Russia

Industry Research Update – Banks

28 November 2016

Authors:

Vladimir Gorchakov
Rating Associate

Ilya Makunin
Rating Analyst

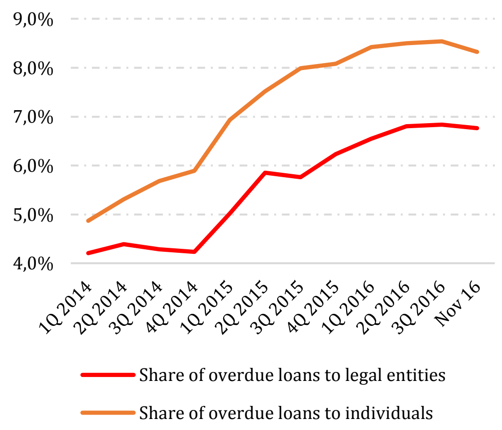
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Russian Banking Sector Metrics

	2014	2015	3Q 2016
Assets, RUB tn	77,6	83,0	79,7
Loans, RUB tn	52,1	57,5	55,2
ROA, %	0,9	0,3	0,9
ROE, %	7,9	2,3	7,8
CAR, %	12,5	12,7	12,7
NPL, % loan portfolio	6,7	8,3	9,2*

*this figure is based on the information provided by IMF as of March 2016
Source: RAEX Europe based on data from IMF and CBR

Graph 1: Share of overdue loans



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

TABLE OF CONTENTS

1. INTRODUCTION
2. INDUSTRY STRUCTURE AND PERFORMANCE
3. BANK REGULATION AND LICENSE WITHDRAWALS
4. OUTLOOK

1. INTRODUCTION

The Russian banking industry continues to be driven by the sluggish performance of the economy as well as by the significant regulatory improvements such as the new resolution framework for banks and a more severe control of the related party lending (see previous banking sector research report from August 2016[1] and section 3 of the current research report). A recent key rate cut (from 10,5% to 10,0% in September 2016) by the Central Bank of Russia (CBR) forced banks' profitability ratios to boost, however the quality of the loan portfolio continued to deteriorate. Trend in overdue debt for the construction, retail and agriculture remains unfavorable in the 3Q 2016, which leaves the banks whose assets are concentrated in these sub-sectors in the risk-zone.

Mid-term performance of the industry will depend on how well the CBR implements its policies towards making the banking sector more healthy, efficient and transparent as well as on the overall condition of the economy, assuming stagnating oil prices and ongoing western sanctions.

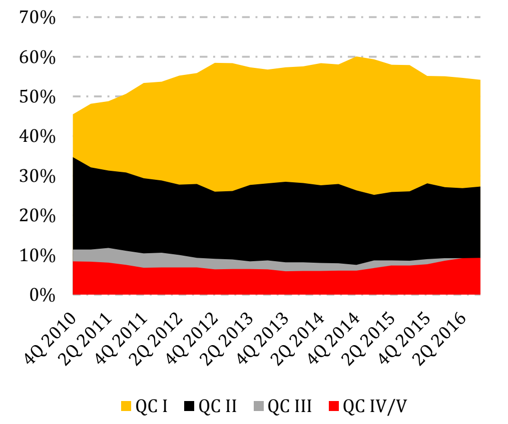
2. INDUSTRY STRUCTURE AND PERFORMANCE

Over the past two years the Agency recorded a steady worsening of credit risk environment in the industry, with the level of overdue debt reaching 5,7% in November 2016 from 3,8% two years ago. At the same time the level of overdue debt to legal entities and individuals constituted 6,8% and 8,3% in November 2016 growing by 2,6p.p. and 2,5p.p. during the last two years respectively. However as a result of loans roll-over and regulatory forbearance, the level of overdue debt on loans has been rather stable throughout 3Q 2016 (see graph 1).

Quality of banks' credit portfolio deteriorated with volume of loans from quality category (QC) I[2] shrinking by 3,7p.p. y-o-y to 54,4% of the total loan portfolio in 3Q 2016. All other categories expanded with the most

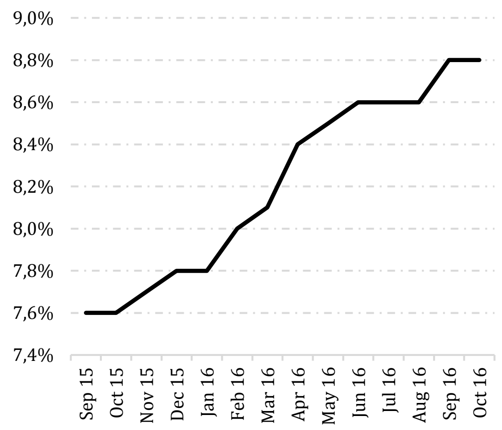
[1] http://raexpert.eu/files/Industry_report-Banks_26.08.2016.pdf
[2] Loans from Ist quality category in accordance to the CBR classification are loans with the highest quality; loans from Vth quality category in accordance to the CBR classification are loans with the worst quality.

Graph 2: Loans by Quality Category (QC)



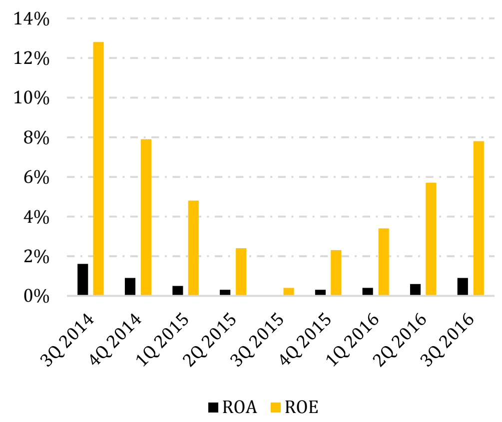
Source: RAEX (Europe) calculations based on data from the CBR

Graph 3: Loan loss provisions, % of total loans



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

Graph 4: ROA vs ROE



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

Graph 5: Structure of financial result, RUB bn

worrisome QC IV/V which grew by 1,9p.p. y-o-y to 6% of the total loan portfolio in 3Q 2016 (see graph 2).

The above mentioned developments are followed by increasing loan loss provisions (see graph 3). However, assuming the stricter CBR inspection, which consistently yield bank violations, ranging from overvaluation of collateral to misreported financial information, banking system could still face a situation with under-provisioned and under-collateralized loan portfolios.

Profitability ratios ROA and ROE increased by 0,3p.p. and 2,1p.p. q-o-q to 0,9% and 7,8% in 3Q 2016. These improving figures can be explained by two components (see graph 4). The recent cut in the key rate significantly reduced the cost of direct funding from the CBR and indirect costs of funds from individuals and legal entities. Simultaneously, the banks have created significantly less loan loss reserves in absolute terms in 3Q 2016 relative to the same period last year (see graph 5), as the level of overdue debt stabilized throughout 2016 (see graph 1).

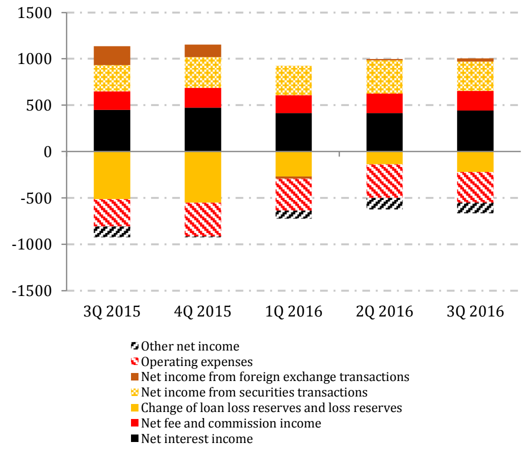
The capital adequacy ratio (CAR) of banks has been fluctuated since February 2016 at around 12,5% after sharp decrease by the end 2015, however the ratio turned to a positive growth trend through 3Q 2016 (see graph 6).

3. BANK REGULATION AND LICENCE WITHDRAWALS

CBR has continued its strategy on reforming the banking sector and improving its quality, hence the trend on banks' license revocations has continued its path in 2016 and a new bank resolution process has been proposed (see previous banking sector research report from August 2016).

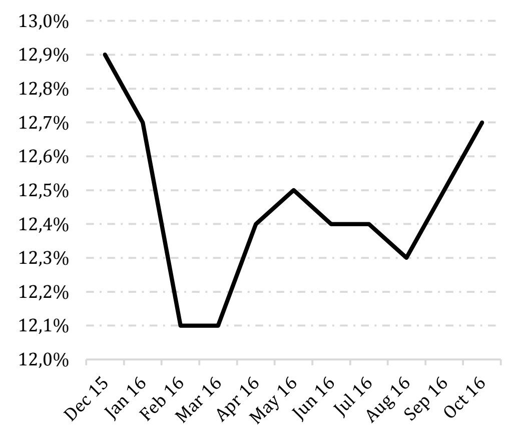
In November 2016 a new federal law amendment bill has been brought in to the public discussion, where it has been suggested that CBR can either bail the problematic banks out via Deposit Insurance Agency (DIA), or via CBR-led Sector Consolidation Fund. Once the restructuring process is finished the restructured banks are intended to be resold on the market. The new process is expected to be cheaper, more effective with regard to the funds expenditure control, and should exclude the dependency of the restructuring process on the financial position of the bank restructuring participants.

CBR extends its policy against the risky lending schemes by obliging banks to comply with a new N25 ratio, which caps the amount of maximum credit risks to related parties at the level of 20% of capital from January 2017 onwards. Despite the goal to reduce related parties lending risks in the system, the policy may push banks to bypass the law by adoption of complicated schemes, which may create an additional risk of license withdrawal. According to market researches, at least 18% of banks were not compliant with the ratio as of November 2016 and 25% of banks were



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

Graph 6: Average Capital Adequacy Ratio (N1.0)



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

close to maximum normative values (more than 15% of the capital). In addition, at least 60% of banks with high level of related party lending were regional.

4. OUTLOOK

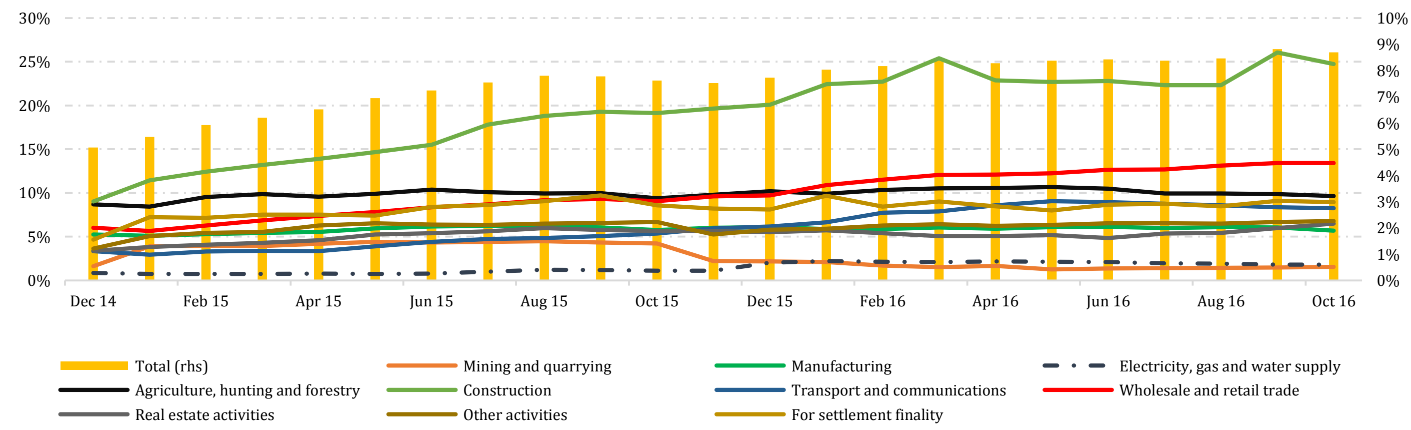
Despite recent improvements in banks' profitability, the sector is still likely to remain vulnerable to credit risks. Construction, retail and agriculture remain the most risky sectors in terms of overdue debt, which accounted for 24,7%, 13,4% and 9,65% of total loan portfolios in these industries respectively in October 2016 (see graph 7). This represents an additional risk to the banking sector, as these three industries constitute more than 30% of the total bank loan portfolio.

We expect the banking sector to maintain consolidation trend as the CBR continues revocation of licenses from toxic banks. However, the Agency strongly believes that inaction of the new related party regulation (January 2017) as well as the new bank resolution process will in the long run contribute to improve the sector's efficiency, reduce moral hazards and conflict of interest.

The oil price has been declining and stagnating since the second half of 2014, which, combined with the Russia's government willingness to control the fiscal deficit, will limit the country's economic growth potential. Low economy growth rates will force the banks to focus on cost optimization, rather than expanding the loan portfolios, hence the credit to the economy will continue to grow at a slow pace (around 8% in the next three years). On the other hand, a continuing decrease in the cost of CBR funding, may reduce the cost of bank credit, and therefore force the growth of the banking credit market.

Furthermore, the growth potential of the banking sector is largely correlated with the status of the western sanction on Russia. A potential lift of sanctions will open up access to international funding for a number of Russian financial companies.

Graph 7: 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