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Banking system to remain stable amid slow economic growth

Russian banking sector 2021 outlook

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- **Slow economic growth is the key factor restraining the banking system's development**. According to ACRA's forecast, banking assets should grow about 8% in 2020. The creditworthiness of financial institutions is unlikely to deteriorate sharply. The Agency expects the quality of assets as well as capital and liquidity positions of banks to remain at acceptable levels.

- **High competition is an important factor pushing the profitability of banks lower.** Government-owned and quasi-public banks will remain the most active players in the financial services market. Return on equity should average 13-14% and NIM (net interest margin) 4%.

- **The increasing importance of large banks and banks whose creditworthiness depends on the creditworthiness of their parent entities remains the overall trend in the sector.** Small and medium-sized credit institutions are experiencing a deficit in quality borrowers and are facing tougher regulatory requirements.

- **With the Bank of Russia changing its regulatory approach to unsecured lending, growth in the loan portfolio should slow down.** ACRA expects the retail loan portfolio to grow 20.3% in 2019 and 17.7% in 2020. At the same time, this lending market segment continues to be the main driver of asset growth in the banking system. Mortgage loans should remain the fastest growing lending segment.

- **In ACRA's opinion, banking sector risks should remain moderate following regulatory changes in retail lending.** As ACRA's stress tests show, many banks that actively expand their unsecured loan portfolios maintain enough capital and profitability to sustain a potential decrease in asset quality.

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Table 1. Dynamics of the key indicators of the Russian banking system in 2016-2021

Indicator	Measure-ment unit	Actual			Forecast		
		2016	2017	2018	2019	2020	2021
Balance sheet items							
Assets	%	-3.5	6.4	10.4	5.3	7.5	7.8
Securities portfolio	%	-2.8	7.5	6.4	6.0	8.2	8.5
Loans and other credit total	%	-3.3	4.5	12.0	4.6	7.5	7.5
Corporate loans	%	*-9.5*	*0.2*	*10.5*	*2.0*	*5.7*	*6.0*
Retail loans	%	*1.1*	*12.7*	*22.4*	*20.3*	*17.7*	*16.1*
incl. mortgage loans	%	*14.6*	*12.7*	*24.9*	*21.9*	*20.3*	*19.3*
Due from banks	%	*5.6*	*7.8*	*-4.8*	*-0.2*	*2.2*	*1.9*
Due to banks	%	19.0	6.9	0.3	-0.2	2.1	1.8
Client deposits total	%	-3.5	7.4	14.2	5.6	8.1	8.8
Corporate deposits	%	*-9.9*	*7.4*	*18.7*	*1.9*	*6.6*	*7.8*
Private deposits	%	*4.2*	*7.4*	*9.5*	*9.7*	*9.7*	*9.8*
Capital[1]	%	14.0	4.1	3.8	9.1	8.6	8.5
Asset quality							
Past due loans[2]	%	5.2	5.2	4.7	5.9	5.9	5.7
Cost of risk	%	1.2	2.5	2.0	1.9	2.0	1.7
Financial ratios							
Net interest margin	%	3.5	3.5	3.9	4.1	4.0	3.9
ROAA	%	1.1	1.0	1.5	1.5	1.4	1.4
ROAE	%	11.5	9.0	14.7	14.6	13.7	13.6
C/I	%	47.7	39.5	39.8	41.5	40.5	41.9
Net income	RUB bln	929	790	1,345	1,419[3]	1,452	1,565
Capital adequacy[4]	%	9.2	8.5	8.9	9.3	9.6	9.8

Sources: Bank of Russia, ACRA estimates

[1] Funds and income.
[2] 1+ past due loans according to Bank of Russia accounting standards.
[3] Adjusted for provisioning effects from transitioning to IFRS 9.
[4] Assessed using the N1.2 ratio.

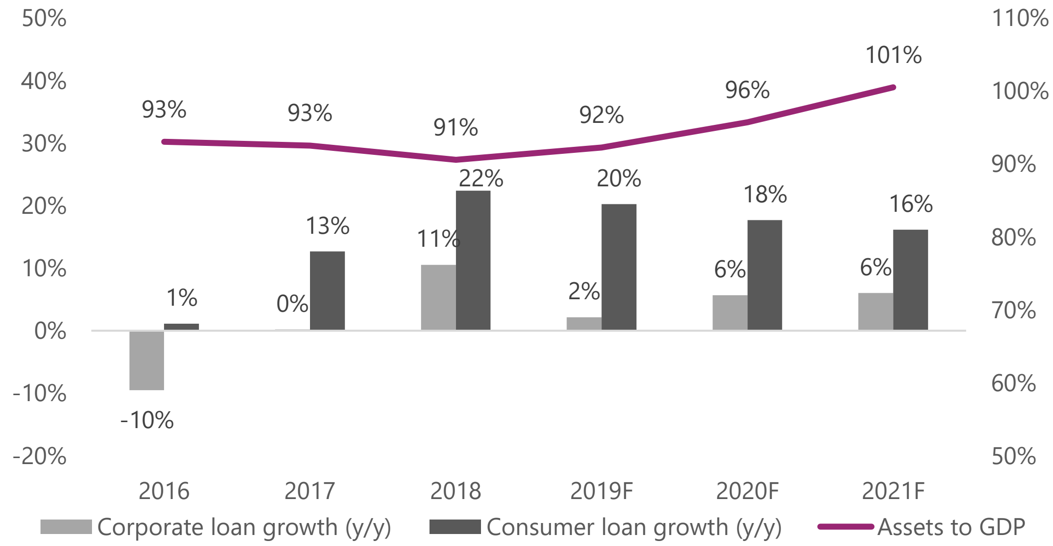
Economic environment holding back potential growth in banking assets

For more details, please see ACRA's macroeconomic forecast titled World trade tensions may escalate to economic downturn by late 2019, dated July 23, 2019.

ACRA assesses the environment in Russia's banking industry as stable overall. Although slow economic growth limits the potential for banks to increase their assets and net income, it also helps credit institutions to maintain strong capital and liquidity positions. In addition, the current environment contributes to the stable solvency of borrowers in the majority of bank lending segments.

ACRA estimates that assets in the Russian banking system will grow 5.3% in 2019 (compared to 10.4% in 2018) and 8% in 2020.

Figure 1. Retail lending should continue growing faster than lending to non-financial companies



Sources: Bank of Russia, ACRA estimates

High credit demand from consumers continues to be the principle driver behind loan portfolio growth. The Agency expects the total retail debt to increase by 20% in 2019; in 2020, however, its growth should slow down to 18% due to regulatory changes and moderately reduced risk appetite from banks in this segment.

Retail debt will increase primarily through growth in mortgage lending – by 22% in 2019 and 20.3% in 2020 – supported by lower interest rates and the expansion of various government incentives. The Agency notes substantial growth potential for the mortgage segment in view of low penetration of this product in the Russian market.

ACRA believes that population's urge to compensate for a significant drop in real disposable income after 2014 largely determines the increased demand for unsecured lending and represents a way for consumers to support their purchasing power.

As such, the higher debt load of borrowers may lower their solvency. However, this should not pose a significant threat to the financial stability of key market players. At the same time, as banks building their retail loan portfolios represents one of the few ways to increase profits in the current environment, their marketing efforts should cushion the effects of stricter regulations on growth in consumer lending.

Mortgage lending to become the fastest growing segment.

The slow growth of the national economy, and therefore in capital investments, should continue holding back corporate lending. After an increase in new corporate loans in 2018, the total corporate loan portfolio is unlikely to grow by more than 2% in 2019 and 6% in 2020. A decrease in new loans to the construction industry following its transition to new financing rules may represent a distinctive factor standing in the way of corporate lending growth. The change in terms and conditions may result in a situation where potential borrowing demand from developers sees both limited supply from credit institutions willing to operate in the new regulatory environment and a deficit in the capital required to satisfy this demand.

In 2019, a new growth trend has emerged in the SME loan portfolio that may total 10% by the end of this year. ACRA believes that the trend is driven more by the actions of large banks rather than by intensified economic activity in the segment.

Retail portfolio quality to deteriorate

A distinct feature of the fast growth in unsecured lending is the stable quality of the portfolio. According to estimates by the Bank of Russia, the share of overdue unsecured loans (90+ days) has declined from 9.1% to 8.4% in January-July 2019.

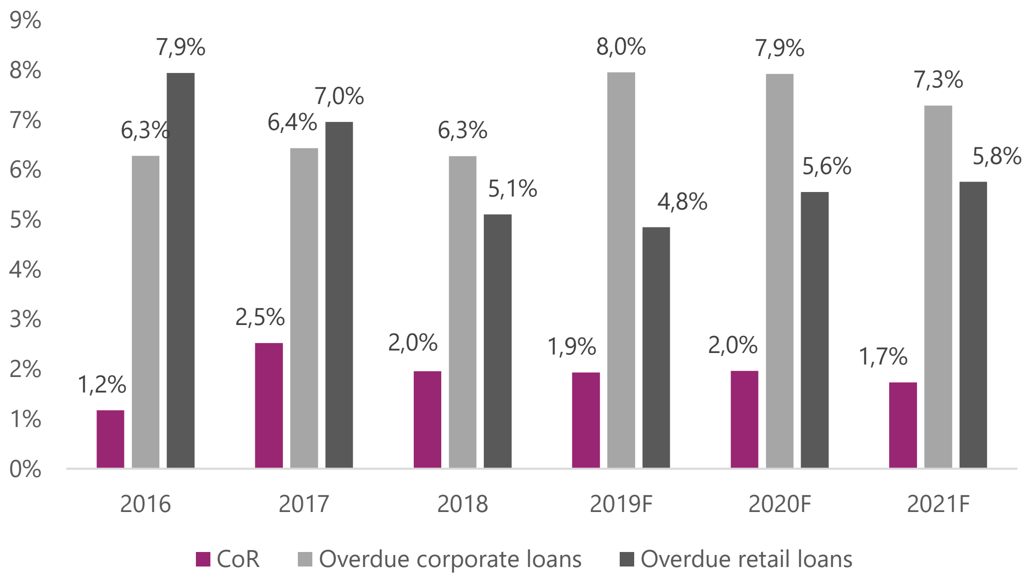
At the same time, ACRA believes that banks are on the verge of exhausting the potential to increase retail lending without eroding the quality of their portfolios. In addition to the sustained slow growth of disposable income (and even its further decline for some demographics) and increased consumer debt load, new rules for calculating risk-weighted assets in the unsecured lending segment may drive the share of overdue consumer loans higher. As the decline in the population's disposable income was one of the main reasons behind lending growth, in ACRA's opinion, the loss of access to bank loans as a stable source of funding for some borrowers may have a negative effect on overall payment discipline. In addition to that, tighter regulations may affect the availability of refinancing options, which would also lead to the deterioration of the loan portfolio quality. ACRA believes that in this context the total amount of overdue consumer loans will increase in 2019 and 2020, reaching 5.6% compared to 4.9% as of August 1, 2019 (please see the section on the consumer lending market).

Regulatory changes in the consumer lending sector may result in deterioration of the retail loan portfolio.

The credit quality of banking assets remains stable overall in 2019. Although the share of overdue loans has increased to 5.8% from 4.7% according to the Bank of Russia, it can largely be attributed to changes in the calculation methodology. It is worth noting that the share of category 4 and category 5 loans has seen virtually no change at 10.2%.

The Agency believes that the stable quality of the corporate loan portfolio offsets the negative impact from the deteriorating quality of the unsecured loan portfolio. Therefore, ACRA expects the total overdue debt to reach 5.9% in 2020. With the seasoning of loans provided to SME's in 2019, they may be a source of additional overdue debt.

Figure 2. Quality of consumer loan portfolio to deteriorate



Sources: Bank of Russia, ACRA estimates

In the above circumstances, the cost of risk (CoR) should remain stable. In 2019, net transfers to loan loss provisions should not exceed 2% of the total loan portfolio. ACRA estimates CoR to range from 1.9% to 2.1% in 2020.

Intense competition to affect profitability

The Russian banking sector remains profitable overall in 2019. Banks have managed to increase their interest income, which is determined substantially by the higher share of consumer loans in the total loan portfolio.

Meanwhile, the profitability of the entire industry continues to be highly dependent on the largest credit institution: ACRA estimates that over 60% of total net income is attributed to the financial performance of Sberbank.

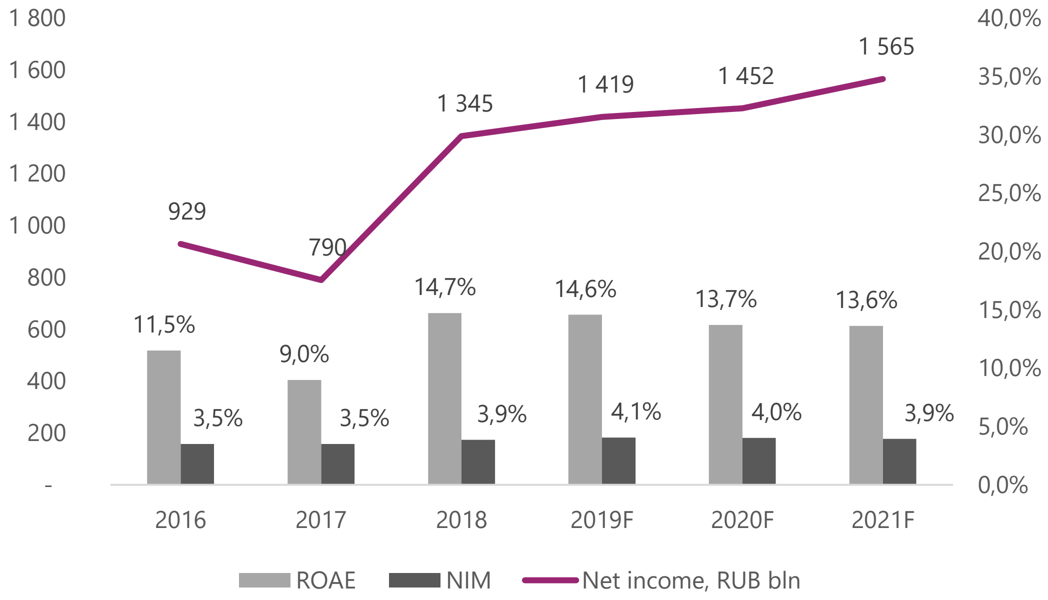
Aggressive competition is the key factor putting profitability under pressure.

The Agency projects return on average equity (ROAE) of the banking sector to be at 14.6% in 2019. This takes into consideration the effects on net income from changes in the provisioning approach in view of the transition to IFRS 9. In 2020, this indicator is expected to decline to 13.7% due to a decrease in NIM and additional provisioning requirements for specific categories of consumer loans triggered by their deteriorating quality.

According to ACRA's forecast, NIM calculated using the RAS reporting of Russian banks should equal 4.1%, which is slightly above 3.9% seen in 2018. However, the IFRS reporting of the largest banks shows lower NIM in the first six months of 2019 y-o-y, which, in ACRA's opinion, may reflect the existing trends more adequately.

ACRA assumes that the profitability of interest transactions of banks will gradually decline, with the primary driver to be high competition between large banks in attracting quality borrowers amid the increased risk appetite of large state-run banks. NIM should equal 4% in 2020 and continue drifting lower in subsequent years. At the same time, the Agency believes that a possible key rate cut will have a limited effect on NIM as credit institutions can timely reevaluate their funding costs.

Figure 3. Intense competition to determine NIM's drift lower



Sources: Bank of Russia, ACRA estimates

The Agency also expects lower inflation and growth in mortgage lending to enable banks to extend the maturity of their loan portfolios and make them less sensitive to key rate cuts by the regulator, which are most likely to continue going forward.

Despite the slower growth of the retail loan portfolio, the share of interest income from consumer loans in the operating income of banks should continue rising. In addition, with the increase of fixed-term consumer deposits of individuals in the funding structure, the share of related payments in total interest expenses should grow.

The projected increase in the share of consumer funds of individuals in the liabilities structure should drive the share of related payments in total interest expenses higher.

The efforts of banks to improve their operating efficiency by providing more digital services and growing sales through alternative channels should have a limited effect on financial performance. The cost to income ratio (CTI) should not see any significant changes in the coming years due to the lower ability of credit institutions to build up their operating income.

Capital and liquidity positions of banks also suggest a stable environment in the industry

Liquidity deficit-related problems are unlikely.

Banks will be able to maintain their capital adequacy ratios at an acceptable level if the growth of the banking industry is limited and operating efficiency and loan portfolio quality remain at their current levels. In the seven months of 2019, the Tier-1 capital adequacy ratio (N1.2) equaled 9.5% (compared to 8.9% as of early 2019).

ACRA expects this ratio to total 9.6% in 2020 with retained earnings representing the principal source of new capital.

The current environment in the industry also helps banks maintain liquidity positions at a comfortable level. The high concentration of client funds remains the key risk for liquidity, which is particularly important for smaller banks. However, with the development of liquidity provision mechanisms by the Bank of Russia and the availability of the repo mechanism for raising funds, liquidity risks in the banking system have substantially reduced.

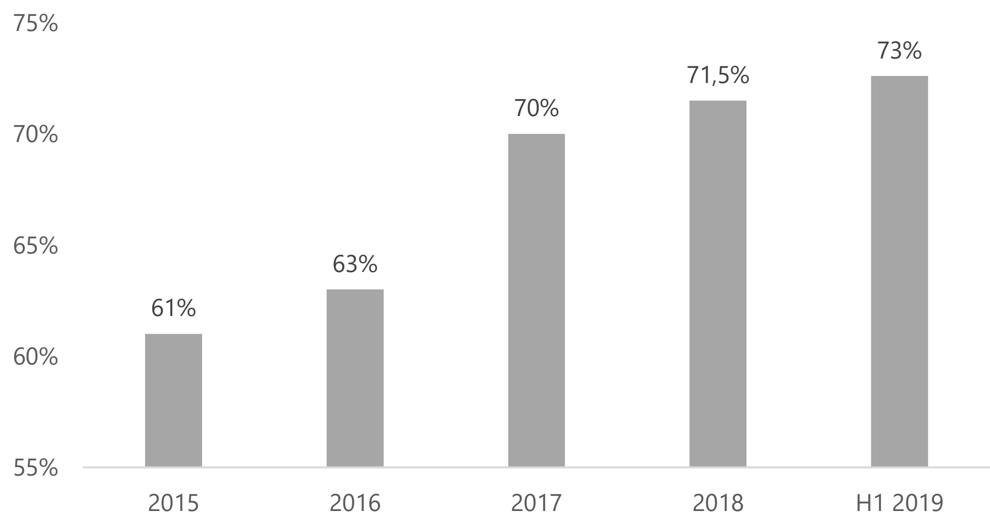
The lack of opportunities to employ funds in loan assets should in turn contribute to the accumulation of excess liquidity by banks. According to the Agency's estimates, highly liquid assets, deposits with the Bank of Russia, and securities combine to represent over 30% of the balance sheet for almost three quarters of Russian credit institutions, while more than 40% of banks use such assets to employ over half of their funds. The share of liquid assets on the balance sheets of banks tends to be higher in smaller credit institutions.

ACRA expects no principle changes in the liquidity environment in the near future. Credit institutions are likely to continue holding excess liquid assets as opportunities to use them more efficiently are limited. Factors such as the emergence of an insurance scheme covering SME funds as well as the lower number and lower size of banks whose licenses may be withdrawn by the Bank of Russia should contribute to more stable balances on clients' accounts.

The share of state banks in industry assets is still growing

Since Asset Management Company of the Banking Sector Consolidation Fund took control of Moscow Industrial Bank in 2019, the share of the public sector in the total assets of the banking system has consistently exceeded 70%. A similar situation can be observed in certain segments of banking operations: various types of lending, consumer deposits, etc.

Figure 4. Share of the public sector in the Russian banking system[5]



Sources: ACRA's estimates based on data from the Bank of Russia, kuap.ru

[5] As of July 1, 2019, these banks included: Sberbank (AAA(RU)), VTB Bank, Bank GPB (AA(RU)), JSC Russian Agricultural Bank (AA(RU)), Bank Otkritie (AA-(RU)), Promsvyazbank (AA-(RU)), Bank TRUST, BM BANK, Bank RRDB (AA-(RU)), Bank DOM.RF (BBB-(RU)), ROSGOSSTRAKH BANK, RNCB (A(RU)), Sviaz-Bank (BBB+(RU)), SME Bank (A+(RU)), Cetelem Bank, ROSCOSMOSBANK, EXIMBANK OF RUSSIA, KRI BANK, NOVIKOMBANK (A(RU)), Bank PERESVET, Post Bank, Vozrozhdenie Bank (A-(RU)), West Siberian Commercial Bank (AA-(RU)), Moscow Industrial bank (BB+(RU)), Asian-Pacific Bank (BB+(RU)), VOCBANK.

The management plans of certain banks currently under state control stipulate future privatization. However, even if these banks are sold successfully, ACRA believes the role of state banks will not change. The development of specialized credit institutions will contribute to the increase in the assets of state-owned banks.

The dynamics of the banking sector are largely determined by the current stage of the economic cycle. The growing dependence of banks on the state leads to wrong-way risk, which in this case can be expressed by the need for banks to attract additional financing increasing, while at the same time the ability of the state budget to provide the required financial assistance decreasing. For a number of state-owned banks, the situation is complicated by the fact that they work closely with clients whose ability to fulfill their obligations depends on the stability of state financing.

ACRA notes that there is a growing number of credit institutions in the Russian banking industry that either previously received emergency support in the form of capital and liquidity from supporting organizations, or expect to receive it if necessary. According to ACRA, of the top 50 Russian banks in terms of assets, only ten cannot count on priority assistance from the state (or institutions under state control), the constituent entities of the Russian Federation, large Russian financial industrial groups, or foreign parent banks, or do not enjoy regulatory relief in their activities.

This trend means that stability of an increasing part of the banking sector depends on other parties and the independence of banks in choosing ways of development is limited. Moreover, there is growing inequality in terms of operating conditions for those banks and credit institutions that cannot rely on external support.

Small and medium-sized banks are losing ground in the industry

The strengthening of state banks in the Russian financial system is occurring simultaneously with the increasing concentration of assets in large credit institutions. In July 2019, the share of assets under the control of the top 30 banks exceeded 82%, while their share of the loan portfolio reached 84% and net income reached 92%. One of the reasons for this was small and medium-sized banks losing competitive position under the influence of both macroeconomic factors and the specifics of industry regulation.

Low economic growth rates and the resulting limited demand for loans from large quality borrowers are pushing industry leaders to work more closely with SMEs, which traditionally make up the main client base for small and medium-sized Russian banks. Under such conditions, large banks gain an advantage both because of the opportunity to offer low cost services and because of the weak impact of their SME exposure on their financial stability (loans issued to this segment have a low share in the total asset structure).

Changes in regulation also limit the development of small and medium-sized banks. Thus, requirements to banks under Federal Law No. 214-FZ and the gradually tightening conditions on credit institutions under Federal law No. 44-FZ will most likely lead to the reduced participation of small credit institutions in financing housing construction and in the bank guarantee business.

Trends in consumer lending

Unsecured lending — Growing, but not because of good conditions

Recent years have seen rapid growth in unsecured lending and according to ACRA, this speaks to the growing social plight of the country's population. The Agency believes that the decline in real disposable income since 2014 determined the slowdown in consumption growth. Real income fell by more than 10% from 2014 to 2018, which corresponds to a loss of purchasing power of about RUB 6 tln. To maintain spending levels, consumers have begun to reduce the share of their income directed towards savings (this figure has been declining since 2016) and actively take out loans from banks and through microfinance institutions (MFIs).

The fact that the population uses borrowed funds to support consumption is partly confirmed by the dynamics of growth in retail trade. This indicator shows minimal values in real terms, despite a sharp increase in the volume of consumer lending. The restrictions imposed by economic conditions on the growth of banking business, the shortage of quality borrowers in the corporate segment, high competition in mortgage lending, and the relative ease in increasing other types of retail lending are all factors pushing credit institutions to more actively offer unsecured loans to consumers.

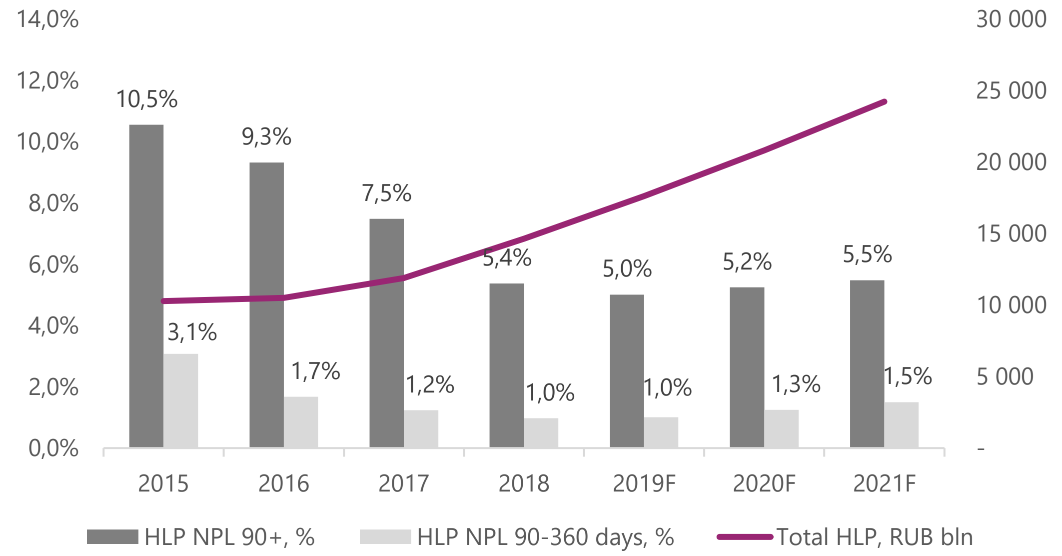
The quality of the consumer loan portfolio is relatively high, but there are signs of deterioration

Despite the above factors, the rapid growth of consumer lending has not yet affected the relatively high quality of the consumer loan portfolio. As of August 1, 2019, bank portfolios of homogenous consumer loans with payments overdue by more than 90 days amounted to 5%, having decreased from 5.4% at the beginning of the year (January 1, 2019) mainly due to the growth in portfolio volume. As of January 1, 2018, this figure was 7.5%. Its decrease by the end of 2018 was mainly due to a decrease in the volume of loans overdue by more than 360 days (due to their write-off or sale by banks). The percentage of loans overdue between 90 and 360 days has barely changed since 2017.

According to ACRA, there are signs of a decline in the ability of borrowers to service their loans. The volume of loans provided to borrowers to refinance previous loans has been growing since the end of 2016. Since the second half of 2017, the share of such loans in new issues was up to 20% according to various estimates. While this process is partly due to lower rates on consumer loans, ACRA believes it also indicates the obligatory refinancing of loans previously taken out. This is also confirmed by the fact that weighted average interest rates on unsecured loans have not changed significantly since the beginning of 2018.

Changes in the Bank of Russia’s approach to the regulation of the unsecured lending segment could be an additional factor negatively affecting the quality of the retail portfolio. The Agency considers it likely that the increase in the risk ratio for such loans will lead to a reduction in the availability of refinancing and an overall decrease in the payment discipline on the part of borrowers, for whom bank loans play an important role in financing consumer spending. At the same time, ACRA expects only moderate growth in the share of overdue retail loans in bank portfolios by the end of 2020, as the current quality of the portfolio is relatively high.

Figure 5. The share of overdue debt on consumer loans should grow at a moderate pace

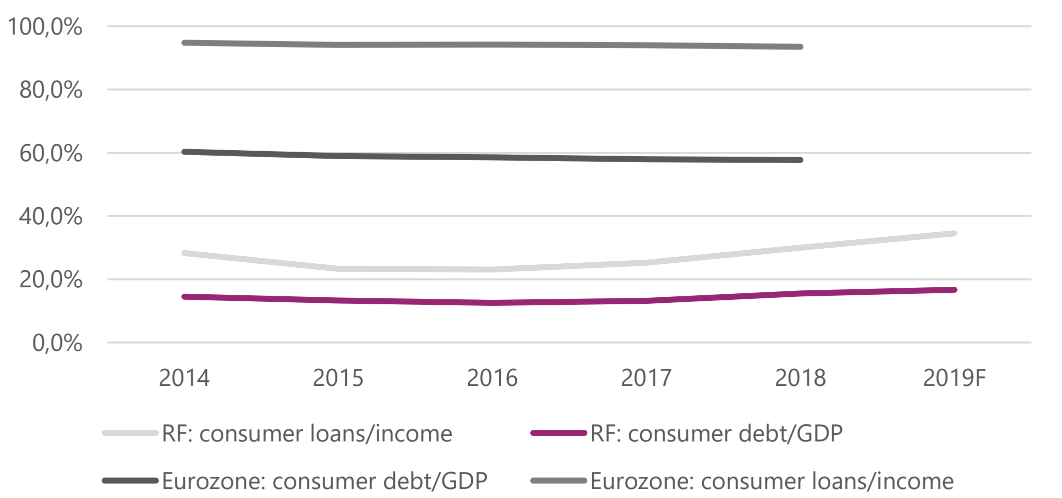


Note: Homogenous loan portfolio – HLP
Source: ACRA's estimates based on data from the Bank of Russia

Growth in the consumer debt load in 2020 will most likely not provoke a crisis in the banking sector

At the beginning of 2019, the ratio of total loan debt of individuals to their annual income (excluding mandatory payments) was about 30%, up from 23% at the beginning of 2017. ACRA predicts that this figure will rise to 34% by the end of 2019. The share of retail lending to GDP is also growing. ACRA predicts this indicator to be 16.7% at the end of 2019 (15.5% in 2018). At the same time, the debt load of Russian households can be estimated as moderate compared to EU countries, for example.

Figure 6. The consumer debt load in Russia remains at an acceptable level



Sources: ACRA's estimates based on info from the Bank of Russia, ceicdata.com

As world practice shows, the growth of consumer debt has a positive impact on macroeconomic indicators in the short-term, while in the medium-term (one to two years), the probability of a crisis in the banking sector increases. The overall low level of consumer debt can be combined with the increased debt of individual households, while the quality of low-income borrowers is more susceptible to potential negative changes from macroeconomic shocks, debt growth, and income reduction.

Of the cash loans issued in Q1 2019, about a third were for borrowers with a debt load of more than 50% (debt load exceeds 80% in about 10% of new loans). At the same time, the share of loans with maturities over five years has increased since the end of 2018, which formally understates the current debt load on borrowers. The increase in the share of consumer loans with high debt loads could lead to an increase in banks' problem debt.

At the same time, the results of ACRA's stress testing show the following: overdue debt levels for consumer loan portfolios, similar to those of the crisis periods for the industry, will not lead to critical consequences for the banking sector. Most of the leading players in the retail market maintain enough capital to cover potential losses, given their mostly high profitability. Of the 20 largest banks in terms of retail portfolios, only two might have problems maintaining capital adequacy ratios. Four banks would violate the minimum allowable numeric value of the capital adequacy ratio buffer.

The measures taken and planned by the Bank of Russia to regulate the consumer lending market contribute to capital growth and the creation of additional buffers for banks to absorb potential losses. On October 1, 2019, requirements were introduced for accounting for debt load in calculating add-ons to risk weights for consumer loans and risk-weighted assets. Prior to this, add-ons were calculated based only on the full consumer loan value. The measures taken by the regulator should help to slow the growth of consumer debt as well as the volume of lending to riskier borrowers.

It is very likely that consumers who have been refused loans by banks will make similar requests to MFIs. As such, ACRA predicts that the growth rate of the microfinance market will continue. The portfolio of consumer loans issued by MFIs in 2018 and 2019 grew faster than that of the banks; growth in 2018 was 45%, and about 16% for two quarters of 2019. In addition, there was an increase in the maturity of microloans, as well as the share of debt overdue by more than 90 days. Therefore, the role of MFIs as drivers of consumer debt growth should become more prominent, which may result in this segment experiencing risk migration as well as the potential negative effects of an increased consumer debt load.

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