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5.1 Impact of the COVID-19 pandemic on the stability of the Ukrainian banking system

Abstract:

The banking system is the important part of the economy, especially in the period of an economic recession, when its health is paramount for the whole country. The effects of the recession caused by the pandemic were researched in the context of whether the quarantine destabilized the banking system and how it changed the rates and trends of the banks' development. Supporting actions of the central bank, adaptive behavior of commercial banks, their financial results and indicators and main risks for the future were analyzed in order to assess the damage of the pandemic. The results of this analysis showed that the banking system of Ukraine proved financially resilient to the "coronacrisis", and commercial banks used the changes in clients' behavior to accelerate digital trends, such as improving remote services and restructuring resources and staff in favor of electronic banking, which presents banks with opportunities to operate more effectively and widen the amount of given services. Key risks for the economy highlighted by subjects of the banking sector included financial risks like FX volatility and those that were out of control for the regulator like the pandemic worsening and international relationships deteriorating, which pose particular danger to the development of the banking system of Ukraine.

Keywords: THE BANKING SYSTEM OF UKRAINE; THE PANDEMIC; THE NATIONAL BANK OF UKRAINE; DIGITAL BANKING; PRUDENTIAL RATIOS; BANKING RISKS.

INTRODUCTION

The whole world is suffering from the economic crisis caused by a now infamous infection. Ukraine is not an exception as the pandemic rages in the country, although

the country just recently has gone through a recession. The last economic crisis in 2014-2015 was the catalyst for the revitalization and rework of the banking system that was prone to failure due to its unhealthy status. After countless reforms, the Ukrainian banking sector can be considered stable and after the crisis, this sector saw high profits that were only rising when 2019 ended. The point of the article is to demonstrate how the banking system adapted to the new environment, how it used it for own benefit and whether this new economic recession will cause the imminent collapse of the banking sector or it will remain healthy and ready to face new challenges that will arise before it.

5.1.1 THE BANKING SYSTEM AND THE REGULATOR

Before analyzing how the Ukrainian banking system adapts to the pandemic, it is essential to go quickly through the banking system itself in order to have a better understanding of it.

According to the law “About banks and the banking activity”:

“Article 4. The banking system of Ukraine

The banking system of Ukraine consists of the National Bank of Ukraine and other banks, as well as branches of foreign banks that are made and act on the Ukrainian territory according to the provisions of this act and other laws.”[133]

So the banking Ukraine consists of two levels: the central bank and the commercial banks.

The National Bank of Ukraine performs the governmental regulation of the banking activity from the administrative point of view like the registration of commercial banks and from the indicative point of view, which is more interesting to us:

“Article 66. Forms of regulation of banking activity

II. Indicative regulation:

- 1) Establishment of the mandatory economic standards;
- 2) Establishment of the mandatory reserve norms for banks;
- 3) Establishment of the reserve deduction norms for active banking operations risk coverage;
- 4) Establishment of the interest policy;

- 5) Refinancing of banks;
- 6) Regulation of correspondent relationships;
- 7) Management of international reserves;
- 8) Regulation of operations with securities on the open market;
- 9) Regulation of the capital import-export.”[133]

As stated in the same document in the article 67, the goal of the banking monitoring is the stability of the banking system and the protection of interests of the bank's depositors and creditors concerning safety of the clients' money stored on the banking accounts. [133]

Important thing to mention is a certain set of functions that the NBU performs, according to the Law of Ukraine “About the National Bank of Ukraine”:

“Article 6. The main function

According to the Ukrainian Constitution, the main function of the National Bank is ensuring the stability of the national currency of Ukraine.

During the execution of its main function, the National Bank must come from the priority of reaching and sustaining the price stability in the country.

Within its powers, the National Bank facilitates the financial stability including the stability of the banking system if it does not interfere with the reaching of the goal mentioned in the second part of this article (the pricing stability).

The National Bank also facilitates the keeping of steady rates of economic growth and supports the economic policy of the Cabinet of Ministers of Ukraine if it does not interfere with the reaching of the goal mentioned in the second and third part of this article (the pricing stability).

Article 7. Other functions

The National Bank performs these functions:

- 1) According to the Main monetary policy guidelines developed by the NBU Council defines and implements the monetary policy;
- 2) Has a monopoly on the emission of the national currency of Ukraine and organizes the cash flow;
- 3) Acts as a creditor at last instance for banks and organizes the refinancing system;

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4) Sets the rules of conducting banking operations for banks, accounting and reporting, protection of information, money and property;

5) Organizes the creation and methodologically supports the system of monetary and statistic information and statistic of foreign balance;

6) Regulates activity of the payment systems in Ukraine, sets the order and forms of payments, including between banks;

14) Performs according to jurisdiction the currency regulation, sets the order of operations with foreign currency, organizes and performs the currency monitoring of banks, as well as non-banking financial organizations and mail operators that acquired a license to perform currency operations;

16) Analyses and forecasts the dynamic of macroeconomic, monetary, currency and financial indicators, including the making of foreign balance;

17) Defines the specifications of the functioning of the Ukrainian banking system in case of the military state or the special period, performs the mobilization preparation of the National Bank system.” [134]

Overall, the article states 35 different functions that are assigned to the regulator. Functions that are mentioned above show that the National Bank of Ukraine controls the banking system and plays the main role in the stability and growth of the economy. Peculiar is the fact that the inflation rate is the most vital for the regulator and the financial stability and economic growth are second in priority. This means that during this crisis caused by a pandemic the regulator primarily will try to keep the inflation level in the certain bounds dictated by the inflation targeting. We will talk later about the measures taken by the National Bank of Ukraine to keep the inflation rate, because it is the essential part of the financial system of the country.

Commercial banks are the second part of the Ukrainian banking system. It is divided into clusters:

- banks with state-owned capital – banks in which the government owns more than 75% of authorized capital, directly or otherwise
- banks owned by foreign banking groups – banks in which foreign banks or financial and banking groups have controlling interest

- banks with private capital – banks in which one or several ultimate beneficial owners are private investors that directly or otherwise own 50% or more of authorized capital. [135]

At the beginning of March (quarantine started on March 12), there were 75 solvent banks, from which 5 are banks with state-owned capital, 20 banks owned by foreign banking groups and 50 banks with private capital. The analysis of total assets shows that 60% of the assets belong to state-owned banks, 27% belong to banks owned by foreign banking groups and only 12% belong to private banks. Furthermore, the amount of assets of the biggest Ukrainian bank, PrivatBank, which is 100% government-owned, accounts for 28% of total assets in the system, making it bigger than either the whole cluster owned by foreign banking groups or the cluster of banks with private capital. [136; Calculations made by the author] This is the most systematically important bank in Ukraine and its healthy state is essential for the whole country's economy.

After we gave an understanding of Ukrainian banking system, let us move to actions that the National Bank of Ukraine took to protect the banks and the people economically.

As soon as the quarantine measures were implemented, the National Bank of Ukraine made a statement about how it would help the banks during the pandemic. It promised to continue the support of liquidity through usual refinancing tools and to keep balancing the Ukrainian currency market. The NBU postponed a number of new regulatory implementations and tests, such as the implementation of capital buffers like the buffer of system importance and the buffer of the capital conservation; inspections of banking and financial organizations; stress tests in banks, etc. In case of need, the regulator would lower the standard of the mandatory reservation of borrowed funds in foreign currency, lower the LCR standard, announce extraordinary tenders for a liquidity support and widen the criteria of acceptance for secured loans for urgent liquidity support. [137]

Additionally banks were asked to postpone the dividends payments.

“The National Bank, like other leading central banks, thinks that it is vital for banks to save their equity for sustaining the economy during the spread of economic problems caused by a pandemic of the coronavirus disease COVID-19. That is why banks are recommended to postpone the profit distribution through dividends payment at least until October of 2020.” [138]

When the quarantine began, due to the rising demand for the foreign currency in March and the absence of international flights, banks faced the problem of the lack of foreign banknotes. To ensure the seamless work of the banking system, the NBU cooperated with foreign financial organizations to get the cash in Ukraine. Additionally the regulator started to supply banks with USD and EUR banknotes in exchange for cashless foreign currency, which was plentiful. [139]

There were numerous other preventive measures used as well, like the added time for the application of the financial statements. [140]

On March 18, the NBU organized an online-conference with the higher management of the biggest Ukrainian banks. The meeting was about the operation of the banking system in the then new conditions of the quarantine. The main point of the conference was to inform the banks about the decreased regulatory control mentioned before, the news about the negotiations with the International Monetary Fund on which Ukraine depends. The important measure that the regulator mentioned was the grace period for the working loans without the negative influence on the capital of banks in order to protect those borrowers that lost their source of income due to the quarantine measures.

"Customers get nervous and ask to introduce effective restructuring approaches. You should start working now. Our regulations, particularly Resolution No. 97, cover restructuring and grace periods. Banks can take an individual approach for corporate borrowers and a standard one for retail customers. A special approach is needed to those economic sectors that are losing their entire income and have closed down, as well as to individuals temporarily out of work due to quarantine measures and ceased operation of some companies," stated First Deputy Governor of the National Bank of Ukraine Kateryna Rozhkova. She reminded that the previous day the parliament

satisfied the NBU's proposal to forbid banks to charge fines and penalty interest on past due consumer loans throughout the period from 1 March to 30 April. "The NBU is against restrictions. Sound communication with customers should be used instead of them. Banks also should regularly refill ATMs with cash and ensure operation of their branches in all regions. This especially concerns the largest banks," she also said, pointing out that banks should impose no restrictions on customer transactions. Deputy Governor Sergii Kholod announced the cancellation of tariffs for providing cash to banks and the temporary cancellation of tariffs in the System of Electronic Payments (SEP).

"While the quarantine is in place, we must focus on remote operations and online payments. We should make cashless payments cheaper than paying with cash," said Mr Kholod. [141]

On April 23, the National Bank of Ukraine issued a statement about the key policy rate that we propose to go through:

"The Board of the National Bank of Ukraine has decided to cut the key policy rate to 8%. The continued monetary easing aims to support the economy during the period of pandemic and quarantine.

In March–April, inflation was lower than expected, despite the temporary price growth in the first weeks of the quarantine.

In March, consumer inflation declined to 2.3% yoy. Price growth was restrained by three major factors: lower global energy prices, the residual effects of last year's appreciation of the hryvnia, and a larger supply of raw foods. These factors outweighed the opposite pressure on prices from the weakening of the domestic currency in March and the panic buying of some goods after the quarantine was imposed.

According to preliminary data from NBU online monitoring, inflation will remain low in April(it did). High demand for basic goods and unrest on the FX market caused by psychological factors waned quickly. As a result, prices for most food products and medicines, which had grown in the first weeks of the quarantine, have declined in recent weeks.

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In 2020, inflation will remain within the target range of 5% +/- 1 pp. This will not be impeded by monetary and fiscal support to the economy.

Inflation will accelerate moderately in the coming months, to reach 6% at the end of 2020, thus remaining within the target range. Fiscal and monetary policy measures that are aimed to support businesses and households will partially offset the decline in consumer demand. However, consumer demand will remain subdued for long after the quarantine ends, keeping inflation from growing above the target level this year.

Inflation will also be contained by declining global energy prices, which will continue to influence domestic fuel prices.

At the same time, the increase in inflation compared with the current level will be primarily driven by a pass through from the recent depreciation of the hryvnia.

In Q1 2021, inflation will temporarily deviate from the target range against a low comparison base. Afterwards, it will decrease and stabilize at the medium-term target of 5%. This level will be achieved thanks to the NBU's prudent monetary policy and a more restrained fiscal policy after the pandemic ends and economic activity recovers.

The economy of Ukraine will contract by 5.0% in 2020 in the wake of the quarantine imposed to overcome the pandemic and due to the global crisis. However, it will resume growth at round 4% in the following years.

The adverse impact of the pandemic on the Ukrainian economy is expected to be relatively short-term, but strong. The quarantine has already affected business activity, consumption, and employment. A decrease in global demand has also limited export opportunities for Ukraine. According to NBU estimates, the effect of these factors will be the most pronounced in Q2 2020.

A gradual lifting of quarantine restrictions will allow the economy to recover in H2 2020. Loose fiscal and monetary policies will contribute to the economic recovery. An increase in budgetary spending by the government to overcome the crisis, along with the NBU's actions to support the banking system, will mitigate the negative impact the pandemic has on the economy.

The NBU revised the forecast of current account deficit for 2020 downwards.

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This year, the current account deficit will be 1.7% of GDP (versus 3.2% in the January forecast). Imports of goods to Ukraine will decrease more than exports. Amid the worldwide quarantine and lower global prices, Ukraine will reduce its purchases of energy and the majority of nonessential goods. The pandemic will affect exports less, as demand for food products is expected to be maintained. At the same time, the decline in remittances from labor migrants will be more than offset by Ukrainians spending less on foreign travel.

The current account deficit will widen again once economic activity rebounds globally and in Ukraine. This will be driven by households' pent-up demand for imported goods, the resumption of investment imports by businesses, and the expected decrease in gas transit revenues. Nevertheless, the deficit will continue to range between 3% and 4% of GDP, as envisaged in the NBU's January forecast.

Continued cooperation with the IMF remains the key assumption of this macroeconomic forecast.

Ukraine is close to having a new aid program approved by the IMF Executive Board. The NBU's revised forecast envisages that Ukraine will receive the first tranche of about USD 2 billion in Q2.

First, this will cover the state budget deficit, which has increased to 7.5% of GDP. This will enable Ukraine to confidently pass through the period of peaking debt repayments, and finance measures to support businesses and households at a time when business activity is slowing down, employment and tax revenues are falling, and foreign investors are leaving emerging markets.

Second, financing from the IMF and other official international partners will help maintain Ukraine's international reserves at USD 27 to 29 billion this year and in the coming years.

In this light, signing a new aid program with the IMF is the main prerequisite for maintaining macro-financial stability in Ukraine during the global crisis. Therefore, the absence of a program with the IMF remains the main risk to this forecast.

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Another important risk to the outlined forecast could arise from a longer-lasting novel coronavirus pandemic and, consequently, longer-lasting quarantine measures being required to overcome the outbreak.

This will have a direct influence on how quickly the global and Ukrainian economies recover.

Other risks also remain significant. They include:

- an escalation of the military conflict in eastern Ukraine
- a drop in the harvest of grain, fruit and vegetable crops in Ukraine in the wake of unfavorable weather
- the higher volatility of global food prices, driven by global climate change and the risk of stronger protectionist measures.

In this light, the NBU Board decided to cut the key policy rate considering that inflationary pressures were moderate, and the economy required substantial support due to the adverse impact of quarantine measures on business activity, consumption and employment.

In view of the above, the NBU continued to ease monetary policy, by cutting the key policy rate by 2 pp, to 8%.

Together with other measures taken by the NBU, such as expanding its set of liquidity support tools and the introduction of preferential terms for borrowers by banks, this will provide the economy with the impetus required to provide support for households and businesses in these difficult times, and to ensure that business activity picks up quickly once the quarantine is lifted.

The NBU expects that the key policy rate to be reduced further, to 7% in the current year.

In deciding how quickly the key policy rate can be decreased to that level, the NBU will take into account how talks with the IMF progress, how the coronavirus pandemic develops, how quickly quarantine measures are lifted, and what anti-crisis measures other governments and central banks adopt.

The NBU leaves open the possibility of a greater easing in monetary policy if a fall in consumer demand due to quarantine measures and weaker business activity put stronger downward pressure on inflation than is currently expected.” [142]

From this article we can extract a couple of interesting thoughts:

- Inflation seems to be even lower than the forecast;
- As forecasted, the effects of the pandemic are most prominent for the Q2 of the year, when DGP subtracted by 11.4% compared to 2Q2019; [143]
- As mentioned, the policy key rate was cut even further to 6% and will stay at that level at least till the end of 2020;
- Ukraine highly depends on the IMF aid program. That poses a great risk as the recent decisions of The Constitutional Court that cancel certain anti-corruption laws puts the relationship between Ukraine and IMF in jeopardy;
- The FX market saw a brief moment of panic. Indeed, in 30 days of March the USD rose by staggering 14%. [144]

The policy key rate should influence the price of loans in order to restrict or stimulate public spending, which in turn influences the inflation rate from the side of the demand. Although interest rates do go down, as seen on the Fig.1, the interest rates of loans to public are significantly higher than the key rate and rates of loans for business. Furthermore, rates of the deposits for public fall faster than credit rates, widening the spread between. It shows that banks do not trust public borrowers and put high level of risk in the price of a loan.

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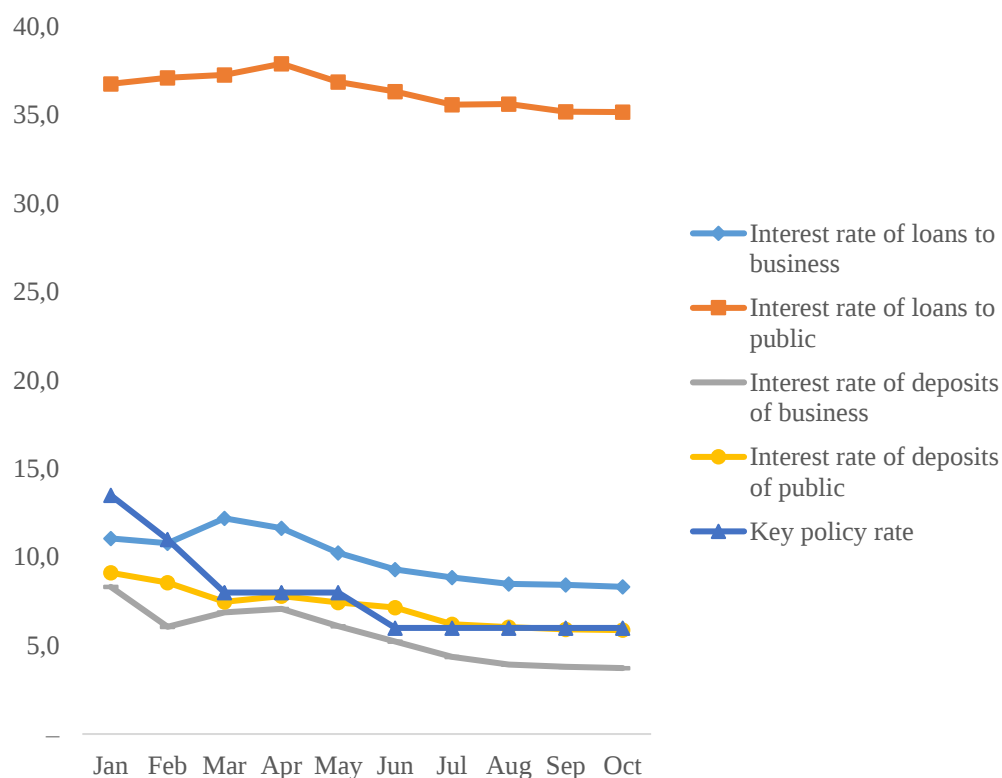


Fig.1 Dynamics of interest rates and a key policy rate in Ukraine in January-December 2020, %

Source: composed by the author on the basis of data from [145]

Although the economy slowed, only three months showed the deflation, and the monthly inflation rates in 2020 are roughly in the same trend as the numbers from the previous years, which can be seen on the Fig.2. That means that the NBU successfully performs its main function.

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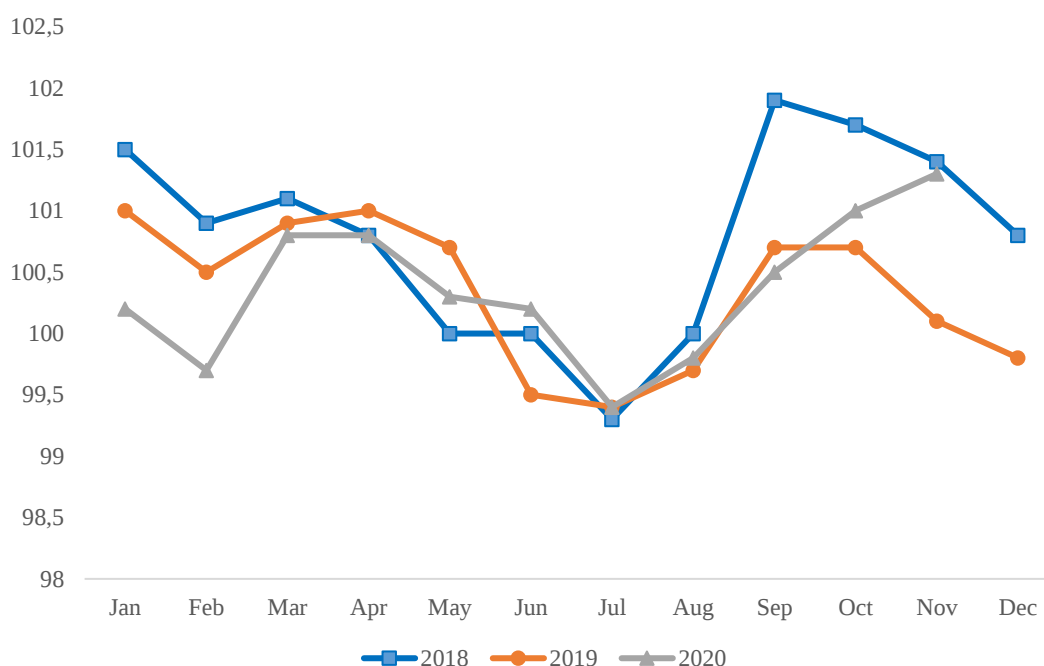


Fig.2 Monthly dynamics of the inflation rate in Ukraine in 2018-2020, %

Source: composed by the author on the basis of data from [146]

5.1.2 HOW COMMERCIAL BANKS REACTED TO THE PANDEMIC

To assess Ukrainian banks' adaptation to a new environment, the "Financial Club" resource had organized an online-discussion with representatives of various banks that work in Ukraine, which was held at 31th of October.

"For our financial organization the situation was rather stressful at the beginning of the quarantine, as from the employee's side and from the client's side," says Oleg Zayatz, the Head of the Individuals Department of Pravex bank. "We took certain measures, for example, we provided employees with laptops so they could work from home, bought safety equipment. We divided our branches into two personnel groups, but now the stressful situation is passed, employees have already adapted to that, and concerning clients, I can say, that they started to really appreciate the human conversation and personal contact with the staff. We were making calls to our clients, asked if everything was okay, if they needed any help with remote services, and there was a great positive effect, despite us living in the digital age. About the financial behavior, we see that Ukrainians unfortunately started to eat more, so we see higher expenses in grocery stores with cards. For the bank, this is good, this is interchange,

cashless and so on, but it is not good for health when people stay at home and eat more. As a bank that is aimed in its strategy for the middle-class clients, our products, cards, for example, were aimed at great propositions while paying abroad, so as soon as the borders closed, we felt a plunge in the commission revenues, which in turn couldn't have not influenced changes in our product range.”

Vladimir Maliy, board member and the Head of business development of Idea Bank, confirmed, that there was an initial period in April and May, when all services had a decline in clients, and the recovery started in July. He added that the whole market was moving online, in 2020 clients used the mobile banking apps 2 times more and the use of the traditional banking services increased by 50%. “That behavior is caused not so much by the quarantine, but due to the development of banking technologies. Talking about the quarantine, this dynamic of use of the banking services is there. We see that cash operations fell by 60% during the peak of the quarantine, which was related to government restrictions and to the fact that we too had to restrict the client-flow, they were waiting on the streets and so on. Right now we see the correction in the use of these services, and concerning the structure of cashier operations now, it is characteristic of one during the quarantine.” He also stated that the deposit clients are clearly moving to online. Before the quarantine, 20% of clients in Idea Bank were making deposits online and by July that figure was 50%. “About the credit clients; we are aimed at the mass segment, mass-plus segment, we see the decline of the demand, a drastic one. Clients are being more cautious about loans. Responsible loaners in this period wait and hold their wants and take fewer loans; the ones who take more loans are clients that go through financial difficulties.”

Andriy Prusov, Deputy Head of Forward-Bank, said, that the main shock at the beginning was concerning transportation and employees being unable to get to the branches, but now the bank is completely adapted to “the new reality” and staff works as effectively from home, as from the office. He also confirmed that the quarantine gave boost to certain digital trends. “We were going into this year with 50%, but now 90% of our clients make deposits through the Internet-bank... There are certain Internet channels of attracting clients, so the number of clients attracted in this year is 5 times

bigger. This is the new level; the attention to the Internet is on the new level.” Another trend that Prusov highlighted was the rising popularity of delivery services that could deliver banking products like credit cards. Clients are now ready to wait for loans, although previously those who required loans were usually requiring money as soon as possible, and that trend is considered a positive one.

Dmytro Zamotayev, the Head of the Retail Business Department of the Globus Bank, added to the discussion. “There is a new trend here. Banks understood that “Corona-crisis” became some sort of a catalyst for changes. If earlier banks used to open branches, organize food-courts for the new branches, ordered renovations of the branches for huge sums of money, now this is in the past. Everybody knows that there is no point in opening branches, on the contrary, banks compete in how many branches are closed. So all those resources that were usually spent on the branch-network and its maintenance are now sourced into online and maybe other invisible for clients changes, like the contact-center, better services, IT-specialists that sharpen services that are invisible for clients. That leads to the intuitively understandable mobile apps, game services (gamification is on the completely new level). Before we were always saying that gamification needs to grow, but there was always something more important to do at that time. Now we have time. To add to what my colleagues said about the clients, they started to react better and faster to online proposition. Earlier the launch of a new online service demanded long rollout, we had to remind clients of it, sometimes hold them by hands and show, what they could do to stop using branches. Now, as soon as people receive information about, for example, new service that does not require the visit to the bank, they are on board immediately. In a month in the current reality, we make results that in “the previous life” took us half a year of active involvement of clients in this process. To take example from our main bank, when this crisis started, we made an online repayment of the collateral-based credits for clients, and in one month, more than 20% of clients moved online. Yes, the bank took additional costs related to those payments, but we did not have to work hard to turn clients online. Before that, they were regularly visiting branches to pay, here as soon as we launched this service, 20% moved there immediately. Now this figure is even

bigger of course; regularly the third of clients work with the bank through the retail channel of repayment, but that is how it is now. Again, in the moment of this crisis, we saw a dynamic division of the client base. One part of the clients (in the card business, for example), market clients or clients that use elite cards, they are susceptible to online technologies, they primarily need service and a mobile app, and (again, in our bank) there is a cluster of “salary-clients”. Sure, they are not in leading positions concerning big organizations, but from the point of view of salary-clients, when there was a little lockdown, these clients were using cards and making payments. However, again, we see that from the middle of summer this dynamic went downwards and this cluster returned to its usual behavior, like using ATMs to get cash and using it as they see fit. So not every clients’ behavior was changed by this crisis”.

The last person to join the discussion was Viktor Kulik, the Head of the Retail Business Development of Alliance Bank, and he only confirmed that the quarantine helped to move online and shape preferences of the clients. “Our life has changed. The behavior model of the clients changed, their consumption model changed. They started demanding more remote channels, anyway we were focused on the digital development, the development of the remote channels of services, but the clients and the situation have stimulated us to make it a number one priority, and we have a couple of breakthroughs, and we see the growth in activity of our digital technologies with clients, we see the growth in activity even, for example, plastic business. Those clients, that got a deposit card, they wanted to retrieve it in half a year, in a year (depending on the terms), but when this whole situation happened they started to turn to us “Can I use that card for that operation? Does this card have a certain functionality?” and so on, so clients started to dive deeper into the “filling” of the card, even though it was just a regular card for getting a deposit when they were making a deposit. We see the growth in activity of cards that were used two-three times a week, now they have eight transactions a day, from small to big. Of course, our internal order changed in branches and head office as well. We, as I also heard from colleagues, moved the call-center online, it was harmless, and everything is good. We changed the working hours of branches; we have sanitation hours as our colleagues have. Masks, sensitization, and I

also want to highlight, that the learnability of a certain bunch of clients, so called “old school clients”, who still have push button phones, it has risen rapidly. They now have a smartphone, they get in and change their deposits in one click, they have a chat bot – they are now online. They are on the same page with us now and we can speak with them practically 24/7 from the call-center to other digital channels”. He also mentioned that clients are getting rid of cash and one of the reasons for that is that cash is not hygienic. [147]

It becomes clear, that the pandemic was not an obstacle for Ukrainian banks as much as it was an opportunity to test and implement online services and move clients in the digital space, something that they wanted to do. Branches became much less important for the banks, which presents a number of positive effects. Restructuration of resources and staff, popularization of online services, less expenses, easier growth and so on. There is a potential of the growth of cashless economy, which will further help to reorganize banks and branches. Clients as well became more into what happens with their money and their bank; they show more interest in the products, they are gladly moving into digital space. Clients that were not familiar or welcoming to new technologies and possibilities, the cluster, which is represented mainly with seniors, are getting more and more acquainted with recent developments. That experience and changes in people’s behavior due to quarantine are going to be a platform for the banks of Ukraine to become a lot more effective.

“We are changing our internal site. It will become more structured, more interactive, more sellable, there will be gamification elements and any client will be able to buy products, leave reviews, look through their bonus program, like it is a bank’s social page. So we are getting closer and closer to clients and they will be able to feel themselves like in the branch while sitting at home couch.” Viktor Kulik said.

To finish this particular topic Volodimir Maliy then mentioned, that while he agrees with the colleagues and with Viktor in particular, this is important to understand, that there will always be a category of clients preferring branches. “We should not think that bank branches will be irrelevant soon, I am sure that they will not lose their relevance.” [147]

5.1.3 ECONOMIC CONSEQUENCES OF THE PANDEMIC

Ukrainian banking system remained profitable in this year, having only two bad months. Analyzing financial results from various directions of the banking activity composed of every solvent Ukrainian bank and their influence on the net profit, it is prominent that interest and commission profits remain stable and the pandemic and quarantine measures did not have a significant effect on revenue and expenses in these particular branches. There are two main factors contributing to fall of profits in March and June: revaluation and results from purchase and sales operations and reserve deductions. Reserve deductions in March and in June, which are the months of added quarantine measures, are significantly higher compared to other months of the year. Results from revaluation and purchase-sale operations remain low since the plunge in June, putting the profit numbers lower than at the start of the year, which in turn caused the fall of ROA and ROC from 4.49% and 33.19% accordingly in May to 2.99% and 23.22% accordingly in October. [148] The dynamic of the profit of the banking system can be seen on the Fig.3:

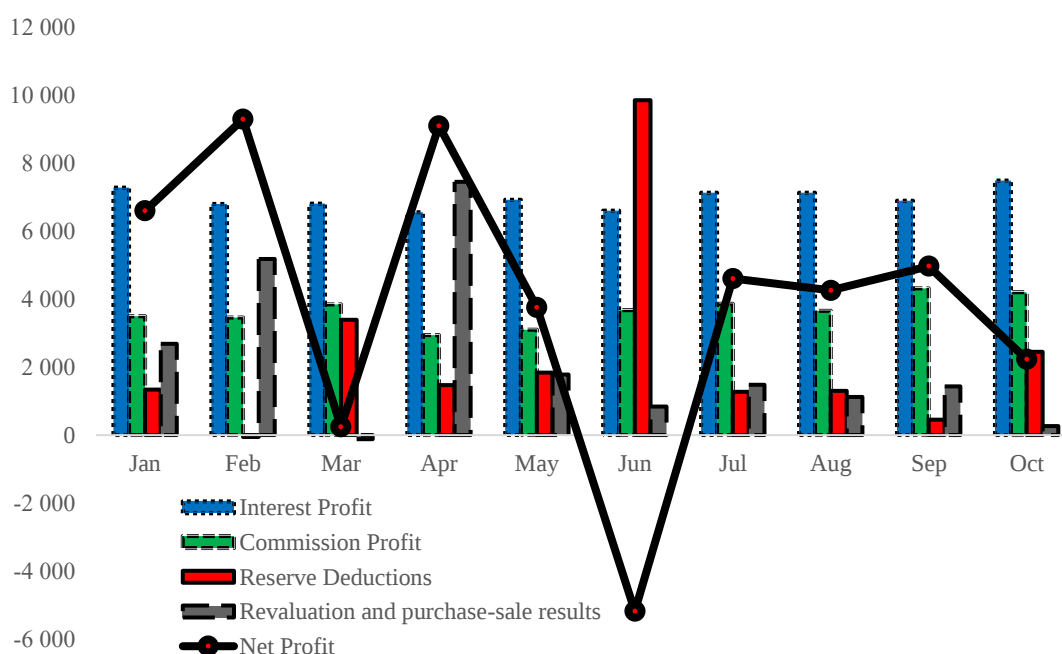


Fig.3 Monthly dynamics of the results from banking activity in Ukraine in 2020, million UAH

Source: composed by the author on the basis of data from [149]

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Due to Ukrainian banks acquiring assets in the first 7 months of year faster than equity, the financial leverage ratio fell under the theoretically acceptable minimum of 10%. Although the ratio has risen by 0.48 percent points by November, the ratio is still under the 10% mark according to Fig.4, which presents danger to the banking system and its ability to manage risk.

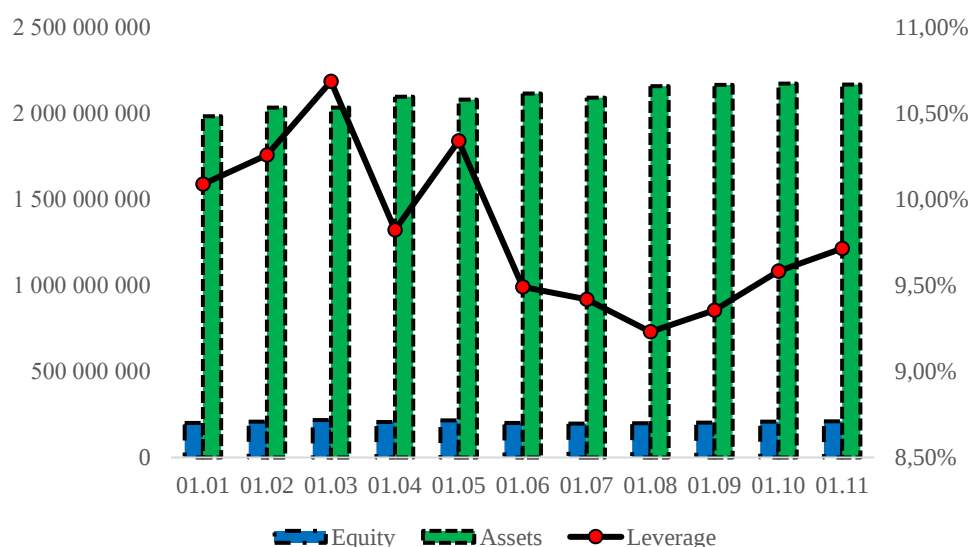


Fig.4 Monthly dynamics of the financial leverage in Ukraine in 2020, % and the dynamics of assets and equity in Ukraine in 2020, thousand UAH

Source: composed by the author on the basis of data from [150]

National Bank of Ukraine implements a set of economic prudential ratios («Нормативи»), which regulate the banking system from the points of equity sufficiency, liquidity, credit risks and investment operations. Of these four groups, the first three are interesting to us, so the following research will be conducted on them. In order to explain the meaning behind each one, we will use the Decree of the National Bank № 368 “On approval of the Instruction on the procedure for regulating the activities of banks in Ukraine” from 28.08.2001 [151]:

The first group contains ratios H1, H2 and H3.

According to Section I, Chapter 2,

“2.1. H1 is a minimum quantity of regulatory capital and should be higher than 200 ml UAH.”

The system and individual banks are successfully meeting the H1 ratio.

According to Section IV, Chapter1,

“1.1. The regulatory capital adequacy ratio reflects the ability of a bank to settle its liabilities arising from trade, credit or other monetary transactions in a timely manner and in full. The higher the value of the indicator of adequacy of regulatory capital, the greater the share of risk borne by the bank's owners; conversely, the lower the value of the indicator, the greater the share of risk assumed by creditors / depositors of the bank.

The Bank is prohibited from paying dividends or distributing the bank's capital in any form, if such payment or distribution will violate the regulatory capital adequacy ratio.

1.2. The regulatory capital adequacy ratio is set to prevent excessive transfer of credit risk by the bank and the risk of non-return of bank assets to creditors / depositors of the bank.

The regulatory capital adequacy ratio is defined as the ratio of regulatory capital to the total book value of assets and off-balance sheet liabilities, weighted by the certain ratios of credit risks.

According to the same Section, Chapter 2,

“1. H3, adequacy of the capital stock, is the ratio of capital stock to total assets and off-balance sheet obligations, weighted by the certain ratios of credit risks.”

Capital stock is the part of the regulatory capital and the formula varies only in the type of capital used, so H3 is closely linked to H2.

With the minimum requirements for H2 and H3 for 10% and 7% accordingly, the banking system is successfully meeting the H2 ratio and it shows little dynamic apart from the increase in June, due to the amount of regulatory capital increasing on 11% and additional reserve deductions.

Due to the capital stock being a part of the regulatory capital, the dynamic of the H3 ratio is similar to the H2, which is visible on the Fig.5.

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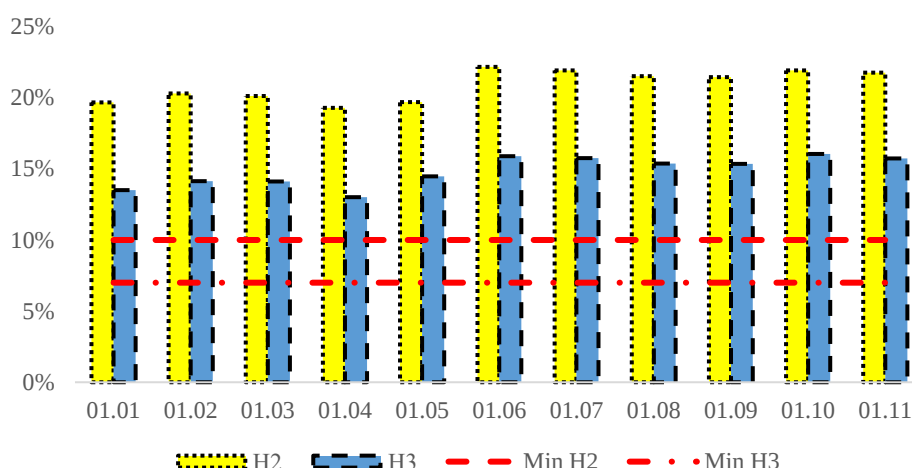


Fig.5 Monthly dynamics of the H2 and H3 ratios in 2020, %

Source: composed by the author on the basis of data from [152]

The next group is the liquidity ratios. According to Section V, Chapter 1,

“1.1. ...

Banking activity is influenced by the risk of liquidity – risk of inadequacy of cash flowing to cover the cash flowing out, which means the risk of a bank not being able to account for its obligations in time due to the impossibility of the fast conversion of financial assets into the payment instruments without significant expenses.

Due to that, banks should always control liquidity, keep it on the adequate level in order to fulfil all of their obligations accounting for their size, terms and the currency of payment, ensure the required ratio between own and borrowed funds, form an optimal structure of assets with the growth of proportion of high-quality assets with the positive level of the credit risk in order to fulfill the rightful demands of the depositors, loaners and every other client.

1.2. In order to control the liquidity state of banks the National Bank sets the following ratios of liquidity: short-term liquidity (H6), liquidity coverage ratio (LCR) for all currencies (LCR_{BB}) and for foreign currencies (LCR_{IB}), net stable financing ratio (NSFR).” It should be mentioned that NSFR is not being used yet.

Same section, chapter 2 states that

“1. The short-term liquidity ratio H6 is defined as a ratio of assets to obligations with a maturity of less than a year.

This ratio sets the minimum requirement in size of assets to cover obligations during one year.”

Next chapter:

“1. Liquidity coverage ratio (LCR) is a liquidity ratio that sets the minimum required level of liquidity to cover the net expected cash outflow within 30 calendar days, taking into account the stress scenario (hereinafter - the net expected cash outflow).

2. The Bank calculates the liquidity coverage ratio (LCR) on a daily basis as the ratio of high-quality liquid assets to the net expected cash outflow.

The Bank refers to high-quality liquid assets that meet the characteristics and requirements established by the National Bank.

4. The regulatory values of the liquidity coverage ratio (LCR) for all currencies (LCR_{BB}) and in foreign currency (LCR_{IB}) must be not less than:

80 percent for the liquidity coverage ratio (LCR) for all currencies (LCR_{BB}) and 50 percent for the liquidity coverage ratio (LCR) in foreign currency (LCR_{IB}), - starting from December 31, 2018;

90 percent - starting from June 1, 2019;

100 percent - starting from December 1, 2019.”

Although H6 ratio shows a little decline, it is only marginal as the ratio of the whole system varies between 89-96%, which is significantly higher than the minimum amount set at 60%.

It seems that the liquidity is not a problem for Ukrainian banks as the LCR standard is several times higher than the limit during the entirety of 11 months, and LCR for foreign currencies (LCR_{IB}) rises rapidly while already being incredibly high, and that is especially prominent on the Fig.6.

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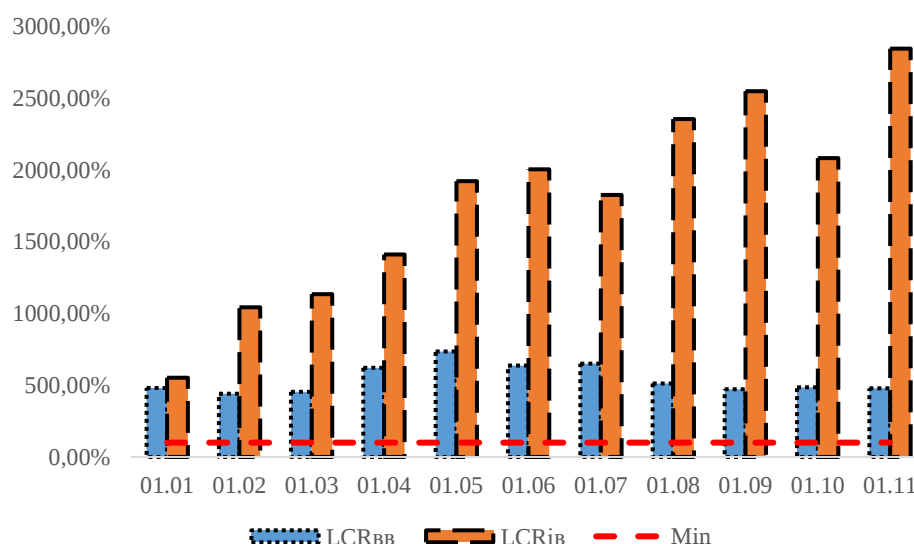


Fig.6 Monthly dynamics of the LCR ratios in 2020, %

Source: composed by the author on the basis of data from [152]

The third and the last set of ratios that interest us is the credit risk ratios.

According to the Section VI, Chapter 1,

“2. In order to reduce banking risks, the National Bank establishes credit risk standards, non-compliance with which may lead to financial difficulties in the bank's activities.

3. The Bank must have effective policies and procedures for timely detection, identification, monitoring, reporting, management and control of credit risk, taking into account the concentration risk, which meet the requirements of the regulations of the National Bank on the organization of risk management system.”

Same Section, Chapter 2,

“2.1. The ratio of the maximum amount of credit risk per counterparty (H7) is set in order to limit the credit risk arising from the failure of individual counterparties to meet their obligations.

2.2. The ratio of maximum credit risk per counterparty is defined as the ratio of the sum of all claims of the bank to the counterparty or group of related counterparties and all financial liabilities provided by the bank to the counterparty or group of related counterparties to the regulatory capital of the bank.”

The next chapter states:

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“3.1. The ratio of large credit risks (H8) is set in order to limit the concentration of credit risk for an individual counterparty or a group of related counterparties.

3.2. The credit risk assumed by a bank for one counterparty or group of related counterparties, all related parties, is considered high if the sum of all claims of the bank to the counterparty or group of related counterparties, all related parties and all financial liabilities provided by the bank to this counterparty or a group of related counterparties, all persons related to the bank, is 10 percent or more of the regulatory capital of the bank.

3.3. The ratio of large credit risks is defined as the ratio of the sum of all major credit risks to counterparties, groups of related counterparties, all persons related to the bank to the regulatory capital of the bank.

3.8 The regulatory value of the H8 ratio should not exceed 8 times the size of the bank's regulatory capital.”

H7 ratio remains stably lower than the maximum limit, not showing any negative tendencies, while H8 ratio is more than 8 times lower the maximum amount and is gradually falling towards the end of the year. This dynamic is shown on the Fig.7.

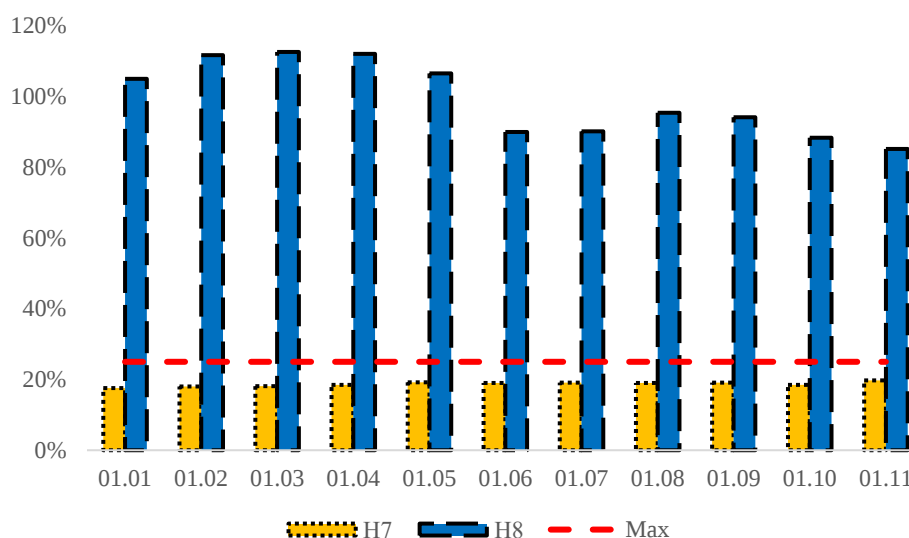


Fig.7 Monthly dynamics of the H7 and H8 ratios in 2020, %

Source: composed by the author on the basis of data from [152]

While the effect of the quarantine measures can be traced in the dynamic of economic ratios, it is so marginal that could be called insignificant. Although some

banks are having a harder time to meet the ratios than others, the banking system overall shows great economic discipline and keeps the high level of adequacy in equity, liquidity and credit risks.

Near the end of this unusual year, the NBU issued the Financial Stability Report, the main goal of which was to show how the regulator saw the effect of the pandemic on the banking system, and it states that the banking sector proved resilient to the crisis and shows signs of economic recovery:

“Financial sector successfully weathers through the COVID-19 crisis and appropriately performs all its functions. The banks faced the pandemics without noticeable imbalances, with sufficient capital and high liquidity. The work on cleansing and enhancing resilience of the banking sector launched in 2015 yielded evident positive results. For the first time on the record, banks have not become a driver of economic instability during this crisis. On the contrary, they support businesses and promote future economic recovery through lending...

Economy including the real sector recovers from the COVID-19 crisis. Although the growth rates of industries are uneven, corporate segment in general turned out to be resilient. Quality of banks' corporate portfolio did not deteriorate substantially. Conservative lending standards promoted borrowers' resilience. Timely restructurings and low proportion of exposures to vulnerable industries facilitated passing through the crisis without significant stresses.

Consumer lending decelerated considerably as the crisis unfolded; both demand and the supply decreased on this market. Over the second quarter, the segment saw a substantial increase in loans past due. Thus, some banks massively restructured unsecured consumer loans. The NBU believes that risks of the sector to banks are high. Therefore, it confirms its intention to increase risk weights for these bank loans to 150% over 2021.

Since September, financial system fully restored its financial intermediation function and gradually increases loan portfolio, with the fastest growth in lending to SMEs. Moreover, mortgage lending is on the rise since July. This is an unprecedented

phenomenon for Ukraine, given the depth of the crisis and remarkable uncertainty. The key driver of lending recovery is a substantial drop in the cost of loans.

In view of their sufficient capital and liquidity as well as ongoing decline in interest rates, the banks stand ready to further support businesses and households through loans, thus promoting economic recovery...

In the medium term, narrowing of interest rate spread is inevitable. Under maintained macroeconomic stability, rates on loans will fall further. At the same time, there is little space for decrease in deposit rates, which are already historically lowest for Ukrainian banking sector. Therefore, narrowing margins on lending is the key risk for banks over the next years...

Over the next two years, the National Bank will introduce several new requirements to bank capital. They all aim at removing certain gaps in regulation and to harmonize Ukrainian rules with the Basel Committee recommendations.

In 2021, the banks have to prepare for phasing in of requirements to capital to cover operating and market risks, thus completing the adoption of Pillar 1 Basel recommendations into Ukrainian legislation. Moreover, gradual introduction of increased risk weights for Ukrainian government securities denominated in foreign currency is to start next year. This requirement will remove the discrepancy between the banks' capital and amount of credit risk they assumed on their balance sheets." [153]

While rates of loans to business are low and are forecasted to fall further, as stated in the report, consumer lending has deteriorated in quality, and in addition to the NBU planning risk weighing increase for consumer loans past due, that will be a reason to leave the interest rates to consumers at least on the same high levels. That leaves the great burden on consumers interested in receiving a loan.

In addition to the NBU forecasting the main risks in the nearest future, banks were given a chance to express their expectations of the next year and what challenges may rise ahead. In the Bank Lending Survey for the fourth quarter of the year, respondents that were represented by banks' credit managers mentioned the following:

“Risks

FX risk was named as the key risk in Q3, with almost 40% of banks saying it had risen. FX risk was previously at such a high level only when quarantine restrictions were imposed and during the 2014 crisis. Only a third of banks indicated an increase in credit risk. Interest rate risk and liquidity risk decreased, according to banks. Banks expect an increase in FX risk in the next quarter. Expectations that other risks materialize were moderate.” [154]

As we can see, the managers of commercial banks do not mention the risk of the narrowing credit spread a key risk, unlike the FX risk, which is influenced by politics and the NBU interventions. That shows that commercial banks, given the past dynamics on the FX market, are not entirely sure, that the regulator and the government will be able to sustain the stability of the national currency.

5.1.4 CONCLUSIONS

The pandemic certainly has not faltered the development of the banking system of Ukraine. It is obvious that the banking system faced the crisis better than it could have. The central bank of the country successfully performs its main functions keeping the inflation rate down and supporting the banking sector in various ways, as well as businesses through the key policy rate, less so households. Commercial banks used the specific nature of the pandemic for their own benefit, boosting desired digital trends while the client base was transforming into a more technologically conscious one. Furthermore, the banks showed moderate profits this year. Economic ratios set by a regulator are met by the system in full, showing that banks remain stable and resistant to negative effects. The regulator and commercial banks are regularly bettering their forecasts with each period. The banking system and the economy still faces numerous risks. Strengthening of the pandemic, FX panic, worsening of relations with IMF and other political tensions characteristic for Ukraine pose threat to the banking system. As most of the key risks are not economical and are out of the control for commercial banks, they should prepare in advance to mitigate the possible negative effects, while the National Bank of Ukraine should form its policy and consult the government in the way that will reduce the threat of economic risks.