKA**	– Deputy Governor of the NBU
Svitlana **REKRUT**	– Managing Director of the Individuals' Deposits Guarantee Fund (DGF)
Yulia **SVYRYDENKO** (*until November 2021*) Rostyslav **SHURMA** (*since December 2021*)	– Deputy Head of the Office of the President of Ukraine.

[1] Over the reporting period.

Key issues considered by the Financial Stability Council

1. Overview of systemic risks

Each Council meeting traditionally started with an overview of systemic risks to financial sector. Since the end of 2021, the Council have noted a substantial aggravation of geopolitical risks, in particular because of actions of russia. The key geopolitical risk materialized in February as russia waged a full-scale invasion against Ukraine. The war has driven up all risks and provoked materialization of several threats for financial stability. As of the end of Q2 2022, most of the risks that the Council analyzes, were at their highest level (Table 1).

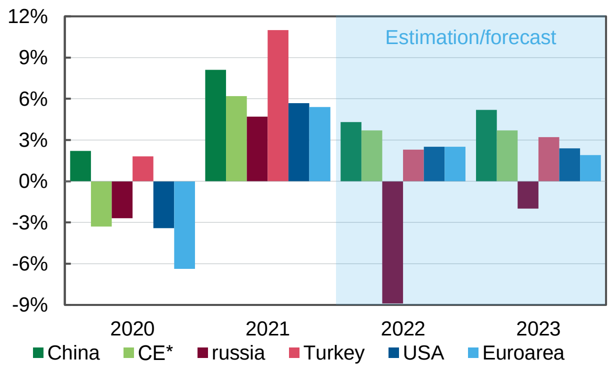
Table 1. Evolution of systemic risks

	Change of risk				Level of risks as of			
	2021		2022					
	Q3	Q4	Q1	Q2	1 Oct 21	1 Jan 22	1 Apr 22	1 Jul 22
Global economy	↗	→	↗	↗	🟡	🟡	🟡	🟡
External demand	↗	↗	↗	↗	🟡	🟡	🟡	🔴
Economic conditions	→	→	↗	↗	🟡	🟡	🔴	🔴
Public finance	↘	→	↗	↗	🟡	🟡	🔴	🔴
FX market	↘	↗	↗	↗	🟡	🟡	🔴	🔴
Geopolitics	→	↗	↗	↗	🟡	🔴	🔴	🔴

Evaluation of change of risks. Arrows up – higher risks; arrows down – lower risks.
The level of risks indicate their intensity: 🟢 green = low, 🟡 yellow = medium, 🔴 red = high.

Global economy. The war in Ukraine and its further escalation became a dominating risk for global economy. It caused downward revision of forecast of global economic growth, contraction of world trade, and led to a price hike for energy and food. For the world economy, the war will result in a notable production slowdown and further acceleration of inflation. In the IMF estimates, global growth rate will halve compared to 2021. Inflation growth forces central banks to speed up the transit to tighter monetary policy. That is going to make financial conditions tighter, especially for emerging markets.

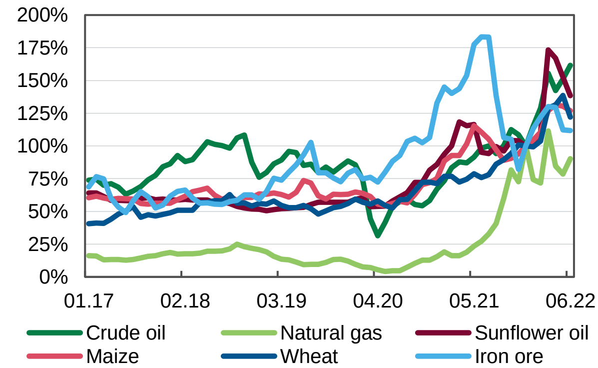
Figure 1. Change of GDP of russia and Ukraine's major trading partners



**Central Europe: Bulgaria, Croatia, Hungary, Poland, and Romania.*

Source: World Bank, Global Economic Prospects, June 2022.

Figure 2. Global commodity prices*, December 2021 = 100%



** Change in USD terms. Crude oil – Brent; natural gas – in Europe; iron ore – CFR China; sunflower oil, wheat, maize – international markets.*

Source: World Bank, "Pink sheet" data, July 2022.

External demand. The war caused a surge in commodity prices. Growth in energy prices and especially gas price in Europe outpaced that of other commodity prices. Blocked logistical channels and exclusion of russia as unreliable supplier from established supply chains wirsened that situation even further. Wheat, maize, and sunflower oil prices reached record levels and stay high. There is still a risk of global food crisis. Ukraine and its partners are looking for options for exporting its goods, in particular through unblocking its sea ports.

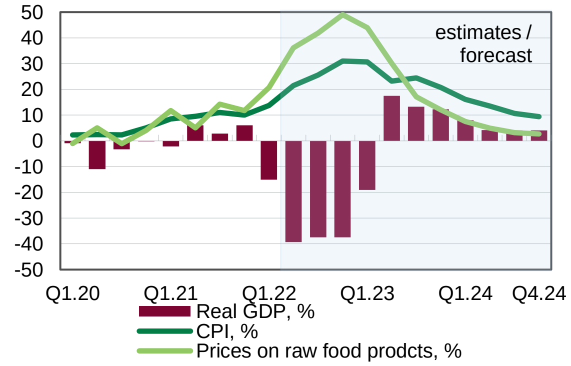
Economic conditions. Because of russian invasion, Ukraine is to lose around a third of its GDP in 2022. Inflation pressure will remain high due to temporary occupation of some of our territories, destruction of industrial and transport infrastructure, disruption of production and supply chains, and high costs for enterprises. On top of lowering current production, the war materially undermines economy's potential. Ukraine also suffers a huge loss of human capital because of migration and people's deaths. Investing has virtually stopped due to high uncertainty. It might take a long while and material support from international partners for the economy to recover from the war fallout.

Risks of inflation acceleration remains considerable primarily due to further increase in production and logistics costs, as well as in prices in partner countries. On the other hand, we price growth will be contained by the weaker domestic demand, exchange rate fixation, substantial supply of grain and vegetable oils due to restrained export, frozen utility tariffs, and renewal of proactive interest rate policy by the National Bank of Ukraine (NBU thereinafter).

Over the first months of war, the NBU did not revise its policy rate as usual market channels for monetary policy transmission were not working. Price and financial stability were ensured through exchange rate support. Fixation of the rate since the introduction of the martial law had a counter-inflationary effect: it contained negative expectations and slowed down growth of prices for imported goods. In early June, the NBU Board hiked policy rate by 15 pp to 25%. This step aimed to relieve pressure on FX market and anchor inflation expectations.

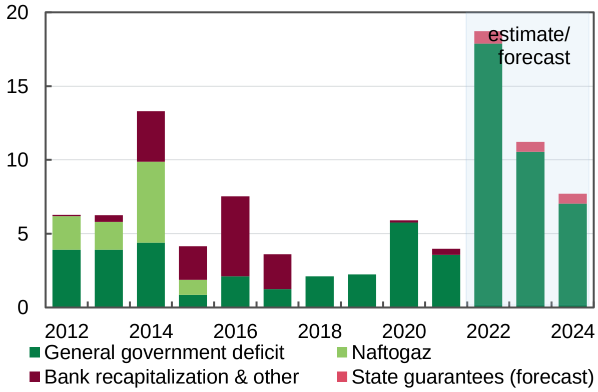
Since the start of the war, outflow of funds from Ukraine was extensive due to faster recovery of imports compared to exports, and migration that entailed material increase in imports of services and cash withdrawals abroad. The overall capital outflow on financial account in January–May reached USD 9.6 billion. It was partially offset by loans from IFIs and partner countries. These funds replenished Ukraine's international reserves. On 21 July 2022, the NBU made a one-off readjustment the official exchange rate of the hryvnia against U.S. dollar by 25%, to UAH/USD 36.5686. This will increase the inflow – and thus the sale of exporters' FX receipts – will minimize speculative component in market participants' behavior, and facilitate stabilization of exchange rate expectations.

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



Source: NBU Inflation Report, July 2022.

Figure 4. Broad public debt deficit, % of GDP



Source: NBU Inflation Report, July 2022.

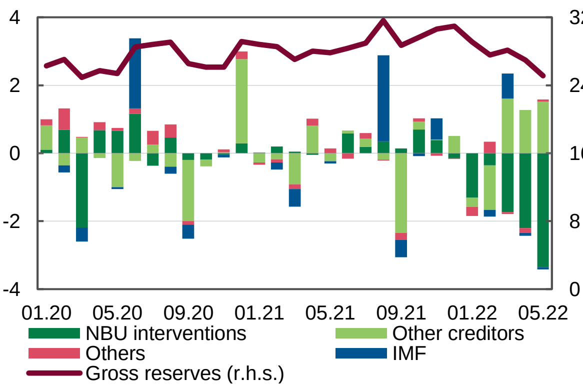
Public finance. Under wartime conditions, the need for financing of state budget deficit has surged. While in Q1 budget revenues were sustained thanks to advance dividend payments by state-owned enterprises and NBU profit transfer, support from international donors became vital in Q2. During the wartime up until mid-July, they have already provided financial assistance of around USD 12.3 billion. As of early July, total committed financial assistance exceeded USD 30 billion. Financing of defense and social expenditures, as well as economy support will still critically rely on international support and its timely provision. Uncertainty around the crisis depth enhances risks of underperformance on budget revenues. The need for budget deficit financing is estimated at around USD 5 billion per month.

Apart from international assistance, funds for financing of government needs came directly from the NBU through purchase of war bonds. In March through May, the NBU purchased UAH 120 billion worth of war bonds, which made 32% of all government borrowings in the first five months of 2022. After its policy rate hike, the NBU purchased another UAH 105 billion worth of war domestic debt securities at floating rate linked to the policy rate. Monetary financing of the budget was a step Ukraine, reluctantly, had to take.

At the same time, excessive monetization of the budget poses the risk of material adverse impact on macroeconomic stability. Thus, the Council focused on risks stemming from monetary financing of the budget at its last June meeting in the reporting period. Council Members agreed that hryvnias issued into circulation cause pressure on the FX market. In order to meet the demand for FX, the NBU regularly intervenes on the market. Volume of interventions rise monthly, thus exhausting international reserves. So far, the decline in international reserves was only partially offset by the inflow of international assistance. A substantial decline in the reserves may provoke a material hryvnia depreciation and a spike in inflation.

In order to mitigate these risks, the Council Members endorsed a list of priority actions aimed at narrowing state budget deficit and a decline in monetary financing thereof. The list includes in particular optimization of government expenses and limiting non-priority and inefficient expenses coupled with further increase in public revenues. Faster inflows of international assistance and expansion of domestic borrowing will limit the need for the monetary financing, mitigate the risks of budget deficit financing, and allow to maintain international reserves at acceptable level going forward.

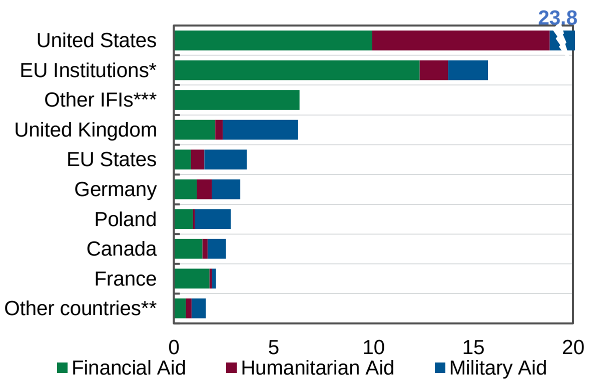
Figure 5. Volume of sale of cashless foreign currency on interbank market (in USD billions terms)*



** NBU interventions: (+) refers to purchasing FX to increase reserves; (-) refers to selling FX from reserves; "others" means the revaluation of financial instruments due to changes in their market value and exchange rate fluctuations, as well as other transactions.*

Source: NBU.

Figure 6. Committed international assistance to Ukraine between end January and early July 2022, billions of euro



** European Commission, European Council, EIB, European Peace Facility; **Japan, Norway, Australia, Switzerland, Rep. of Korea, New Zealand, China and Taiwan, India, Turkiye; *** IMF, World Bank, EBRD.*

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

FX market. Since the start of the full-scale war, the NBU limited most transborder capital transactions (later some of these restrictions were relaxed). The NBU fixed official hryvnia to US dollar exchange rate at the 24 February level and adjusted it once on 21 July in view of the change in Ukraine's economy fundamental characteristics during the war. Although capital controls have mitigated pressure on the FX market, this market still sees the deficit of the FX inflows because of the exports decline. Thus, the NBU has to sell substantial amounts of FX on the market. Financing from international donors helps to sustain international reserves. As of early July, international reserves were at the acceptable level of UAH 22.8 billion. The NBU will have to remain actively present on the market until the preconditions for a shift to a market-based FX rate setting are in place.

Geopolitics. The hostilities may still spread to other regions of Ukraine. However, Ukraine enjoys the support of a broad coalition of partners that provide us with military, financial, and humanitarian assistance, while russia became the most sanctioned country in the world. Sanctions gradually reduce the economic potential of the invader state.

At the same time, unprovoked large-scale russian invasion encouraged consolidation of the EU and its cooperation with Ukraine. In particular, Ukraine applied for EU membership and was granted candidacy in June 2022. Currently, the plans for Ukrainian economy recovery are being designed with international organizations and partner-states. Implementation of these plans is likely to be linked to implementation of large-scale reforms.

Council's position. Council Members agreed with the assessment of systemic risks and sources of threats for financial stability. The Council Members also agreed on key actions aimed at narrowing state budget deficit and lowering the volume of monetary financing, i.e.:

- Optimization of public expenditure, in particular limiting non-priority and non-efficient expenses
- Additional increase in public revenues, primarily through raising taxes on imports, exercise duties (in particular on fuel), and rent payments. Approaches to tax raising should be balanced, fair, and differentiated.
- Promotion of domestic borrowing market for state budget financing
- Activation of efforts for increasing volumes and predictability of inflow of international assistance.

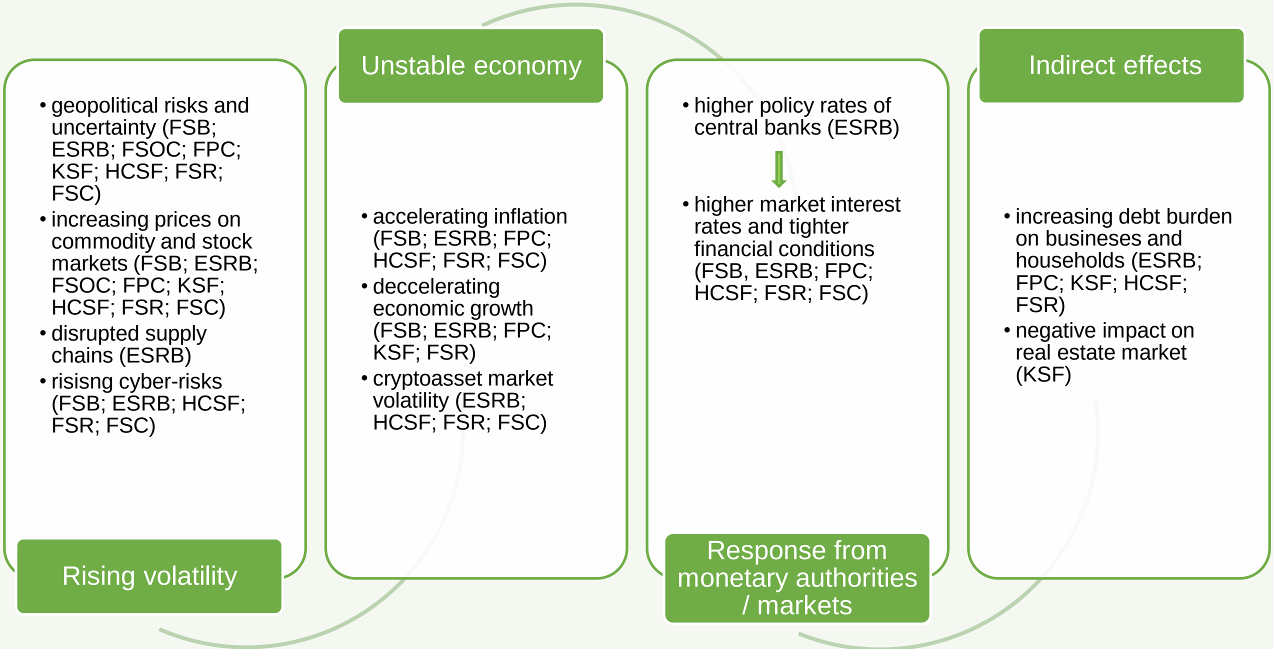
All the steps should be in line with principles underpinning Ukraine’s cooperation with international donors and integration into the EU.

Box. Risks and key recommendations of financial stability councils/ committees around the world in H1 2022

Secretariat of the Council monitors systemic risks identified by international and leading national financial stability councils and committees as well as recommendations they provide. This report focuses on analysis of H1 2022 risks after the start of russian full-scale invasion. The war became a new challenge and source of risks for global and primarily for European financial system. Direct risks for most of financial systems are limited due both to limited exposure to Ukrainian and russian assets and relatively small size of these countries' financial sectors. However, the war gives rise to a range of threats and risks that have a strong although indirect impact on financial systems across the world – primarily through a price surge on global commodity markets and change in value of assets that are linked to those prices. At the same time, the fallout from the war for financial systems across the globe is so far smaller than the one from the COVID-19 crisis. This judgement is shared by the NBU experts.

As of now, there is no coordinated regulatory response of international financial stability councils/ committees.

Figure 7. Major risks arising from russian aggression as identified by financial stability councils/committees



FSB – Financial Stability Board (G20); ESRB – European Systemic Risk Board; FSOC – Financial Stability Oversight Council (USA); FPC – Financial Stability Committee of the Bank of England; HCSF – High Council for Financial Stability (France); KSF – Financial Stability Committee (Komitet Stabilności Finansowej, Poland); FSC – Financial Stability Committee (Financieel Stabiliteitscomité, Netherlands), FSR – Financial Stability Council (Finansiella stabilitetsrådet, Sweden).

It is worth noting the ongoing discussions at professional platforms around the consequences of the COVID-19 crisis both due to its long-term effect on public debt in many countries, which rose and became less sustainable, and lockdowns that still occur in China.

There is a vivid discussion in the EU on enhancing counter-cyclical component of the macroprudential policy. This concerns primarily upgrading mechanism of counter-cyclical capital buffer for banks to make them more usable, in particular through introduction of non-zero neutral buffer rate for normal times.

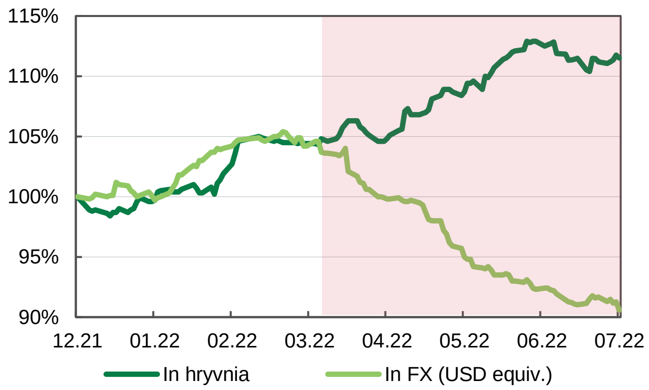
The impact of climate change on financial stability stays high on agenda in many jurisdictions (FSB, FPC, FSOC, and FSR). The first priority is collection of reliable, granular, and comparable information on impact ad threats from climate change for economy and financial sector in particular, as well as analysis of the risks with scenario analysis and stress tests. Discussions on potential macroprudential tools to respond to these risks are still at early stages.

2. Governmental programs for lending support

The Council focused on further development of the government support program *Affordable Loans 5-7-9%* at its meeting in June 2022. The program became the key lending driver in wartime. It plays a great role in supporting business activity as a necessary precondition for financial stability.

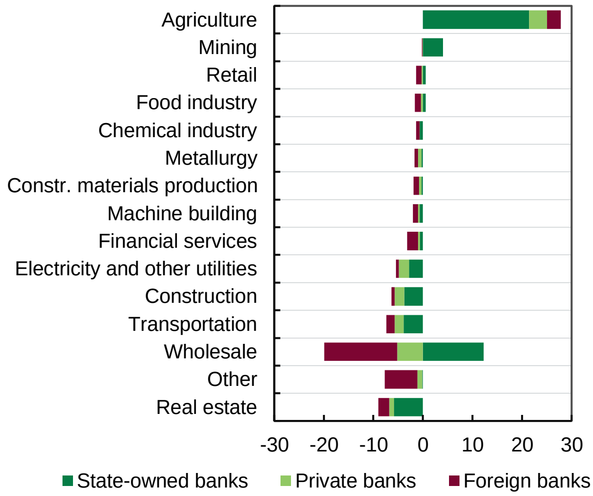
In order to meet enterprises' demand for loans, the banks were widely using government support programs, which were specifically expanded to cover agricultural enterprises. In March-June 2022, under the improved terms of *Affordable Loans 5-7-9%* program, the banks issued UAH 39 billion. Most of these loans were extended to agricultural enterprises. In spring, the government granted UAH 24 billion worth of loan guarantees in order to facilitate sowing campaign. The banks often combined these two programs, thus offering borrowers moderate rates and lowering their own credit risks. Lending under the government programs accounted for over a half of growth of hryvnia loan portfolio. As of 1 August, total volume of agreements signed under the program reached UAH 133 billion, with 46,000 of enterprises and sole proprietors taking advantage of the support. State-owned banks are leading in expanding loan portfolios under the government programs.

Figure 8. Net corporate loans, 31 December 2021 = 100%



At banks that were solvent as of 1 July 2022.
Source: NBU (based on daily balance sheets of banks).

Figure 9. Change in nonperforming corporate loans by industries between 1 March 2022 and 1 July 2022, UAH billions



At banks that were solvent as of 1 July 2022.
Source: NBU.

Because of high uncertainty and low production recovery rates, enterprises will face an increasing need for debt restructuring. Appealing terms of government program *Affordable Loans 5-7-9%* bring down credit risks. Thus, the enterprises will take advantage of opportunities the program offers for refinancing and business support.

Overall, the banks find the terms of government programs acceptable enough. However, they stress one crucial issue – arrears on compensation of interest rates from Entrepreneurship Development Fund. Given the prospect of growing loan portfolio and increasing market interest rates, the government needs to update the planned volume of expenditure under those programs for 2022.

Council's position. Council Members backed intentions of the Ministry of Finance of Ukraine, together with Entrepreneurship Development Fund, to update plans on developing government programs for support of lending in order to promote Ukrainian business further and proper meet liabilities to banks related to compensation of interest rates**.**

3. Reforms of the deposit guarantee system and enhancing of the DGF capacity

The Council had been working on reforming the deposit guarantee system and enhancing DGF capacity for long time, as was noted in past Council reports. In particular, in February 2021, the Council endorsed restructuring of the DGF debt by converting them into contingent liabilities and defining the sources for their repayment; specifics of JSC Oschadbank joining to the retail deposit guarantee system; and gradual increase in covered deposit amount to UAH 600,000 from 1 January 2023.

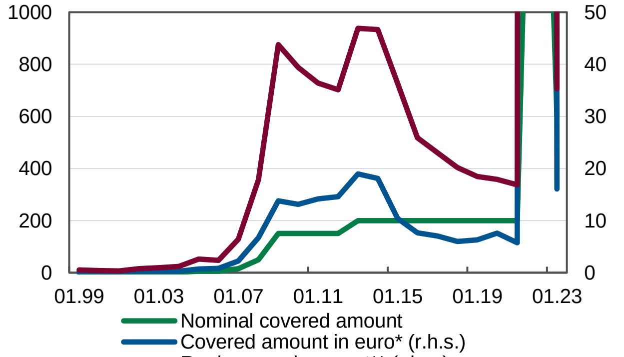
The approaches developed by the Council and DGF were underlying the adopted amendments to the Law of Ukraine *On the Household Deposit Guarantee System* (the Law hereinafter) that took effect on 13 April 2022. The key amendments were:

- An increase in the guaranteed amount of deposits to UAH 600,000;
- A temporary full guarantee of retail deposits for the duration of martial law and three months thereafter
- The inclusion of Oschadbank in the deposit guarantee system
- The DGF's solvency problem has been resolved.

Tippling of covered deposit amount (from UAH 200,000 to UAH 600,000) compensates depositors for losses caused by inflation since the last increase of the covered deposit amount over a decade ago. As of now, the new coverage level allows to guarantee most household deposits at banks to some extent. Moreover, most lower- and middle-income households have their deposits virtually fully covered. At the same time, large deposits over the threshold are not covered with guarantee. Thus, owners of the deposits have to make conscious decisions on placing their funds and be fully responsible for related risks. This approach is fully in line with international principles of building efficient deposit insurance systems.

As the Law was adopted after the start of the full-scale russian invasion, the draft Law saw changes that provided for blanket coverage of retail deposits for the period of martial law and three months after it ends/is lifted. Temporary blanket deposit coverage is a common response to a crisis across the globe. It aims to prevent bank runs. Both advanced and emerging economies took decisions during domestic and international crises, like Sweden in 1992 and Germany in 2008, or Mexico in 1994 and Malaysia in 2008.

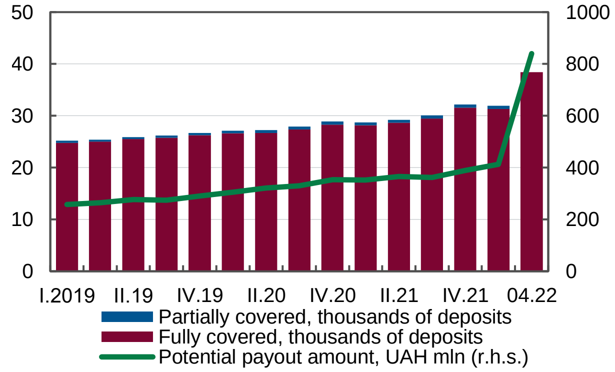
Figure 10. Evolution of covered retail deposits*



** Under assumption that the martial law ends in autumn 2021. Unchanged exchange rate assumed for euro as for 1 January 2023. Inflation rate forecast in 2023 from the NBU Inflation Report of July 2022. ** In 1999 prices.*

Source: DGF, NBU estimates.

Figure 11. Amount of potential payout by DGF* and number of covered deposits



** Amount of retail deposits on current, savings, and time deposits eligible for repayments from DGF in case of potential failure of member banks.*

Source: NBU.

The inclusion of Oschadbank in the deposit guarantee system means that retail deposits at this bank will be covered by the DGF, and not directly by the state as it used to be. Oschadbank will make regular contributions to the DGF. This approach is in line with EU acquis provisions on participation of credit institutions in deposit insurance systems and promotes a level playing field for all banking institutions in Ukraine. This also complies with long-term plans of the state as owner, as Oschadbank joining the deposit guarantee system had been discussed since 2001 and was provided for in the Strategy for state-owned banks' reform.

Adaption of the Law finally resolved the issue of the DGF solvency. This issue of the DGF debt emerged during the crisis of 2014-2017: total DGF repayments to depositors of nearly a hundred failed banks that were withdrawn from the market, exceeded its financial capacity. Therefore, the DGF took UAH 80 billion in loans from the NBU and the government. As of early 2022, the DGF fully repaid its debt to the NBU and transferred almost UAH 22 billion to the Ministry of Finance of Ukraine to repay its liabilities. However, total debt to the Ministry of Finance exceeded UAH 65 billion, 24 times the annual contributions of member banks to DGF in 2021. Thus, DGF revenues fell short to service the debt. Legal amendments provide for gradual repayment of the debt principal with the DGF funds. The interest on loans will be repaid to the extent and within the receipts from sale of assets of insolvent banks and recovery from their former owners and related parties who caused these banks' failure. Therefore, the state partially relieved the deposit guarantee system from the burden of costs of the former banking crisis, and so opened the way for building safety margins for future repayments.

Another important line of the DGF activity were measures on recovery of assets of failed banks and losses in Ukrainian and foreign jurisdictions, both from management and ex-beneficiaries of the banks. As of early July 2022, the DGF initiated over 100 commercial litigations, civil lawsuits under criminal cases, and civil lawsuits based on convictions in criminal cases, around UAH 120 billion worth in total. In Ukrainian jurisdictions, the lawsuits target mostly former bank managers. In foreign jurisdictions, the work focuses primarily on ex-owners of the banks, implying larger cash flows. The DGF initiated selection procedures for foreign legal firms that would search and arrest assets and represent interests of the DGF and insolvent banks in foreign jurisdictions. The DGF funds its work in foreign jurisdiction from its investment income.

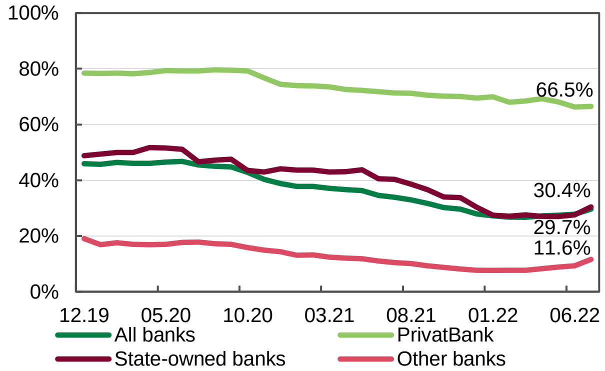
Council's position. The Council recommended the DGF to keep to the strategy that it had chosen on actions on recovery of damage/losses done to banks and their creditors, in particular through initiating new and maintaining existing litigations in courts of foreign jurisdictions.

4. Management of non-performing exposures at the state-owned banks

Activity of state-owned banks, and especially their management of impaired assets have been on the Council's agenda for a few past years. Since the Council endorsed NPL reduction plans in June 2020, the Council has twice assessed the progress in their implementation in 2021. Until 24 February 2022, state-owned banks had been properly implementing their plans on reducing NPLs on their balance sheets.

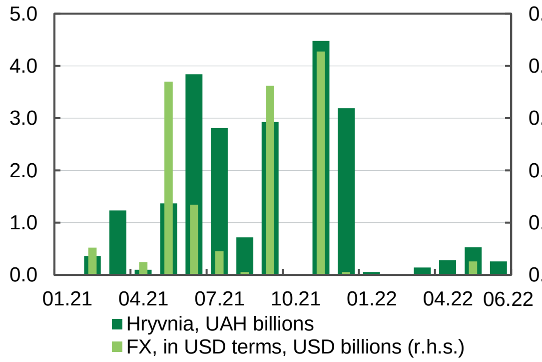
Because of the full-scale military invasion into Ukraine all risks for banks surged, and first of all the credit one. A material share of loan portfolio will turn nonperforming, thus entailing a rise in NPL ratio. Therefore, NPL reduction strategy are expected to require an update after ending or lifting of martial law[2]. As of now, state-owned banks account for 82% of all banking system NPLs. From 1 January 2021 through 1 March 2022, NPLs in the banking system shrank by UAH 63 billion, of which state-owned banks cut UAH 51 billion. Overall NPL ratio in the banking system declined from 37.7% to 26.7% between 1 January 2021 and 1 March 2022.

Figure 12. NPL share in bank portfolios



Source: NBU. At banks that were solvent as of 1 July 2022.

Figure 13. Monthly volumes of loans written off by state-owned banks



Source: NBU.

The major tool for portfolio quality improvement was writing off of previously provisioned NPLs. Between late 2021 and March 2022, banks wrote off UAH 21.0 billion worth of hryvnia loans and UAH 47.2 billion worth of FX loan (in hryvnia terms).

The banks also resolved debt through restructuring. Between 1 January 2021 and 1 March 2022, the banks restructured UAH 9 billion worth of debt for 7 borrowers under the Law of Ukraine *On Financial Restructuring*. Mostly state-owned banks engaged in the restructurings.

After the beginning of the martial law, the NPLs increased somewhat, by UAH 33 billion, including UAH 16 billion at state-owned banks. As of early July 2022, NPL ratio was already 29.7% and is expected to grow further. However, even after the martial law was introduced, banks have completed financial restructurings started in late 2021 for two borrowers for over UAH 5 billion. Since the start of the war, restructurings for other three borrowers were launched for over UAH 2 billion.

Council's position. The Council recommended state-owned banks to recognize credit risk in time and, as necessary, to restructure loans, and to work further on improvement of quality of loan portfolios.

[2] Regulation of the Board of the National Bank of Ukraine of 25 February 2022 No. 23 *On Certain Issues of Activities of Banks and Banking Groups* (amended).