

IMPACT OF WAR ON THE FINANCIAL SYSTEM OF UKRAINE

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The article examines the impact of the war on the financial system of Ukraine, systematizes the mechanisms of manifestation of this impact. The features of the impact of war on the economy in domestic conditions are revealed. The continuation of the war exacerbates most of the risks. The largest one, credit risk, is already being realized and the losses from it will grow in the future. Financial institutions are gradually recognizing credit losses and reflecting the impact of negative events on asset quality. Limited demand for loans, especially from households, worsening portfolio quality, and higher provisioning increases profitability risks.

The dynamics of the ratio of the volume of loans, bank deposits and other indicators of the financial system of Ukraine was analyzed. The role of bank lending in combating the consequences of military aggression is revealed, and measures aimed at mitigating its negative impact on the economy are substantiated.

An analysis of the dynamics of indicators of non-banking financial institutions was also made. Unlike banks, part of the market did not cope with operational risks: financial institutions stopped working, processes were disrupted, and information was lost. The volume of transactions of non-banking financial institutions has significantly decreased. Demand for insurance and lending has fallen, the quality of the loan portfolio of credit unions and financial companies is deteriorating.

Measures aimed at improving the state of the financial system of Ukraine are substantiated.

Keywords: financial system, war, banking, loans, deposits, non-bank financial institutions.

Introduction

The increased geopolitical risk associated with the war in Ukraine affects the financial stability of the financial system of Ukraine both directly and indirectly. The mechanism, strength and horizon of influence of these factors on the financial system are diverse and complex, which, in our opinion, can be grouped into four groups: external environment, macro environment, microenvironment and households. The consequences of the influence of the third and fourth groups of factors partially materialized in the first weeks of the armed conflict in Ukraine. They are mainly related to the exposure of Ukrainian banks, enterprises and households to assets in the war-torn territory and counterparties in Russia and Belarus, as well as to an increase in market risk caused by increased volatility and an increase in the risk premium.

External Environment

Russia's invasion of Ukraine led to an escalation of geopolitical tensions and a series of unprecedented sanctions imposed by the EU, the USA and other countries on Russia and Belarus. As a result, the consequences of the Russian attack on Ukraine affected the entire world economy, especially Europe due to a noticeable slowdown in production and subsequent acceleration of inflation.

The war led to heightened tensions in financial markets, an unprecedented rise in commodity prices, and uncertainty in the economy, manifested by slowing economic growth and rising inflation. According to the latest report on financial stability, which is regularly published by the National Bank of Ukraine (NBU), growing uncertainty regarding the volume, scale and duration of disruptions in the functioning of the world economy caused by the armed aggression of the Russian Federation against Ukraine is the main external factor affecting the functioning of the Ukrainian financial system.

Immediately after the invasion of the Russian Federation, our partner countries began to provide military, financial and humanitarian support to Ukraine. At the same time, with their sanctions, they restrain the economic potential of the Russian Federation.

As of the beginning of May 2022, according to the Institute of World Economy, the total amount of weapons and military goods provided and agreed to be sent to Ukraine amounted to about 30 billion USD. Up to a third are non-refundable grants, the rest are low-interest loans and credit guarantees. The amounts of loans from the IMF, the EU, the EIB, the World Bank, and foreign governments since the beginning of the war exceeded 7 billion USD by mid-June. It is planned to introduce a "holiday" for Ukraine to pay its foreign debt because Ukraine has a monthly budget deficit of about 5 billion USD.

Macroeconomic factors

As a result of the armed aggression of the Russian Federation against Ukraine, there was a significant deterioration of the domestic economy. According to the NBU, the loss of GDP in 2022 will amount to at least a third. Production in the regions where hostilities are ongoing temporarily almost stopped and consumption fell sharply in almost all regions. According to NBU surveys, the share of enterprises that reduced the utilization of production capacities by more than a third or did not work at all decreased from 61% in the first decade of March to 54% at the end of May 2022.

In addition, according to NBU estimates, losses of physical capital from the destruction of enterprises, housing and infrastructure reached 100 billion dollars USA by the beginning of May 2022, which is equal to 50% of GDP in 2021. Losses of human capital due to the death of citizens and migration are very large.

The aggression of the Russian Federation led to a significant decrease in exports due to the destruction of transport and production infrastructure facilities and blocked Black Sea ports, which reduced foreign exchange earnings.

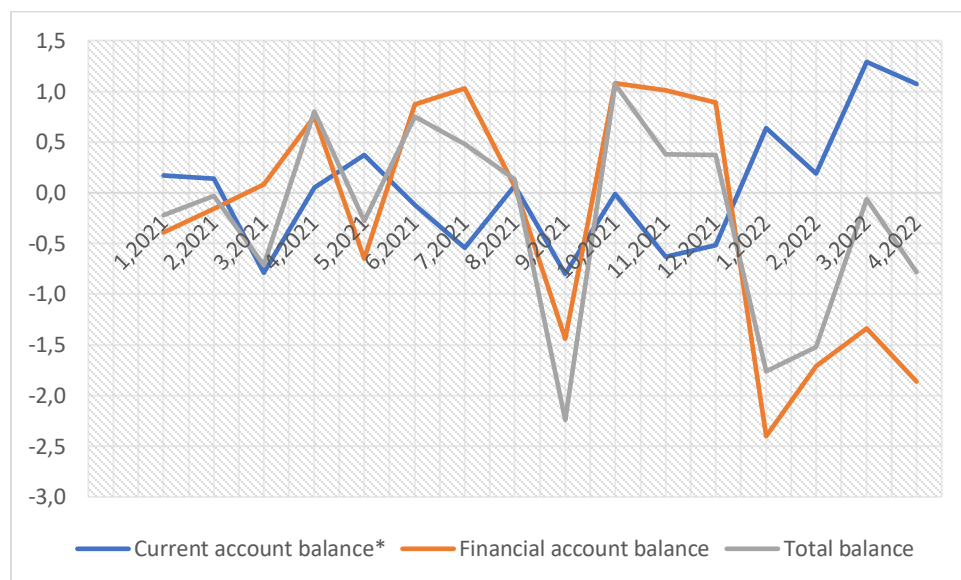


Fig.1 Monthly balance of payments of Ukraine in 2021–2022, USD billions

Source: National Bank of Ukraine.

At the same time, imports decreased due to disruption of logistics routes, narrowing of domestic demand, restrictions on the purchase of foreign currency to pay for non-critical imports. However, the volume of import of services increased due to the spending of funds by forced migrants (residents of Ukraine) abroad. In addition, inflows of remittances in foreign currency from residents of Ukraine remained stable. According to the NBU, the current account surplus for January–April 2022 previously amounted to \$3.2 billion USD.

In February 2022, the NBU fixed the exchange rate of the hryvnia against the US dollar in order to stop a possible uncontrolled devaluation. The NBU was forced to sell significant amounts of currency on the market.

With the beginning of the armed aggression of the Russian Federation, inflation in Ukraine increased significantly. Moreover, it behaved heterogeneously by product groups and regions. The factors of price growth were the increase in production costs, primarily due to the increase in the price of energy sources, the destruction of production and storage facilities, and the disruption of supply chains. In May 2022, inflation in Ukraine accelerated to 18.0% in annual terms.

At the beginning of June 2022, the NBU increased the interest rate by 2.5 times from 10% to 25% per annum in order to ease pressure on the foreign exchange market and stabilize inflationary expectations.

Households

The war led to an increase in security threats to households, mass migration, and partial or total loss of employment. Real incomes of households have fallen, their demand for loans has sharply decreased, and the debt burden will grow. Household savings are kept in liquid assets, the attractiveness of currency funds has increased. In May 2022, Info Sapiens conducted a survey, according to the results of which Ukrainian households estimated that their well-being had fallen by a third since the beginning of the war.

From the beginning of the full-scale war (February 24, 2022) to mid-June 2022, according to the UN, approximately five million more people left Ukraine than returned. Most of forced migrants found shelter in EU countries, about two-thirds of them received temporary protection. At the end of May 2022, the International Organization for Migration (IOM) estimated that more than seven million people were internally displaced, but about two million internally displaced persons had returned to their homes. According to a survey by Gradus Research, a third of Ukrainians who are currently abroad do not plan to return home. Almost half of the foreign migrants of working age were previously employed, and two-thirds have higher education.

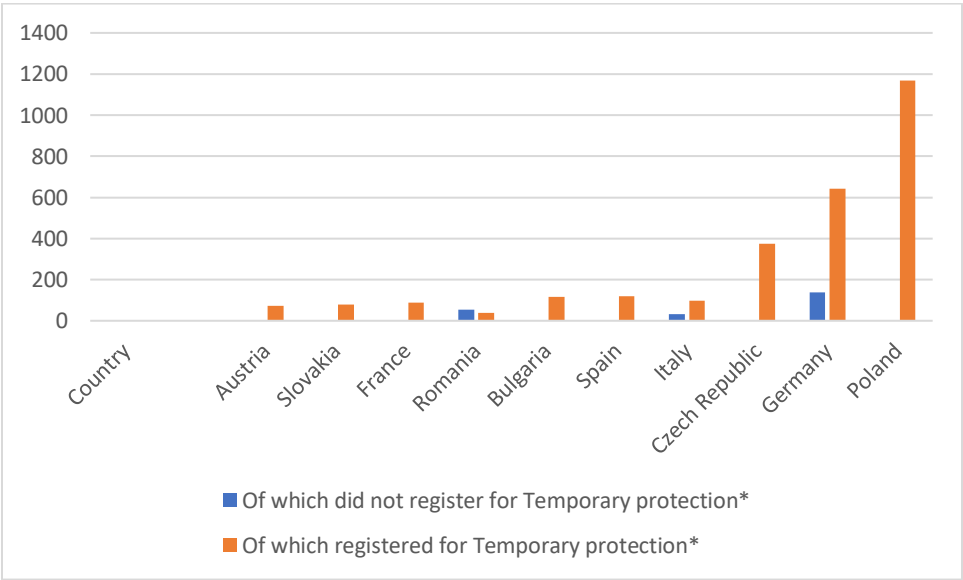


Fig. 2 Number of displaced persons from Ukraine in countries that accepted the largest number of Ukrainians, as of 17 June 2022, thousands of persons.

Source: The Office of the United Nations High Commissioner for Refugees.

Microenvironment

The decline in economic activity since the beginning of the full-scale war has led to a drop in demand for loans from most businesses. However, at the same time, the demand for loans from enterprises of the defense industry, critical infrastructure and agriculture for the sowing campaign increased. According to the NBU, in order to maintain lending, banks provided significant amounts of loans within the State program "Affordable loans 5-7-9%" in April-May. Due to the growth of the loan portfolio, the government almost quadrupled the funding of the program.

At the same time, banks experience large losses from credit risk. According to the NBU, the share of defaulting companies will exceed 20%.

The retail loan portfolio is also shrinking. According to NBU data, for March - May 2022, the net portfolio of loans to households decreased by 10.3%. Real estate lending has almost stopped (see Fig. 3).

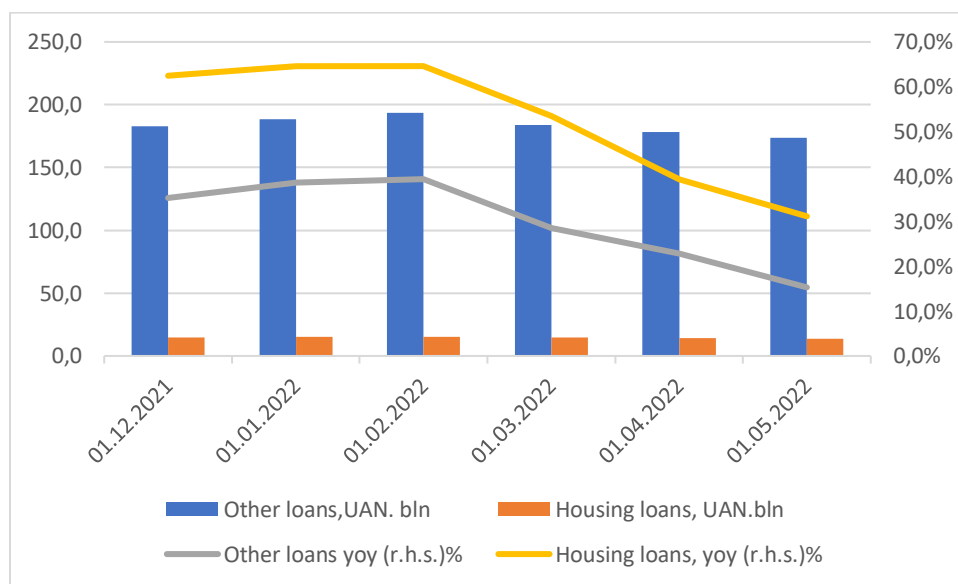


Fig. 3 Net hryvnia retail loans to households of Ukraine, UAH billion

Source: National Bank of Ukraine, for solvent banks as of 10 June 2022.

The war had a negative impact on the operational activities of banks. According to the National Bank of Ukraine, as of the beginning of May 2022, 51 banks reported losses from the war related to their operational activities, which were estimated at approximately UAH 6.6 billion. Many bank branches, investment real estate and other bank property remained in the war-torn territory. According to the NBU, at the beginning

of May 2022, the value of real estate of banks in these territories exceeded UAH 700 million. Banks estimated the total losses at 154 million UAH, of which 33 million UAH – in the territories where hostilities are taking place, or which are occupied.

In January-September 2022, insurance companies of Ukraine collected UAH 28.4 billion in insurance premiums and made insurance payments of UAH 9.5 billion, which is 25.4% and 29.3% less than in the same period last year, respectively.

More than 40% of insurance premiums traditionally go to car insurance. During the period of military aggression, the share of these types of insurance in the portfolio increased. The "Green Card" became the driver of insurance business support. During the war, this type of insurance increased by 76% compared to the same period last year.

Conclusions

The financial system of Ukraine withstood the first blows of the war. The system of electronic payments and transfers works smoothly. The liquidity of banks has only increased since the beginning of the war, hryvnia deposits of households have also increased, and the demand for cash has fallen. Financial institutions paid special attention to resistance to cyber-attacks. Such actions strengthen clients' trust in financial institutions and reduce liquidity risks. Ukrainians kept their trust in the banking system, and fears about outflows of funds did not materialize, on the contrary, an increase was observed. At the same time, losses incurred by banks negatively affect their profitability and capital. As stipulated by international standards, the requirement to maintain capital for operational risks will remain.

The insurance market works. The war became a catalyst that showed the real situation of each insurer. Financially stable companies continue their activities and are tested by war.

In order to ensure the financial stability of banks in the extremely difficult conditions of wartime, it is necessary to take into account both the situation in the external environment and the macro and microenvironment, as well as the behavior of households.