Rating-Agentur Expert RA confirmed at 'BBB-' the ratings of Russia. The rating outlook changed from positive to stable.

Rating-Agentur Expert RA confirmed the sovereign government credit rating (SGC) of Russia at 'BBB-' (Moderately high level of creditworthiness of the government) in national currency and at 'BBB-' (Moderately high level of creditworthiness of the government) in foreign currency. The rating outlook changed from positive to stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The effective monetary policy of the Central Bank of Russia (CBR) supports macroeconomic stability by adhering to inflation targeting and a flexible exchange rate regime. Annual inflation in 2019 fell to 3%, driven by the depletion of the effect of VAT increases, lower food price pressure, a stronger RUB, and restrained domestic demand. In 2020, the CBR continued the easing of monetary policy against the background of the disinflationary influence of falling demand. Consequently, the key rate was cut by 75 b.p. to 5,5% during 4M of 2020. If disinflation risks will dominate, mainly related to the uncertainty around the coronavirus pandemic in Russia and worldwide, the CBR is likely to continue reducing its key rate. Given the current direction of the monetary policy, annual inflation will remain close to 4% until the end of the year. We expect that the monetary policy of the CBR will balance between the necessity to stimulate economic growth and keeping annual inflation within the target;
- The external position remains firm against external shocks, supported by the accumulated buffers of international reserves, which amounted to USD 566 bn as of May 2020, having increased by almost 14% y-o-y. The stabilization of the exchange rate will be further facilitated by the sale of currency by the CBR within the budget rule. The expected deterioration of the government's financial position is protected by the budget rule, according to which the government will replenish the budget's shortfall in hydrocarbon revenues from the National Welfare Fund, which amounted to 11% of GDP as of April 2020;
- The ratio of government debt to GDP after a gradual decline has stabilized since 2018 and remained at 14,6% to GDP and 40,7% of the budget revenues as of the end of 2019. The share of FX in government debt is only 21,3%, which poses a low exposure to currency risk. Besides, the favorable maturity structure of debt remains, with the share of short-term liabilities up to one year at 7,1% of gross government debt in 2020. We expect the government's debt position to remain favorable in 2020, with a moderate increase in the public debt-to-GDP ratio to 17%, influenced mainly by domestic borrowing and exchange rate revaluation.

Restricting factors:

- We estimate that the level of domestic credit to GDP in 2019 rose slightly to 54,7% as compared to 53,9% in 2018. The banking sector increased lending in 2019 by 4,6%, mainly by expanding the retail segment. At the same time, this level of bank lending to the economy is quite low, while in BRIC countries the average level of domestic credits to the financial sector exceeds GDP. We do not expect this indicator to improve for Russia in 2020, as banks are actively restructuring loans and slowing down issuing new ones;

- The resilience of banks increased in 2019; however, ongoing turbulence is forcing revisions of short-term forecasts. Although ROA and ROE in the banking sector strengthened to 2,2% and 19,7% in 2019, the improved profitability was partially due to one-off adjustments associated with the introduction of IFRS 9. We anticipate that in 2020 banks will generate less income, with a significant reduction in the interest component. In terms of capitalization, banks have a solid stock of capital (5% of total assets[1]) to cover expected losses. As of December 2019, the capital to assets ratio stood at 10,4%, and the regulatory capital adequacy ratio strengthened to 12,2% as of March 2020. We consider that the accumulated stocks of capital and macro-prudential buffers will help to ease the pressure of expected deterioration of loan quality. Despite the structural surplus of liquidity in the sector, the regulator cautiously launched 1-month and 1-year REPO auctions and softened short-term liquidity requirements for systemically important banks;
- The total capitalization of the stock market at the end of 2019 increased to 44,2% of GDP, although it remains significantly below the world indicators of developed countries. Besides, the stock market is now experiencing a period of high volatility and it is traditionally focused on the top 10 large companies and commodity export companies;
- The economic competitiveness of Russia remains around average levels according to the Global Competitiveness Index from the World Economic Forum (Russia ranked at 43rd place out of 141 countries in 2019). The economic competition and business efficiency are limited by the weakness of its institutions and the significant influence of the state;
- Although net FDI inflows in 2019 were 3x higher than in 2018, returning to a stable level, this was primarily due to technical flows between companies and their overseas shareholders. Real foreign investment continues to be constrained by sanctions risks and the downturn in global markets;
- The general government budget surplus reached 1,9% of GDP in 2019 through strong growth in non-oil revenues, which offset a decline in oil revenues. As a result, the non-oil deficit continued to decline and amounted to 5,3% of GDP in 2019, compared to 7,9% in 2017. Given the sharp drop in oil prices, worsening foreign economic conditions and the economic downturn, we expect in 2020 a significant deterioration of the federal budget position with contraction of fiscal revenues. The government will maintain the stimulus fiscal policy and the general government budget deficit may exceed 5% of GDP;
- GDP growth in 2019 totaled at 1,3% slightly above our forecast driven by the growth in household consumption and public expenditures, but lower than in 2018. The economy entered 2020 with an acceleration due to the intensification of national projects and easing of the monetary policy. However, as a result of falling energy prices and pandemics, a sharp slump in GDP is expected in the 2Q 2020 and projected year-end negative GDP dynamic may reach 5-6%. We will monitor the implementation of the government plan with a budget of RUB 5 tn, which is aimed at recovering GDP growth to at least 2,5% by 2021;
- The current account surplus decreased to 3,8% of GDP in 2019, compared to 6,8% in 2018, mainly due to the shrinking of the trade surplus and widening of the investment income. Exports declined due to lower world prices for energy and metals, while imports, on the contrary, widened supported by the RUB appreciation. In 2020, we forecast a stronger reduction in the trade balance as a result of a drop in exports of goods, which may lead to a negative current account balance in 2020-2021 if dividend payments to foreign shareholders are maintained.

Negative factors:

- The risk of contingent liabilities' materialization heightens under the current uncertain situation as a result unknown full-fledged impact of the pandemic on the economy, the

[1] According to the CBR's estimations.

volatility of commodity and financial markets and the global economic downturn. These risks stem from the strong footprint of the state in the formal sector (about 40%) and employment (about 50%)[2]. Also, SOBs concentrate almost 70% of banking sector assets. In addition, according to the latest data, as of December 2019, the external debt of the banks and corporations under state control[3] was 8% of GDP;

- By early 2020, the banking sector approached a more favorable structure of the loan portfolio and the level of NPLs to total loans fell to 9,3% as of December 2019 against 10,1% a year earlier. Significant expansion of unsecured consumer lending, which led to an excessive increase in individuals' debt burden, began to slow down, forced by the restrictive regulatory measures. However, in 2020 we expect to see an increase in NPLs caused by the worsening financial situation and customer defaults arising from the lockdown measures implemented due to the pandemic and a decline in export revenues. As a counteraction, the regulator introduced a relaxation of provisions for restructured loans and banks have already restructured around 5% of sector loans as of June 2020 according to CBR estimates. Besides, the regulator plans to allow banks to gradually dissolve accumulated macro-prudential capital buffers in order to offset the consequences of the loan portfolio deterioration.

Stress factors:

- The high concentration of tax revenues in the oil and gas industry is due to the industry's dominance in exports with a 57% share in 2019. Oil and gas revenues accounted for 20,1% of total consolidated budget revenues in 2019, although their significance is gradually declining, while tax revenues are diversifying into other sectors of the economy (moderately weak stress-factor);
- The threat of sanctions risks remains high with additional sanctions imposed by the U.S. on Nord Stream-2 at the end of 2019. In addition, sanctions packages against new sovereign debt, state banks, and the energy sector are still under discussion in the U.S. Congress (moderately strong stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Increase in the oil prices higher than our base scenario to support GDP growth and the external trade position;
- Faster and stronger than originally anticipated recovery from the current economic crisis with higher non-oil GDP growth and improvement of non-oil fiscal balance;
- Relaxation of sanctions regime could be an incentive for the revival of the investment climate and reverse the outflow of the foreign capital.

The following developments could lead to a downgrade:

- Significant deviation from current monetary and fiscal policies, which may lead to macroeconomic instability;
- Weakening of the banking system, which would materialize contingent liabilities of the government.
- Increasing pressure from international sanctions against large state-owned banks and the oil and gas sector, which may lead to materialization of implicit contingent liabilities;

[2] https://www.imf.org/en/Publications/WP/Issues/2019/03/09/The-Russian-States-Size-and-its-Footprint-Have-They-Increased-46662

[3] Liabilities of the entities in the banking and other sectors that are public corporations, which are subject to control by government and the Central bank. Control is established (directly or indirectly) through ownership of more than half of the voting shares or otherwise controlling more than half of the shareholder voting power.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- None.

"The Agency confirmed the sovereign credit ratings of Russia at 'BBB-', with a change in outlook from positive to stable. This reflects our view on the balance and development of factors, which can be crystallized in the upcoming years.

The negative impact of the current oil market's volatility and the restrictive response to the pandemic outbreak has worsened and we have adjusted the forecasts of economic growth, the perspective of the banking system, and the dynamic of the budget. At the same time, the rating is still restrained by the long-standing structural economic problems, the significant footprint of the state in the economy, excessive concentration of exports on the hydrocarbon industry, and the risks arising from sanctions.

Factors that support the rating and provide resilience in the face of ongoing turbulence include the low government debt burdens, as well as strong external position with buffers of international reserves that can cover current government spending. Moreover, an effective and consistent monetary policy with adherence to a flexible exchange rate and the fiscal rule smooth out the impact of external shocks." – Clarified Denys Anokhov, Rating Analyst of Rating-Agentur Expert RA.

Research report on Russia is available at:

https://raexpert.eu/reports/Research_report_Russia_12.06.2020.pdf

Next scheduled rating publication: 11 December 2020. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2020

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
13.12.2019	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Positive	Positive
14.06.2019	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
21.12.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
06.07.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
12.01.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
14.07.2017	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
20.01.2017	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
22.07.2016	Scheduled revision of both types of ratings for the country	BB+	BB+	NA	NA
29.01.2016	First assignment of both types of ratings for the country	BB+	BB+	NA	NA

Minute’s summary

The Rating committee for Russia was held on 12 June 2020. The quorum for the Rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The Chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version (from April 2019). Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency’s website in the section for Internal policies.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: IMF, WB, Central Bank of Russia, Ministry of Finance of the Russian Federation, World Federation of Exchanges, Russian Federal State Statistic Service, International Monetary Fund, World Bank, Trading Economics, World Economic Forum, Doing Business, United Nations, Moscow Stock Exchange (MOEX), Cbonds.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency’s website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency’s internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency’s press-release and research report.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.