Summary

In 2024, macroeconomic conditions were favorable for operations of the financial institutions. They managed to ensure that payments and transfers were made properly, and that households and businesses had secure and uninterrupted access to their savings. They were also able to provide increased financing to the economy to overcome the fallout of the war. The liquidity, solvency, and operational resilience of the banking system do not raise any concerns. The war remains the key risk to financial stability. While it does not pose immediate challenges to the banks and non-bank financial institutions, it significantly increases their operating costs and restrains their risk appetite for developing certain business lines.

Economic growth continues, although its pace has been volatile in recent months. Domestic demand remains the main driver of the recovery, with growth also supported by the government's capital expenditures on defense, and by stable functioning of logistical export routes. The effects of these factors are expected to continue into the next year. Energy terror of russia restrained companies' activity in Q4, but did not stop the growth in their production and revenues. The restoration of energy infrastructure will increase the potential for economic growth next year. At the same time, the Ukrainian economy continues to be subject to structural war-induced vulnerabilities. The state budget deficit and public and gross external debt remain high. A significant foreign trade deficit persists due to a steady increase in demand for imports and a slow recovery in export capacity. Pressure on the FX market is rising, although the liberalization measures taken so far have had a rather limited impact on the demand for foreign currency. Steady inflows of international assistance ensure there are regular influxes of capital, which mitigate these risks. The NBU's stock of international reserves allows it to guarantee stable FX market operations and to smooth out excessive exchange rate fluctuations.

At the end of the year, inflation accelerated, exceeding the NBU's forecast. This was primarily driven by higher food prices due to weak harvests, as well as a certain increase in electricity costs, higher labor costs, and the hryvnia's depreciation over the course of the year. Inflationary pressures will ease in the middle of next year as new crops come to market. In December, the NBU raised its key policy rate by 0.5 pp, to 13.5%, in order to prevent the unanchoring of inflation expectations. The tightening of monetary conditions will halt the decline in commercial bank rates that has been going on for more than a year.

The banks continue to rely on client deposits as their core funding. After a spell of seasonal volatility, retail and corporate deposits with the banks are growing. This maintains a significant level of liquidity in the banking sector: the banks meet short- and long-term liquidity ratios with a considerable margin to spare. In the autumn, the NBU increased its reserve requirements, which somewhat reduced the stock of banks' unbound liquidity. As the banks, especially the state-owned ones, invested more actively in domestic government debt securities, the share of certificates of deposit in their high-quality liquid assets shrank. Such a change in the composition of liquid assets will require the banks to manage liquidity more actively, so they may be expected to offer more attractive terms to attract client deposits. At the same time, the banks' liquidity is now favorable for further increasing investments in domestic government debt securities and lending.

Lending continues to be active across all segments, driven by stronger demand. In the lending survey, the banks reported an increase in clients' demand for credit, and estimates of corporate loan demand were at their highest since the end of 2021. The net hryvnia portfolio of corporate loans grew by more than 20% over the year, and that of retail loans by more than 30%.

Corporate loan portfolios are growing at banks of all groups, and across companies of all sizes. Financial institutions are actively financing enterprises in the largest industries – agriculture, trade, and industry – thus contributing to their growth. A memorandum signed by the banks in the summer facilitated the financing of energy sector recovery on favorable terms. The step-by-step implementation of the *Lending Development Strategy* is closing existing gaps in the market to facilitate access to credit. The banks are competing for corporate clients, which is reflected in the easing of lending standards. The financial standing of companies allows the banks to expand their portfolios by lending to stable and solvent clients. Even those that use benefits are mostly able to service their debts on market terms. Accordingly, the quality of the corporate loan portfolio is very good, with default rates at the level of 2021.

In the segment of unsecured retail lending, competition is even stronger than in corporate lending. An increasing number of banks are actively trying to strengthen their role in lending to households. Therefore, the market share of the leading banks has slightly decreased over the past six months. Despite the growth in loans, their penetration rate remains quite low relative to GDP and household income. This indicates that there is significant room for portfolio expansion. Mortgage lending is active, but is the least stable of all of the segments. Its volumes are determined by the dynamics of the government's *eOselia* program, which dominates the market and leaves little room for the development of market-driven mortgages. Recently, attempts have been made to redirect this program to the primary market, but its financial resources are limited. As a result, lending slowed at the end of the year.

Reform of the program *Affordable Loans 5–7–9%* is slow, and it is still lacks focus on the clients who need it most. This resulted in a significant increase in the debt on interest compensation to the banks at the end of the year. Funding under the program will also be complicated by the requirements for the banks to comply with environmental and social standards, which will require additional expertise from the banks and their clients. Activity under the program is expected to decline. The role of government support in corporate lending is further weakening, with the share of subsidized loans in the corporate loan portfolio falling back to one third again. Market-term unsubsidized loans and the banks' access to credit risk sharing instruments will ensure the continuity of corporate financing. Further on, the design of government support programs should ensure that market mechanisms dominate, in particular in determining interest rates, and that they target only those borrowers who need them. This applies to both the *Affordable Loans 5–7–9%* program and the *eOselia* program. The development strategies for these programs and for the activities of the managing institutions should be updated to reflect market needs. At the same time, guarantees to cover credit risk are playing an increasingly important role in the resumption of corporate lending. For example, guarantees from both the Ukrainian government and international financial institutions are becoming more accessible.

The prolonged decline in interest rates prompted the banks to manage their assets more actively. As a result, the banks were largely able to maintain asset yields, while their funding costs declined slightly. As a result, the banks' net interest margins remained very high. Thanks to the continued high profitability of core operations, as well as an increase in fee and commission income, the banks can sustain higher administrative costs without losing efficiency. Given the high quality of their portfolios, the banks are incurring almost no provisioning expenses. As a result, their profitability remains strong, and this allows them to maintain a high level of capital. A recent second increase in the income tax rate, to 50%, which will apply to the profits for the whole of 2024, was a significant unfavorable factor for the banks' profitability. The practice of retroactive tax changes considerably complicates capital planning for the banks and, for some, reduces lending opportunities.

The key regulatory novelty of the last six months is the banks' transition to a new three-tier regulatory capital structure. The banks also started to take into account all three key risks in full – credit, market, and operational one – when calculating their capital. In addition, financial institutions obtained the first results of their own capital adequacy assessment under the ICAAP. Taken together, this contributed to significant progress e in bringing domestic banking regulations into line with EU acquis. This work will continue going forward.

Non-bank financial institutions will transform further under the influence of updated regulatory requirements. In many areas, the work has only just begun, and market players still have a long way to go to adapt to the new legislation and prudential requirements. The number of market participants has declined significantly in recent years, but this has not led to a narrowing of access to financial services. The assets of the non-bank financial sector are growing, as is its resilience to adverse events. This will continue to boost confidence in non-bank financial services and promote market development.