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Russian Banking Sector Metrics

	2014	2015	Mar 2016
Assets, RUB tn	77,6	78,1	81,1
Loans, RUB tn	37,4	44,4	50,1
ROA, %	0,9	0,3	0,4
ROE, %	7,9	2,3	3,4
CAR, %	12,5	12,7	12,4
NPL, % loan portfolio	6,7	8,3	9,2

Source: RAEX Europe based on data from IMF and CBR

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1. INTRODUCTION

The Russian banking sector is highly concentrated on a few large national banks. The top six largest banks[1] accounted for 69% of total assets and 83% of total loans to customers in 2015. The rest of the market is distributed among smaller banks, most of which operate at a regional level. Even though the high amount of small and regionally-important banks remains significant, the Central Bank of Russia (CBR) has been implementing measures which contributed to further consolidation of the banking sector.

Driven by the lack of banking supervision, ease to obtain bank's licenses and low financing opportunities in the market after the collapse of the USSR, the number of commercial banks increased sharply in the early 1990's, up to 2 700 banks in 1995. However, in 2013 a new chapter in the Russian banking system began after Elvira Nabiullina was appointed head of the CBR. Under her administration banking regulation became stricter as a number of bank licenses were withdrawn and resolution processes took place in many commercial banks.

Currently, the Russian banking system is comprised of more than 600 banks with the three largest banks (Sberbank, VTB and Gazprombank) amounting to 60% of total assets and 71% of total loans as of 2015. This concentration has become stronger through time, as these three banks accounted for 53% of assets and 64% of loans in 2012.

The sharp decline in oil prices, combined with western sanctions and Russian counter-sanctions following the Russia-Ukraine conflict, had a negative impact on the Russian economy and banking sector in recent years (see graph 1). Since 2014, the industry showed a weak performance,

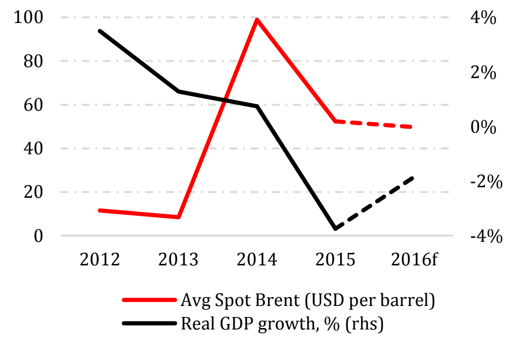
[1] As of 2015 the top six Russian Banks according to assets were Sberbank, VTB Bank, Gazprombank, Otkritie, Russian Agricultural Bank and Alfa Bank.

with profit indicators narrowing and non-performing loans (NPLs) increasing.

In order to prevent a downfall in the country's financial system, the CBR introduced forbearance measures to offset financial market stress on banks' balance sheets and implemented a number of regulatory changes in the banking regulation. Also, many banks (mainly major state-owned) were heavily capitalized through the Deposit Insurance Agency (DIA).

Even though the CBR announced a number of new regulatory changes which range from stringent controls on off-shore holdings to stronger stress tests, the banking sector remains exposed to a number of risks which could damage the industry if they materialize.

Graph 1: Real GDP growth vs. Average Brent oil price



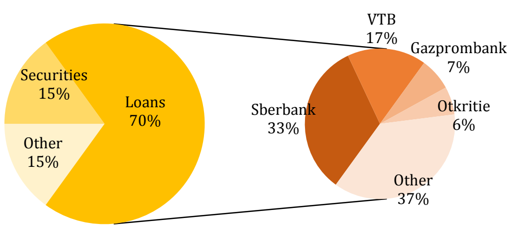
Source: RAEX (Europe) calculations based on data from the IMF and EIA

2. INDUSTRY STRUCTURE AND PERFORMANCE

Russia's financial market is mainly dominated by the banking sector, whose assets and credit to the private sector amounted to 103% and 57% of GDP in 2015. The Russian banking sector is strongly concentrated and state-owned banks are, by far, the most important players in the industry. State-owned commercial banks account for more than half of banks' assets. Sberbank and VTB group together accounted for 46,3% of total assets as of May 2016.

The business model of Russian banks is mainly based on traditional credit intermediation as loans equal 70% of banks' assets (see graph 2), followed by corporate and government securities and interbank lending. Banks are mostly funded by deposits of non-financial corporations and individuals, while funding from capital markets is still very limited.

Graph 2: Structure of the Banking sector

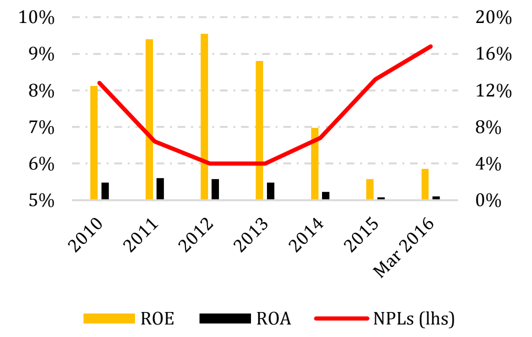


Source: RAEX (Europe) calculations based on data from the IMF

According to an IMF classification, Russian banks can be grouped into three tiers depending on their access to the interbank market, rating and exposure to risks. The first group is comprised of large banks with high credit ratings and therefore low funding costs, which rely mainly on the FX swap market for wholesale ruble liquidity and which have access to both secured and unsecured interbank markets. The second group is characterized by mid-sized banks which heavily depend on CBR facilities for funding as they have no access to unsecured interbank markets. The third tier is dominated by small banks with low credit ratings, little or no access to interbank markets and often non-transparent ownership structures and lending practices.

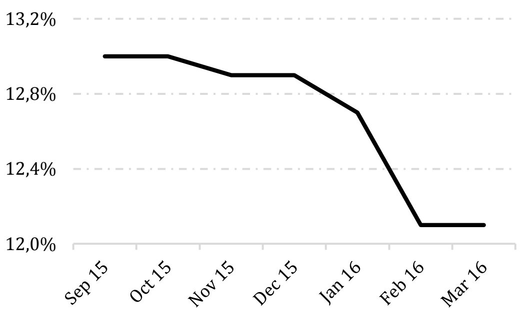
Over the last two years there was an accelerated deterioration of credit risk among Russian banks, with NPLs at 9,2% in 1Q 2016 from 6% in 2013 (see graph 3). This was the result of a number of internal and external factors which translated in lower internal demand, higher prices and

Graph 3: NPLs vs ROA and ROE



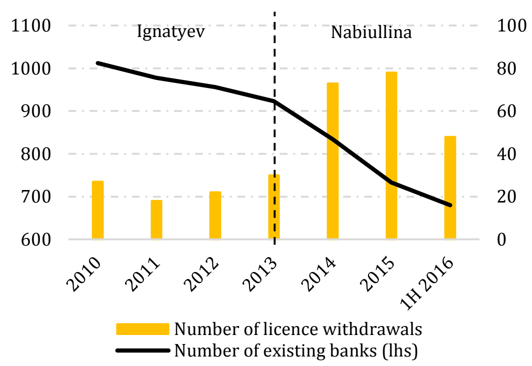
Source: RAEX (Europe) calculations based on data from the IMF

Graph 4: Average Capital Adequacy Ratio (N1.0)



Source: RAEX (Europe) calculations based on data from the CBR

Graph 5: Bank license revocations in Russia



Source: RAEX (Europe) calculations based on data from the CBR

negative economic growth. However, as a result of loans roll-over and regulatory forbearance, overall NPLs were stable during 2H 2015.

Despite profitability ratios of banks increasing slightly in 1Q 2016, they remained negligible as shown by ROA and ROE, that stood at 0,4% and 3,4% by end-March 2016. These low figures, similar to those observed during the 2008 financial crisis, can be explained by different factors. While net interest margins declined as a consequence of slower asset growth and higher policy rates, net fees and commissions reduced in line with net interest income. Additionally, non-interest expenses declined at a slower pace than net interest income and provisions have risen following the deterioration of the loan portfolio.

The capital adequacy ratio (CAR) of banks was stable in 2015 at about 13% helped by capital injections and regulatory forbearance. However, CAR declined to around 12% after forbearance was reduced in early 2016 (see graph 4).

3. BANK RESOLUTIONS AND LICENCE WITHDRAWALS

A stricter banking policy and control aimed at improving the quality of the banking system was enforced since Elvira Nabiullina became head of the CBR in 2013. This resulted in an increase of banks' license revocations and open bank resolution processes (see graph 5).

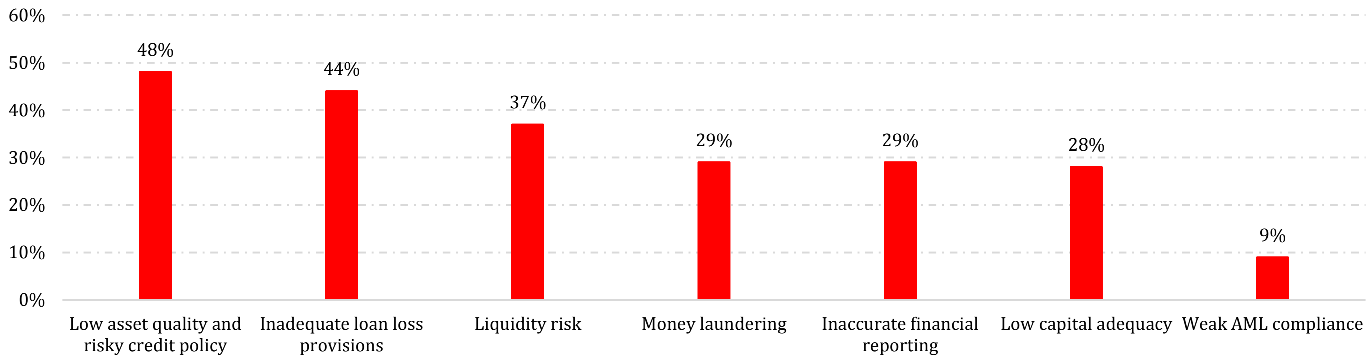
The CBR is the only authority responsible for determining which bank shall enter into resolution as well as for choosing the resolution method to be used. Under the resolution framework implemented so far, the CBR can carry out an open bank resolution or a purchase and assumption[2] (P&A) transaction with the participation of DIA in systemic cases, rather than liquidating a troubled bank. In addition, the CBR applies regulatory forbearance to the bailed-out banks.

DIA has been involved in the operational part of the bank resolution procedure by providing funds to the failed bank either through the Deposit Insurance Fund (DIF) or through its own accounts, funded by the CBR loans or the government. Non-systemic banks are generally liquidated and DIA conducts insured deposit payouts.

Between January 2014 and end-July 2016, the CBR has revoked a total of 214 licenses and 28 banks were put into open bank resolution using public funds amounting to 1,1% of GDP. The reasons of license revocation range from data misreporting and breach of capital requirements to money laundering schemes and weak anti money laundering (AML) compliance (see graph 6).

[2] A P&A is a transaction in which a healthy bank purchases assets and assumes liabilities from an unhealthy bank.

Graph 6: Reasons of license withdrawal between Jan 2010 - Oct 2015



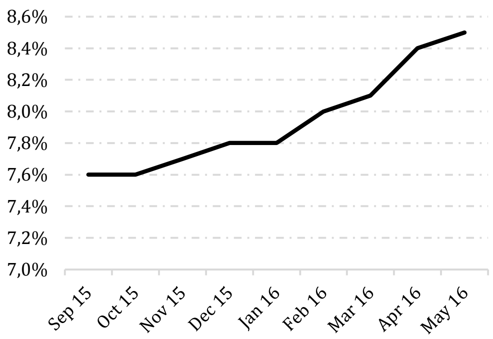
Source: RAEX (Europe) calculations based on data from the CBR

4. INDUSTRY RISKS

The Russian banking sector is heavily exposed to changes in the external and internal position of the country. While currently stable, the banking system is exposed to potential developments which introduce risks to the industry. Even without further economic slump and uncertainty in the country's economic performance, there could be significant risk materializations and credit losses.

The stricter CBR inspection on banks since early 2013 has unveiled a number of bank violations, which range from overvaluation of collateral to misreported financial information. This has introduced additional risks in the loan portfolio of banks, as loan loss provisions have recently increased slightly (see graph 7) and could be insufficient if NPLs are potentially higher than reported. If this materializes, the banking system could face a situation of under-provisioned and under-collateralized portfolios.

Graph 7: Loan loss provisions, % of total loans

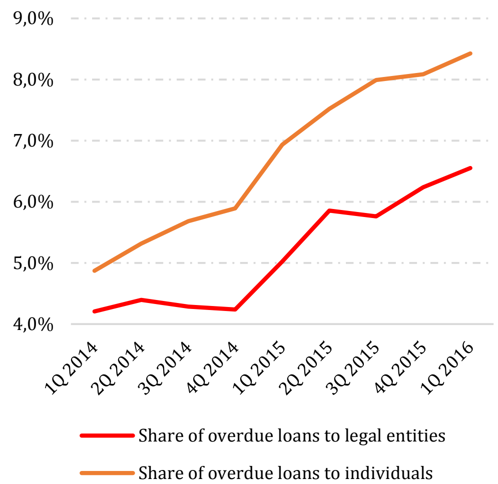


Source: RAEX (Europe) calculations based on data from the CBR

Partly as a consequence of unsecured consumer lending, NPLs in the banking retail sector sharply increased from 4,9% in 1Q 2014 to 8,4% in 1Q 2016. Additionally overdue loans in the corporate sector have been also increasing since 4Q 2015 (see graph 8). The construction and real estate sectors are bearing the highest exposure as contracts in these industries are mainly denominated in foreign currency and were not rolled over when the RUB depreciated during 2014-2015 (see graph 9). Also, as a result of low domestic demand and declining government spending, the mining, trade and agricultural sector are facing increasing credit risks.

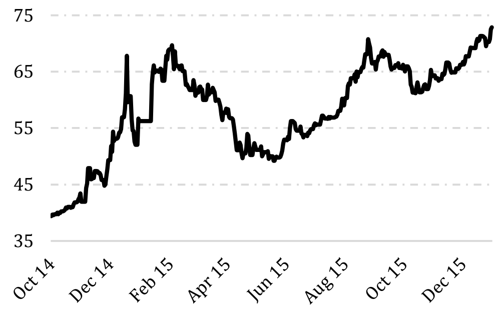
Even though the banking system as a whole does not bear liquidity risks, selective small banks could still be exposed to liquidity shocks. As described by the IMF classification, larger banks are generally highly rated and therefore have access to low cost funding from secured or unsecured

Graph 8: Share of overdue loans



Source: RAEX (Europe) calculations based on data from the CBR

Graph 9: USD/RUB



Source: RAEX (Europe) calculations based on data from the CBR

interbank operations. In contrast, low-rated small and medium banks rely on higher yielding collateral, short-term secured markets and CBR facilities to obtain funding. Ultimately, this makes them more exposed to the liquidity risks than larger banks.

5. REGULATORY CHANGES

A series of regulatory changes have been introduced in order to mitigate the contagion in the banking sector and reduce the share of “suspicious” banking transactions.

As of January 2016 the capital adequacy regulation tightened as the risk-weighted assets (RWA) calculation became stricter. Weights were increased for sovereign and regional bonds, claims to CBR, natural monopolies, among others. Despite the reduction of the minimum required levels of capital adequacy ratio (N.1.0) from 10% to 8% and Common equity tier 1 (CET 1) ratio (N.1.1) from 5% to 4,5%, keeping Tier I Capital adequacy ratio (N.1.2) at the same level of 6%. The latter normative value became the most critical amongst all of the capital adequacy ratios, as many Russian banks had their N1.2 ratios very close to the minimum required level of 6% even before RWA calculation rules had changed.

Additionally, the CBR published a list of ten systemically important banks in October 2015 (see table 1), which are subject to an additional requirement of capital in line with Basel III and additional short term liquidity (LCR) ratio. LCR is calculated as a ratio of high-liquid assets (assets that can be turned into cash within 30 days or that can be sold at a minimum discount) to net forecasted outflow of funds within the next 30 days. The minimum required level of this ratio is currently at 70% though shall be gradually increased to 100% by the end of 2018.

In order to support banks, the CBR relaxed the requirement for two regulatory ratios N2 and N3 (these ratios assess liquidity risks within one and 30 business days respectively) improving banks’ liquidity ratios in February 2015. As a result, aggregated N2 and N3 ratios of the banking system jumped from 58,9% and 72,7% in December 2014 to 89,9% and 127,1% in April 2015 respectively (see graph 10).

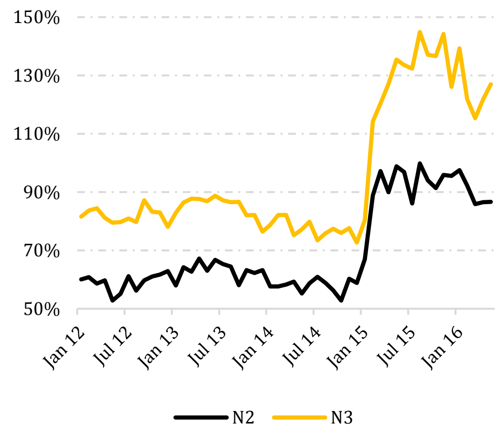
Furthermore, the CBR continues its policy against fraudulent schemes by obliging banks to create 50% reserves against the borrowers having signs of no real activity and classify corresponding loans to 3rd loan category or lower. Maximum exposure to related parties will also become subject to a more stringent regulation (through the new N25 normative ratio) from January 2017, limiting such exposures at 20% of capital. According to the

Table 1: Systemically Important Banks

Name	Position by assets 01.07.2016	Assets, RUB tn
Sberbank	1	22,8
VTB Bank	2	9,5
Gazprombank	3	5,2
Bank "FC Otkritie"	5	2,8
Russian Agricultural Bank	6	2,7
Alfa-Bank	7	2,2
UniCredit Bank	9	1,3
Promsvyazbank	10	1,3
Raiffeisenbank	12	0,8
Rosbank	13	0,7

Source: RAEX (Europe) calculations based on data from the CBR

Graph 10: Normative ratios N2 and N3



Source: RAEX (Europe) calculations based on data from the CBR

CBR's estimations as of May 2016, it can be a problem for more than 150 Russian banks to comply with N25.

In order to prevent banks from taking on too much risk, the CBR advises or directs them to limit the deposit growth or even bans new deposit issue. Also, banks which are to be allocated federal budget and state owned corporations' funds face tougher requirements on capital (more than RUB 25 bn); in addition these banks have to be under direct government control or to be a member of the DIA.

In June 2016 Elvira Nabiullina proposed a discussion of a number of new regulations designed to fight inefficiencies and contagions of the banking sector in the CBR report on the dynamics of Russian banking system.

One of the most important announcements was that CBR plans to depart from its current expensive and ineffective policy on banks' resolution through DIA (see part "Banks resolutions and license withdrawals") towards a CBR-led Sector Consolidation Fund. CBR intends to control restructuring process itself directly investing into the problem banks as the cheap DIA funding (0,51% interest rate) was often miss-used by participants, becoming a source of their own financial problems' solution as well as an uncontrolled quantitative easing in the economy. The restructured banks will be then resoled in the market, making the process of restructuring cheaper and faster. On the downside, this leads to a potential conflict of interest, despite the CBR's commitment to build up a 'Chinese wall' as part of its regulatory mandate.

The second important announcement of the CBR is the creation of a three-layer banking system. In addition to the systemically important ones, the CBR will also classify banks between federal and regional. The latter group (estimated at 1,6% of total banking assets) will benefit from eased prudential regulation. This will come at the cost of such functionality constraints as inability to open branches and offices outside the core and neighboring regions, access to interbank market only through CCP (central counterparty) and inability to conduct international operations. The rest will be classified as federal banks and will have to satisfy a capital requirement of RUB 1 bn and amount of assets more than RUB 7 bn and will have to gradually implement international standards.

The CBR also announced consolidated control and regulation on the off-shore holdings, by requiring these entities to create a separate managing body registered in Russia. The aim of the managing body will be to consolidate reports of all financial organizations inside the holding. This regulation will also apply to multi-branch holdings and parallel financial companies.

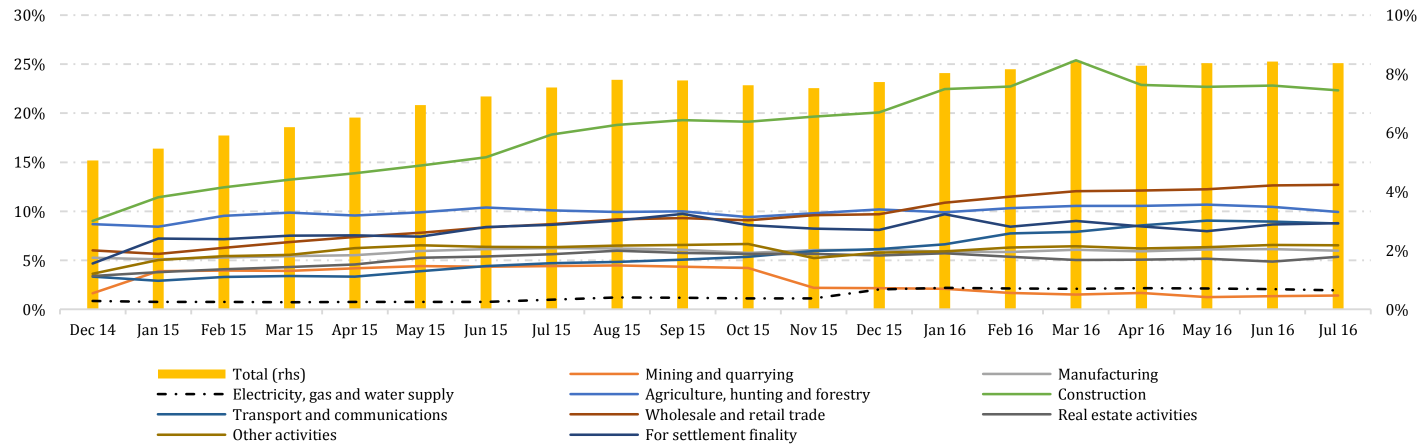
In addition, the CBR plans to increase the importance of stress testing, shifting it from a monitoring exercise to a capital-deterministic. Those banks, which fail stress-tests and/or have underdeveloped risk-management procedures will be subject to stricter capital adequacy requirements.

Three years of Nabiullina's administration have been marked by the fight against the weak and vulnerable banks, at the same time CBR confirms that "cleaning" of Russian banking sector from unreliable players will continue until mid-2017. Those who remain will have to comply (proportionally with their status) with ever stricter international standards.

6. OUTLOOK

The banking sector is likely to remain vulnerable to credit risks. Overdue loans in the construction, wholesale and retail trade, and real estate sector have steeply climbed since December 2014, accounting for 22,3%, 12,7% and 5,4% of their total loan portfolios respectively by June 2016 (see graph 11). This presents a potential risk for the industry as these three sectors together represent more than 38% of the loan portfolio (see graph 12) and their performance is not likely to pick up rather soon.

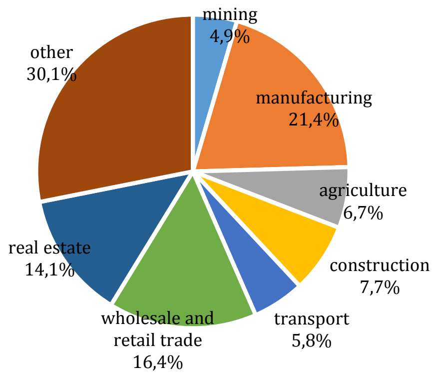
Graph 11: Overdue debt by sectors in domestic currency (Legal Entities and Individual Entrepreneurs), % of total loans per sector



Source: RAEX (Europe) calculations based on data from the CBR

We expect the banking sector to continue consolidating as the CBR continues its purge by stepping up its revocation of licenses (only in August 2016, seven licenses were revoked as of the report date). At the same time, if the CBR decides to finally enact the new related-party-lending regulation (limiting it at 20% of the regulatory capital) which is supposed to start in January 2017, the Agency believes that it will contribute to improve the sector's transparency and reduce moral hazards and conflict of interest. However, we also expect this policy to further put

Graph 12: Loans by industry, July 2016



Source: RAEX (Europe) calculations based on data from the CBR

pressure on banks' earnings which rely substantially in this type of lending.

The outlook for the banking sector in regard to capital and liquidity looks stable after stress-tests carried out by the CBR and IMF. However, the single factor stress-test, which analyzes the bankruptcy of a bank's five largest borrowers, resulted in high negative impacts for the system, reaffirming the risks derived from the high loan concentration in the sector.

The oil recovery, which started around November 2015, stalled in June 2016 and has been declining and volatile ever since. Given this dynamic combined with the government's willingness to reduce the fiscal deficit, we expect the subdued economic growth to continue in Russia. Furthermore, financial intermediation will remain low as the weak economy activity will cause credit to the economy to continue growing but at a slow pace (around 8% for the next three years).

The perspective of the banking system also depends on the status of western sanction on Russia. A potential lift of sanctions will open up access to international markets for a number of Russian financial institutions. Nonetheless, this event could spur FX leveraging positions hurting assets quality and driving currency mismatches.