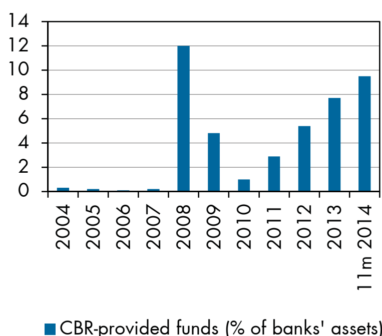
# Perfect storm a blow to near-term and medium-term outlook

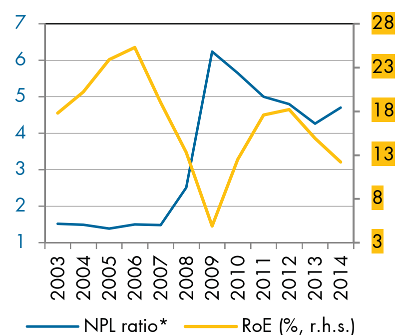
- **Weak RUB and low oil price add to pressure on banks, economic recovery likely to be shallower than after 2008/09**
- **Buffers that helped to preserve a decent growth and profitability performance in 2014 are increasingly exhausted**
- **Pressure on funding and asset quality started to materialize, full deterioration to be reflected in 2015 figures**
- **Increasing risk of a credit and capital crunch – current external and domestic conditions unchanged**

**Share of CBR-funds in total funding**




*Source: CBR, RBI/Raiffeisen RESEARCH*

**NPLs and profitability**




* *% of total loans*
*Source: national sources, RBI/Raiffeisen RESEARCH*

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**Introduction**

Most recently the situation in the Russian banking sector has further escalated from the one that we were observing 3-6 months ago, where we already warned to downplay the effects of the ongoing macro and banking sector deterioration (see our Special Note from 19 September "EU/US sanctions: What is in it for domestic banking in Russia?"). Given the structure of the Russian economy it goes without saying that the recent RUB devaluation and massive oil price drop added to already anticipated downsides. Currently, the Russian banking system is experiencing one of the most serious sustainability issues within the past decade. Even though the Russian economy and local financial markets have been exposed to a number of stressful situations, the current one differs in a sense that it is jeopardised by harshly escalated political risks, a deep and swift fall in RUB and oil prices that is unlikely to reverse quickly, and rather negative overall expectations with respect to the recovery outlook (e.g. we expect the recovery in 2016 and onwards to be much shallower than back in 2010, see our Special Note from 9 of January "Weighty GDP drop in 2015, CBR more active amidst weak oil prices").

Although somewhat relieved by already disbursed or upcoming state support to the economy, these trends are expected to roll through 2015 at least, and should result in a noticeable decline in banks' ability to generate revenues, and hence being less able to maintain lending at levels comparable to current and previous years' trends. Moreover, the banking system, by definition, is highly exposed to negative economic and political sentiment not only through purely economic factors, but also due to behavioural patterns, induced by risk-minimising strategies of banks themselves, their clients and providers of external financing to the Russian banking sector and economy. This has been already reflected in 2014 on the Russian banks' funding side (money withdrawals by households, deposit "dollarization"), an increasing risk awareness revealing on the lending side (lending suspension, asset quality deterioration) as well as decreasing foreign funding flowing to Russia. All in all, 2015 and 2016 will be very challenging years for the Russian banking sector. Moreover, current capitalisation levels are on the lower side by historical standards and compared to a lot of CEE and emerging markets peers. That said we see increasing risks of a capital and credit crunch on the Russian market – current external and domestic conditions largely unchanged. For challenges on the individual bank level see our corporate coverage on p. 8-10 (including Sberbank, VTB, Gazprombank and RSHB).

**Please note the risk notifications and explanations at the end of this document**

**Focus on: Risks and factors of support for Russian banking market**

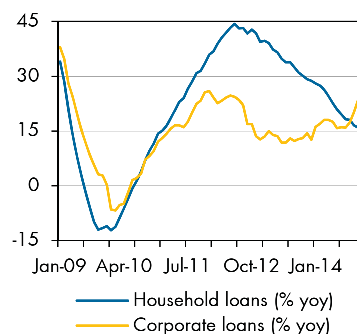
**Key risk factors**

- *Swift RUB devaluation and RUB volatility that is unlikely to reverse soon given the outlook for low oil prices in H1 2015, negative news flow from rating agencies and the Russian economy*
- *Scarcity of funding from all domestic and international market-related sources that is unlikely to change soon (given that Western sanctions are unlikely to be reversed soon and credibility losses will stay as well), may require substantial funding and capital support from the state*
- *Allowed changes to accounting provisions may contribute to increasing market uncertainty going forward (banks are allowed to re-evaluate obligations in calculation of statutory ratios at previous FX rates, a measure that is a standard tool in crisis time to arrest negative feed-back loops between market overshooting, fire sales and banking); according to our estimates FX-denominated assets of Russian banks amount to some USD 300 bn and hence the RUB depreciation seen in December could result in an increase of risk weights and pressure on capitalisation (while some banks may not meet minimum requirement levels); moreover, banks are allowed to apply eased credit risk requirements in case of emergency*
- *Quick deterioration of asset quality, which is weighing on profits and capitalisation, current capitalisation ratios are fairly low by historical standards and compared to peers*
- *Swift RUB devaluation caused dysfunctional RUB markets, jumpy official and market rates leave no viable benchmark money pricing, and hence both banks' funding and lending interest rates have to pass through a period of re-adjustment*
- *Overall macroeconomic recovery expected later in 2015/16 is likely to be weaker than in 2008/09*

**Key factors of support**

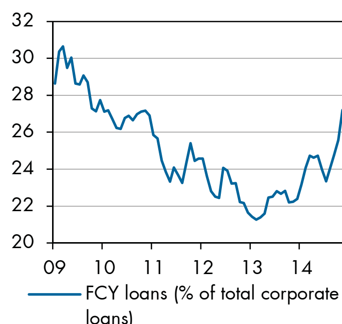
- *State support for the banking sector and systemic enterprises is available, although the scale of it remains unclear and overall volumes provided to the banking sector and real economy are likely to be lower than in 2008/09*
- *Allowed changes to accounting provisions (e.g. regarding FX rates and credit risk requirements) may limit near-term adjustment pressure*
- *Banks have already obtained experience in crisis management, at least stemming from 2008/09 crisis; lending expansion in recent years was less risk-based (compared to the period of time from 2004-2007/08)*
- *Substantial cost reduction potential exists in Russian banking sector via restructuring, cost-cutting etc., which can offer some support for profitability*
- *"First wave" of panic behaviour (usually the most dangerous one) could be already behind us (December 2014); moreover, the system credibility was maintained as there were no bank failures during that period of time (predominantly on state support)*
- *Peak of crisis-induced deposit withdrawals and "dollarization" should be mostly passed by given the increasing and coordinated crisis management to fend of pressure on RUB markets*

**Loan growth by segments***




** in LCY terms, latest data point Nov-14*
*Source: CBR, RBI/Raiffeisen RESEARCH*

**FCY loans in corporate lending**




*Source: CBR, RBI/Raiffeisen RESEARCH*

## Loan dynamics

Overall loan growth rates have not been under tangible pressure up to now. In fact total loan growth rates in Q4 2014 had been more or less at the levels seen at the beginning of the year in LCY terms (around 17-20% yoy). That said total loan growth is yet much more stable than in the downfall environment seen in 2009. Back then total loan growth rates decreased from around 37% in January 2009 to -2.5 in December 2009 (with a drop from 34% yoy in household lending to -11% yoy and 38% yoy to zero in corporate lending respectively). However, loan growth trends do differ a lot across business segments. Household loan growth has been on a continuous decline throughout 2014, a trend that has already started in 2012. At present the corporate segment is even growing faster than retail lending, a situation that is totally different compared to the situation that was characterising the banking sector over the last few years. That said the secular decline in household lending over the last 24 months or so cannot be per se considered as crisis induced. The current decent loan growth rates in the corporate segment are supported by compensation effects for foregone external funding in the corporate sector as well as the strategy of some corporate to draw extended facilities to the extent possible. That said we would expect corporate loan growth to soften throughout 2015, a trend that should clearly contribute to a softening of loan growth in 2015 (around 70% of loan books are in corporate lending). Therefore, total loan growth is likely to come down to 10% or even below that in 2015, which means that there will be no loan growth in real terms given current elevated inflation rates. Therefore, the banking sector is unlikely to offer much support to the ailing real economy in 2015. This assumption is also backed by a fairly low capitalisation (around 12.2%) at present com-



Please note the risk notifications and explanations at the end of this document

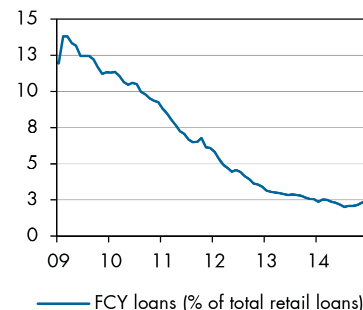
pared to the long-term historical average on the Russian market and compared to emerging market peers.

The modest setback seen up to now in Russian banking sector growth fits to the overall picture of a more modest setback, also in the real economy, compared to the situation back in 2008/09. However, it has to be stressed that the recovery prospects seems to be also weaker nowadays. This holds true from a macroeconomic and banking sector perspective. This assumption is backed by several factors. Firstly, the overall medium-term oil price picture looks less supportive nowadays compared to the period of time from 2008-2010. Secondly, Russia designed one of the largest fiscal and banking sector packages in 2008/09 to support the economy and banking sector. Such a support seems not feasible at present. Thirdly, the RUB devaluation seen in 2014 was sharper than in 2008/09 and we do not expect a very quick reversal here according to our baseline assumptions. Nevertheless, we want to stress that we do not see the RUB weakening as a near-term systemic issue for the banking sector given the aversion of the banks to issue loans in FCY, particularly to households. The data show that the proportion of FX-denominated loans in total banks' retail loan portfolios has slumped from around 14% in early 2009 to only 2.5% as of year-end 2014. Within the corporate segment, the share of FCY-denominated loans is more stable, and has decreased only modestly from a level of 30% in the beginning of 2009 to 25% as of September 2014. It even has surged to above 27% by November 2014 (the latest data point that we have here), pointing to perhaps to a state-encouraged increase of corporate loans over the past months of the year, especially in external funding substitution to systemically important enterprises. However, the FCY lending in the corporate segment traditionally bears much less risks than FCY lending in retail. Hence, we do not expect knock-on effects on the banking sector from FCY loans portfolios like we have seen in other CEE markets in the past (e.g. Hungary, Ukraine).

## Funding issues and deposit dynamics

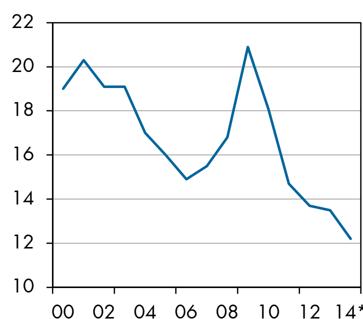
Three major points are to be tackled with respect to funding patterns on the Russian banking markets: customer funds dynamics, funding and liquidity support from the state, and own revenue generation capacity by Russian banks. State support in terms of CBR funding and liquidity injections had been vital for the banking system back in 2008/09. In the current situation it is of the prime importance too, especially at the moment of swift RUB depreciation, high RUB volatility and dysfunctional local markets, like in Q4 2014. On the positive side, the support has arrived and likely will stay, although it remains unclear to which extent it will be required to keep the system afloat. The Russian banking system has already been too accustomed to liquidity and funding provided by the regulator (stemming from 2008/09 crisis), and this dependency has already put the system into something like "CBR-support trap". Once introduced back 7-8 years ago, the funding pumped by the CBR has stayed in the system more or less, and any withdrawal seemed unfeasible without notable deterioration of the banking (and market) liquidity situation. Since 2007, when the Central Bank first appeared as the largest lender at the market, its funds' share on the Russian banks' balance sheet stayed within the range of 6% on average (with the minimum reached at the end of 2010 when it has shrunk to 1% or so). By end-November 2014 the funding from the CBR reached about 10% of the banks' total balance sheet, and we are likely to see this share higher (the peak back at end-2008 was 12% of the total Russian banking balance sheet). In this context is has to be stressed that the transition to a more market based monetary policy in terms of liquidity provision to the banking sector and the exchange rate went hand in hand

**FCY loans in retail lending**



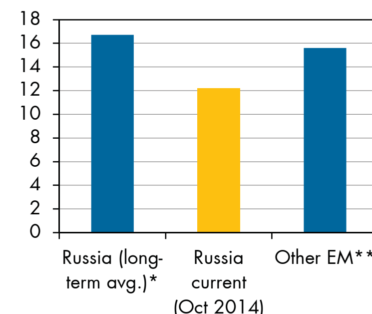

*Source: CBR, RBI/Raiffeisen RESEARCH*

**Regulatory Capital to RWA (%)**



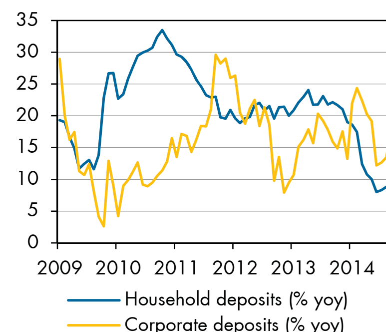

** latest available data as of Q3 2014*
*Source: CBR, RBI/Raiffeisen RESEARCH*

**Regulatory Capital to RWA (%)**



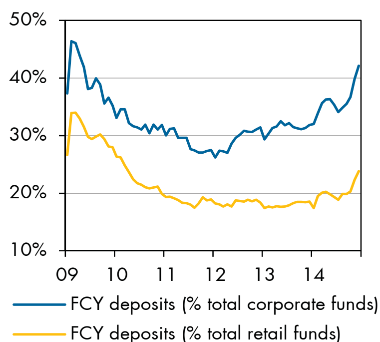

** 2000-2013*
*** CN, IN, ID, PH, UA, BY, KZ, PL, RO, TR, BR, MX*
*Source: CBR, IMF, RBI/Raiffeisen RESEARCH*

**Deposit growth by segments***



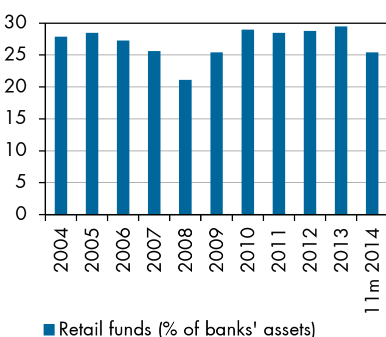

** in LCY terms, latest data point Nov-14*
*Source: CBR, RBI/Raiffeisen RESEARCH*

**FCY deposits by segments (%)***



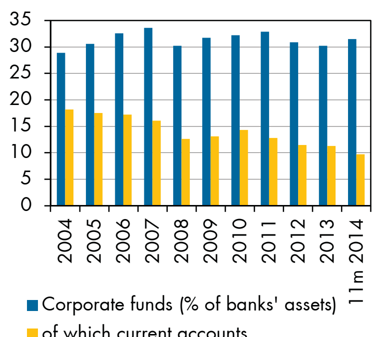

* latest data point Nov-14
Source: CBR, RBI/Raiffeisen RESEARCH

**Retail funds in total bank funding**



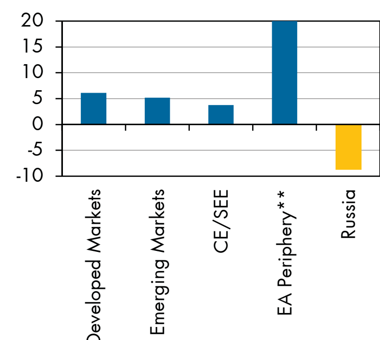

Source: CBR, RBI/Raiffeisen RESEARCH

**Corporate funds in total bank funding**




Source: CBR, RBI/Raiffeisen RESEARCH

**Cross-border claims (last 4 quarters)***




* BIS-reporting Western European banks, latest data Q2 2014; ** ES, GR, PT, IE, IT
Source: BIS, RBI/Raiffeisen RESEARCH

with a significant deterioration of the overall market situation in recent years. Going forward the major aspect here will be how the CBR can balance the goal of preserving financial stability, without compromising too much in terms of collateral standards for monetary policy operations.

As for the own revenue generating capacity, the anticipated decline in lending coupled with increasing provisioning costs due to the likely asset quality deterioration, are the major burden for retained earnings. We will further analyse NPL dynamics below, but the experience from recent crisis years shows that NPLs reached levels of 8-10% of total loans (IFRS-based) in the individual banks (the CBR-reported, RAS-based system-wide NPL figure was capped by 7% then). Moreover, given past experience and according to market and rating agencies estimates, the cumulative gross problematic assets, which include restructured loans and repossessed collateral under the rating agencies' definition, could exceed 30% of total loans.[1] We think that this time it would be reasonable to anticipate similar asset quality trends. A similar trend has started revealing somewhat, with the total own funds share in Russian banking sector funding (reported by CBR by Russian accounting standards, comprising mostly retained earnings and capital) declined to 10% in November 2014, down from 14% year-end 2013.

On the deposit side the downside pressure had been somewhat stronger than on the loan/asset side in recent months. The deposit downtrend even looked more similar to the developments seen in 2009 – at least on a temporary basis in H2 2014 (in particular during the period of swift RUB devaluation, RUB volatility and strongly increasing inflation). Retail deposits have seen substantial pressure in H2 2014 in particular, compared to corporate deposits. Most recently there seems to be some stabilisation in overall deposits, mostly driven by corporate deposits. The latter developments seem to be a reflection of cautious investment strategies in the corporate sector as well as pre-cautionary savings (e.g. against external repayments or a situation where the government may offer less support to strategic enterprises). As we think that the worst time of market panic could be behind us and corporate depositing is likely to stay with us for some time we do not expect additional significant downside pressure on the deposit base in case Russian authorities are successful in RUB stabilisation. Nevertheless, we may still see some pressure on household deposits given still remaining inflationary pressure and the need to draw from pre-cautionary savings.

Both in corporate and retail sector, the FCY-denominated deposits saw U-shaped dynamics, growing in their shares of total customer funds to levels observed at the edge of the deterioration in 2008/09. For retail deposits, the FCY-denominated share in total deposits reached 24% by December 2014, from lows at about 18% within the course of 2011. The dollarization of retail deposits went on the back of their general slump of them in the banks, with their rate of nominal growth in RUB terms (LCY and FCY taken together) lowering from 22% yoy in the beginning of the year to 9-10% yoy in December 2014. Given the substantial RUB devaluation in Q4 2014 this means that the "clean" nominal deposit growth rate (if expressed in RUB) should be around zero. On the corporate deposit side, the FCY deposits peaked at 42% of total corporate funds in November 2014, from their lowest level of 27% in spring of 2012. At the same time, the nominal growth of corporate deposits in RUB terms has accelerated by end-2014 (from 18% yoy in the beginning of the year to 30% yoy in November 2014), which is explained by a surging FCY-denominated component (we assume that the loan "extras" that large Russian corporates managed to get from the state as external funding substitution, were largely put on deposits as rainy-day reserves, and thus

1 S&P, "Banking Industry Country Risk Assessment: Russia", September 24, 2009.



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**Focus on: Cross-border claims of European banks on Russia**

*Cross-border claims of Western European banks on Russia had been already underperforming broader European and global trends over the last few quarters and in H1 2014 in particular. We expect this trend to continue in H2 2014 and well into 2015 (latest data available for global cross-border banking claims are as of June 2014). Up to a certain extent this trend is definitely a reflection of a much more cautious risk assessment regarding cross-border exposures towards Russia. Given the developments in H2 2014, we think that the risk assessment towards Russian cross-border exposures has even intensified (e.g. due to the pricing in of capital control risks on CDS markets, the swift and hefty RUB devaluation in Q4 2014, a decreasing availability of risk insurance in trade financing etc.). That said it has to be stressed that the decline in cross-border exposures also reflects a lot of other aspects that are not per see linked to pure country-risk aspects. For instance, external trade volumes with Russia have dropped substantially in 2014 and this tendency is unlikely to reverse soon. Given the experience in other periods of market stress and the pricing in of extreme country risk assumptions (like the pricing in of euro break-up risks at the peak of the euro area crisis) we would expect that total cross-border exposures of Western European banks towards Russia may decline by some 40% (taking into account the already realized cuts of some 15% over the last few quarters and additional reductions in H2 2014 and possibly early 2015). The decline in cross-border exposures of Western European banks towards Russia definitely adds to funding challenges on Russian markets where Western European banks had been among the traditional providers of financing and liquidity.*

*Financial analyst: Gunter Deuber*

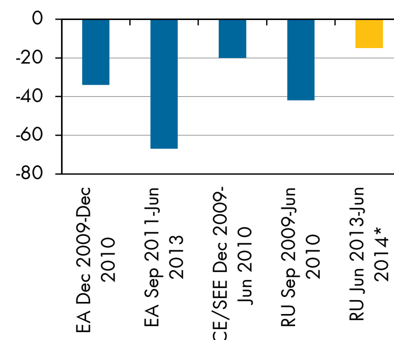
influenced the stated corporate deposit trends). Moreover, data show that the corporate savings behaviour over the past months of 2014 was greatly devoted to savings in FX. The share of corporate current account as percentage of banks' funding sources has deteriorated by some 2-3% over the past months of the year, while all possible surplus corporate funds went to deposits (the total share of corporate funding in the banks remained approximately constant at 30%).

Given the sketched deposit developments, it comes as no surprise that the loan-to-deposit ratio has seen a moderate uptrend in H2 2014 although the overall ratio is still remaining a tad below 100%. However, we would remain cautious in terms of the interpretation of this ratio. The overall market ratio is definitely not representative for a lot of larger players on the Russian market that are all characterised by loan-to-deposit ratios well above 100%. Therefore, it comes as no surprise that the overall dependency of the Russian banking sector on CBR funding has increased substantially throughout 2014. In fact, as mentioned, the dependency on CBR funding is already close to the peak level seen in the 2008/2009 deterioration. Moreover, the Russian banking market is increasingly locked into itself. The market share of Western (European) banks on the interbank market has constantly decreased throughout 2014, to around 33% according to latest data (down from peak levels at around 45-55% in recent years). Logically the market share of Russian lenders and offshore accounts on the Russian market has increased to 50% (Russian lenders only) or 64% respectively (Russian lenders plus offshore accounts) up from levels from around 27-29% in 2008/2009 for Russian lenders and 40-50% for Russian lenders including offshore-accounts.

## Profitability, asset quality and NPL outlook

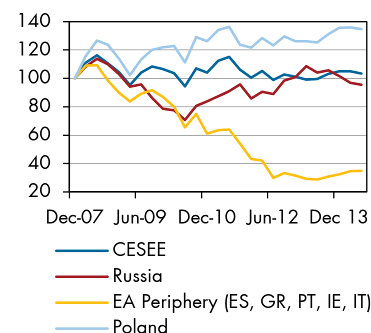
Up to now profitability in Russian banking has held up fairly well. Throughout 2014 the RoE has dropped by some 1.5 percentage points, down from around 14% in Q1 2014 to around 12.4% in Q4 2014; the RoA has dropped from levels around 1.8% to 1.4% during the same period of time. That said an extreme downfall in profitability has been avoided up to now (e.g. back in 2008/2009 we have seen quarterly RoE swings by 5-7 percentage points). Up to now profit-

**Cross-border "crisis cuts"***



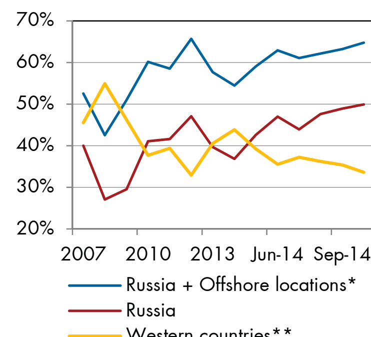

** Cross-border claims BIS-reporting Western European banks, latest value RU 2014: June*
*Source: BIS, RBI/Raiffeisen RESEARCH*

**Cross-border claims (2008=100)***



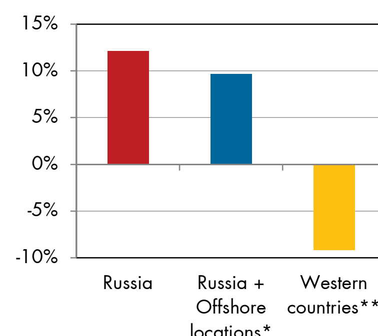

** BIS-reporting Western European banks*
*Source: BIS, RBI/Raiffeisen RESEARCH*

**Shares Russian interbank market (%)**




** RU + CY + 70% NL + 90% Others*
*** UK, US, DE, FR, IT, AT*
*Source: CBR, RBI/Raiffeisen RESEARCH*

**Chg. share RU interbank market*****

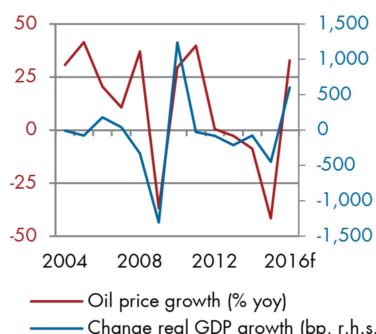



** RU + CY + 70% NL + 90% Others*
*** UK, US, DE, FR, IT, AT*
**** pp, Oct-2014 compared to 2007-2012 average*
*Source: CBR, RBI/Raiffeisen RESEARCH*

**RUB depreciation trend***

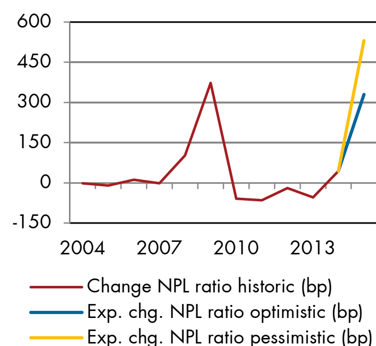
** Indexed chart, January 2007 = 100*
*Source: Bloomberg, RBI/Raiffeisen RESEARCH*

**Oil price and GDP growth**




*Source: IMF, national sources, RBI/Raiffeisen RESEARCH*

**Change NPL ratio (bp)**



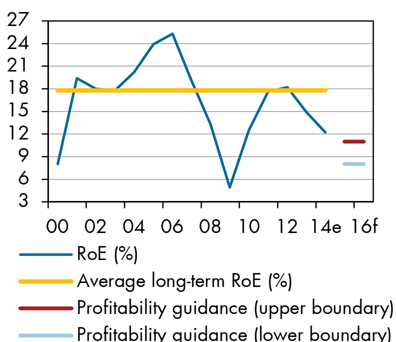

*Source: national sources, RBI/Raiffeisen RESEARCH*

**NPL ratio by segments (%, eop)**

| | 08 | 09 | 10 | 11 | 12 | 13 | 14* |
|---|---|---|---|---|---|---|---|
| Corp.** | 2.1 | 6.1 | 5.2 | 4.6 | 4.6 | 4.1 | 4.2 |
| Retail** | 3.7 | 6.8 | 6.9 | 5.2 | 4 | 4.4 | 5.9 |

** latest value; ** High last cycle Corp.: 6.5; Retail: 7.5; including intra-year data not just eop values*
*Source: CBR, own calculations, RBI/Raiffeisen RESEARCH*

**RoE historical and outlook**




*Source: CBR, RBI/Raiffeisen RESEARCH*

ability indicators are largely reflecting our long-held view that there are substantial buffers available in the Russian banking sector on aggregate and that the expansion seen since 2010 was less aggressive and risk-based than in the run-up to the 2008/2009 downfall. Hence, asset quality deterioration has been also modest up to now. That said we would remain sufficiently cautious on the earnings outlook for the next 12-18 months. Most of the macro and banking sector deterioration seen in H2 2014 is likely to be fully reflected in H1 2015 or full-year 2015 figures. This holds especially true as the effects of asset quality deterioration will only materialise in 2015. Moreover, the changes to accounting standards announced by the CBR in December will only buy time to manage potential losses from market valuations resulting from the substantial RUB devaluation (that is unlikely to be reversed substantially soon). Currently, we would expect the NPL ratio to reach at least a level of 8-10% over the next 6-12 months, while additional upside pressure on the NPL ratio cannot be ruled out later on, largely a function of the oil and GDP recovery. That said the outlook for a shallower recovery in the real economy and banking sector compared to 2008/09 is adding to medium-term profitability and asset quality challenges beyond the 12 months horizon. This holds especially true for foreign-owned banks given the substantial RUB devaluation that is unlikely to totally reverse soon. Moreover, increased costs of funding are also burdening the banking sector. This trend is largely a reflection of the secular shift towards more costly domestic funding (not only CBR funding). The turn to more costly domestic funding is clearly supported by trends in interbank lending on the Russian interbank market as well as decreasing (cheaper) cross-border financing. Another complication, internally, is that the money pricing equilibrium appeared to be broken following the harsh exchange rate devaluation in December 2014. The jumps of official and market rates have left no viable benchmark money pricing for the banks for the time being; and hence both banks' funding and lending interest rates have to pass through a period of re-adjusting. Moreover, the current level of elevated short-term interest rates is unlikely to improve substantially in 2015. The CBR may bring back the key rate to levels around 12-15% in H2 2015 in case of somewhat supporting external conditions, decreasing inflation and a more sustained stabilisation of RUB markets. However, we want to stress that there are still buffers available to boost profitability in the Russian banking sector in terms of cost efficiency, an aspect that was of less relevance in the recent boom phase.

## Changes in market structures

Throughout 2014 state-owned and state-near players have seen an increase in their market shares, a trend that we would expect to continue in 2015. Nevertheless, we want to reiterate that we expect Russian authorities to offer liquidity support (and potentially additional support) to all systemic players. At least throughout 2015 we see an untarnished willingness and ability to do so. Moreover, all market players with a sufficiently viable business model should have sufficient assets/loans that would be CBR eligible in light of the changes to standards to CBR eligibility seen over the last few weeks. Moreover, we think this time the political rationale to support systemic banks is even stronger than back in 2008/09. Nevertheless, that does not rule out that we may see additional troubles at individual institutions, while there could be also closures of smaller banks. Overall the Russian banking market still looks overcrowded in terms of number of banks operating on the market. Moreover, we think that this time Russian authorities have to be more cautious in their support strategies compared to the situation back in 2008/09, where there was no de facto closure of international markets for Russia-related transactions.

*Financial analysts: Gunter Deuber, Elena Romanova*



**Please note the risk notifications and explanations at the end of this document**

**Focus on: Uninspiring prospects – compared to previous expectations (2012 vs. 2015 assumptions)**

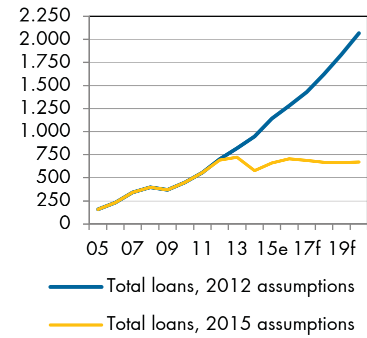
*The current challenging macroeconomic situation and the subdued medium-term outlook are increasingly a burden for the earnings and growth prospects in the Russian banking sector. The earnings outlook is especially clouded for Western foreign-owned banks given the substantial RUB depreciation that is unlikely to be reversed soon; although some RUB recovery might be in the pipeline later in 2015 or 2016. From a medium-term perspective and based on Purchasing Power Parity considerations we would expect EUR/RUB at around 80-100 by the end of this decade. Depending on business models, asset structures and hedging strategies the massive RUB devaluation itself may cut the near and medium-term revenue stream for foreign-owned banks in Russia substantially compared to previous expectations. On top of the currency effects asset quality deterioration will be a burden for the next 12-18 months as well. Moreover, a quick rebound (like seen after the 2009 downfall) seems very unlikely on the banking market and for the whole economy.*

*Beyond the short-term perspective the long-term effects of the recent massive RUB depreciation as well as the subdued macro-outlook are substantial as well. With regards to the medium-term banking sector outlook there are several negative factors at play at present and most likely also in the years to come. Firstly, income levels of the population and investments are likely to stagnate for a longer period of time. Hence growth opportunities in banking in terms of net new lending will be limited, which implies that Russia is unlikely to experience a meaningful financial deepening over the next few years. Given our current macro projections we would expect the Russian loan-to-GDP ratio to hover around a level of 50% in the next few years. Some three years ago we still expected a decent financial deepening in Russia resulting in a loan-to-GDP ratio close to 70% by the end of this decade. Or in other words: Banking sector growth is unlikely to outpace GDP growth on a sustained basis going forward. In nominal terms we would now expect the total loan stock in Russia to reach some RUB 60 trn in 2020, compared to our previous belief in some RUB 80 trn in 2020 (i.e. the 2020 loan stock will be 30% lower than anticipated previously). In EUR-terms the effects will be even stronger. In nominal terms we would now expect total loans on the Russian market to reach some EUR 670 bn in 2020, compared to our expectations for a loan stock at around EUR 2.000 bn in 2020 (i.e. in EUR-terms the 2020 loan stock could be 70% lower than anticipated previously). Secondly, the refinancing side and capitalisation are increasingly becoming a constraint for further banking sector expansion. The loan-to-deposit ratio has increased substantially over the last few months. Pressure on capitalisation is likely to intensify in 2015, while overall capitalization levels are way below their 2008/2009 levels. Moreover, the full effects of the most recent deterioration in H2 2014 will be only reflected in the H1 2015 or full-year 2015 results. However, as the recovery prospects and medium-term growth outlook for the whole economy and banking sector are much weaker than back in 2009, asset quality and capitalisation issues cannot be easily compensated by new business.*

*Given the overall outlook sketched previously and experience with similar scenarios in other CEE banking markets the profitability in the Russian banking sector is likely to remain in a range of 40-60% of pre-crisis levels. Or in other words: The Russian banking sector RoE and RoA are likely to oscillate around 8-12% and 1.2-1.4% respectively. Hence the banking sector RoE may stay below refinancing costs and government bond yields for a certain period of time, which is usually a challenging situation for banking business. With regards to foreign-owned banks it has to be stressed that the bleak macroeconomic and banking sector earnings outlook may also impact the balance sheet valuation of Russian subsidiaries of foreign economic actors going forward. The risk-reward calculation in terms of profitability on the Russian market is also changing substantially for Western European banks given the increased country risk costs, increasing cost of capital as well as additional capital buffers required for Russian exposures by home country regulators. This holds true despite the fact that some foreign-owned banks were constantly able to outpace the market RoE over the last few years.*

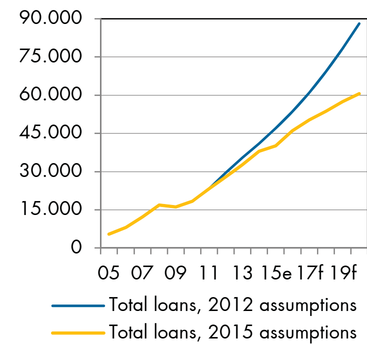
*Financial analyst: Gunter Deuber*

**Russia: Total loans (EUR bn)**



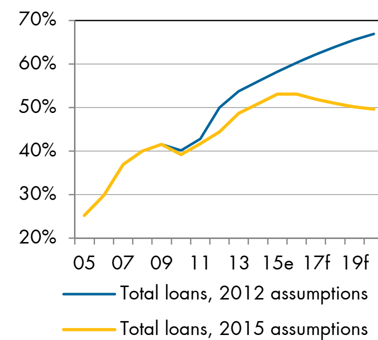

*Source: CBR, RBI/Raiffeisen RESEARCH*

**Russia: Total loans (LCY bn)**



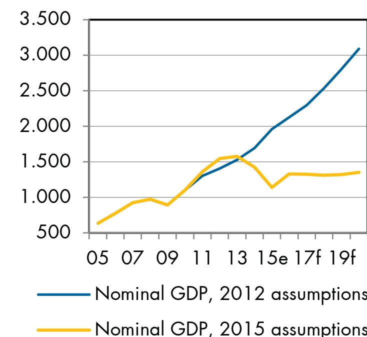

*Source: CBR, RBI/Raiffeisen RESEARCH*

**Russia: Credit-to-GDP ratio (%)**




*Source: CBR, RBI/Raiffeisen RESEARCH*

**Russia: Macro assumptions (EUR bn)**




*Source: national sources, RBI/Raiffeisen RESEARCH*

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## Credit assessment of the major Russian banks

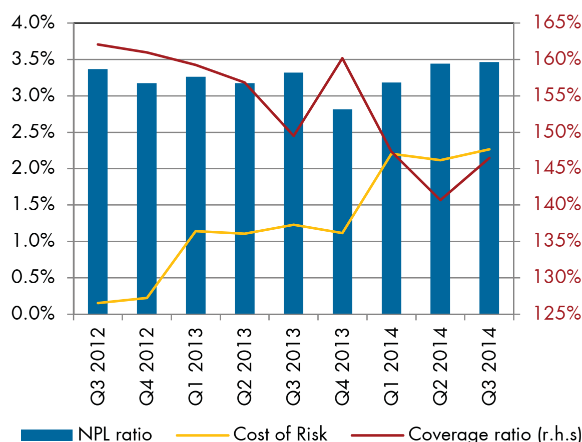
Apart from Ukrainian conflict, the Russian banking system was forced to cope with lower private consumption, tighter credit conditions and rising non-performing loans as a result of declining economic growth. However, the impact of the imposed sanctions and the miserable investment climate, as well as the current operating environment, present huge challenges for Russian banks and are putting both their balance sheets and business models to the test.
In addition to the medium-term risks for Russian banks, which include asset quality and scarcity of capital, the lasting problem of high single-borrower concentrations and related-party exposures might now escalate the situation even further. The imposed interest rate hikes are pressuring margins of the entire sector and the repricing of funding costs are about to impair the business models of many banks (consumer lenders!).

We remain cautious on private-owned banks since support is potentially much lower and those banks are in general more vulnerable to shocks and have lesser access to liquidity. Amongst non-state-owned banks, Alfa Bank is best positioned to withstand the challenges ahead in our view but has the same tight capital buffers just like the rest of the sector. With regards to state-owned banks, we are maintaining our overweight on Sberbank's senior and subordinated debt as it has the best credit quality in the country and is more likely to maintain its investment grade rating. In the medium-term we expect the Basel III debt of the major Russian banks to remain at their distressed levels and investors will continue to demand double-digit yields from this type of security and risk.

## Asset quality and Ukrainian exposure

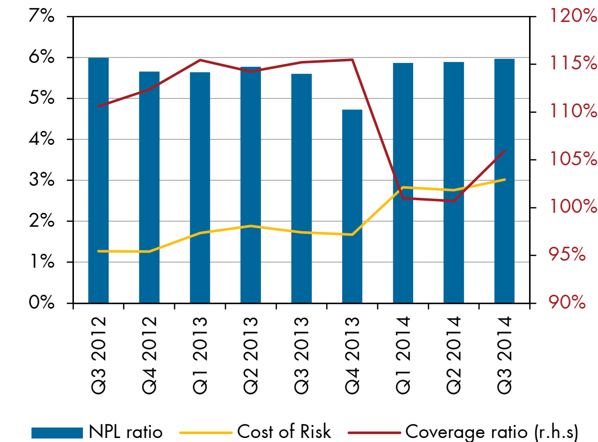
Sberbank did not provide many details regarding its exposure to Ukraine as it announced its Q3 2014 figures. However, the direct exposure of Sberbank and VTB to their Ukrainian subsidiaries totalled RUB 80 bn and RUB 62 bn, respectively, which translates into about 4% of the group's equity for Sberbank and 7% of equity for VTB. In terms of equity, Vnesheconombank has the highest exposure on Ukraine via its subsidiary Prominvestbank, which accounted for a rather significant 20% of equity. Among the top five financial institutions in Russia, Gazprombank and Russian Agricultural Bank are the least exposed to Ukrainian risk as they have no subsidiaries in Ukraine and are therefore not directly lending locally. We expect the Ukrainian exposure to have a significant impact on VTB's P&L, which already revised its earnings forecasts and we expect VTB to post a loss in Q4 due to escalated provisioning charges. As of Q3 2014, Cost

**Sberbank: Asset quality and CoR**




*Source: Company data, RBI/Raiffeisen RESEARCH*

**VTB: Asset quality and CoR**




*Source: Company data, RBI/Raiffeisen RESEARCH*



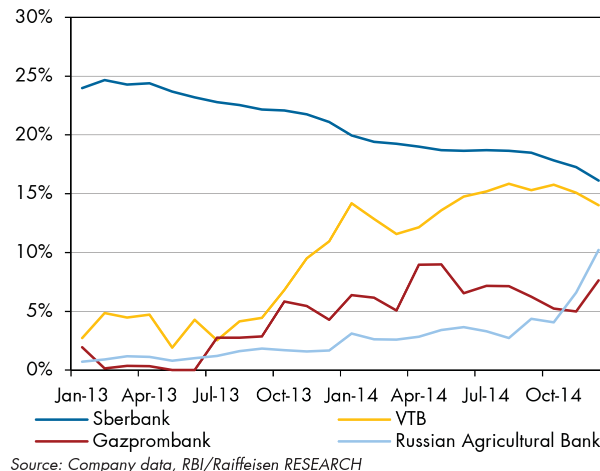
**Please note the risk notifications and explanations at the end of this document**

of Risk (CoR) already reached 3.0% at VTB (2.3% at Sberbank), the highest level since Q4 2009. The effects on asset quality also started to become visible with VTB's NPL ratio increasing to 6.0% and Sberbank's NPL ratio rising to 3.5% as of 9M 2014.

## Funding, refinancing and liquidity

The funding situation remains tight. Customer deposits represent the major source of funding for Russian banks (57% of the sector's liabilities). As deposit growth started to slow, the banking system's reliance on funding from the Central Bank of Russia (CBR) increased over the last two years. The share of CBR funding increased especially among the fundamentally weaker state-owned banks, whereas Sberbank's reliance is successively declining. Still, loan-to-deposit ratios of Sberbank as well as VTB have weakened to 114% and 141% at 9M 2014 (9M 2013: 105% and 133%), respectively and this trend is expected to continue. The CBR became a major source of funding in FX in addition to the foreign currency swap facility introduced on 17 September. Moreover, it announced that it is ready to further increase its FX repos from the current USD 50 bn.

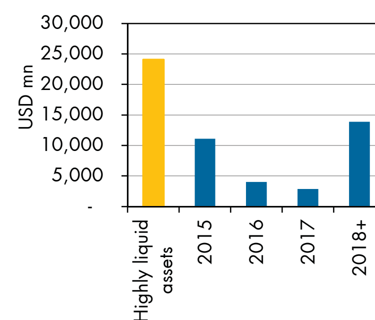
**Reliance on CBR funding in % of liabilities**




*Source: Company data, RBI/Raiffeisen RESEARCH*

Liquidity remained sufficient for the major banks reported sufficient liquidity buffers to cope with the USD 18 bn of Eurobonds in the financial sector coming due in 2015. Sberbank is again facing much lower liquidity risk and its profitability is likely to remain stronger than the rest of the banking sector. As liquidity has become much more expensive and funding costs have risen the sector will continue to feel the pressure on its margins. When comparing the two major banks, VTB is more vulnerable to rising funding costs due to its higher loan-to-deposit ratio and higher share of short-term liabilities.

**Sberbank: Cash vs. Debt**

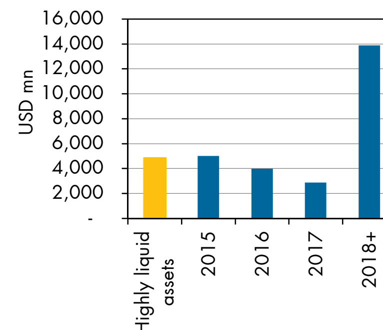



*Source: Bloomberg, company data, RBI/Raiffeisen RESEARCH*

## Shortage of capital and first bailouts

As a result of aforementioned factors and in combination with the massive RUB devaluation, some Russian banks have already found themselves to be technically insolvent at the end of December 2014. In response, CBR swiftly imposed a "temporary moratorium" in order to limit the impact of revaluation of assets and liabilities in FX. Still, on 26 December one of the biggest bailouts since the rescue of Bank of Moscow (2011) occurred and the CBR has chosen Bank Otkritie as an investor in charge of the financial rehabilitation of TRUST Bank, which has been experiencing financial difficulties due to deposit outflows, as well as increased credit costs from retail lending. The Russian authorities have provided a 10-year RUB 99 bn loan via the Deposit Insurance Agency (DIA) to TRUST Bank and another RUB 28 bn over six years to Otkritie Bank. S&P affirmed Otkritie's BB- rating but revised the outlook to negative reflecting the view that this new acquisition will be fairly challenging and pressure Otkritie's credit profile.

**VTB: Cash vs. Debt**

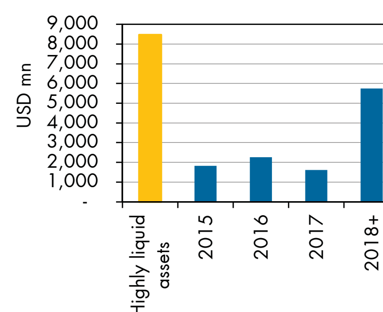



*Source: Bloomberg, company data, RBI/Raiffeisen RESEARCH*

**The most significant actions of the CBR and Russian authorities**

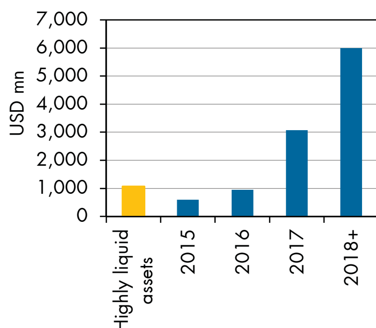
- The Russian authorities have indicated that RUB 400 bn from the National Wealth Fund can be distributed among Russian major banks in the form of subordinated loans.
- Furthermore, the government has also announced its plan to recapitalize the banking sector with a capital boost of up to RUB 1 trillion Russia's lower house of parliament hastily approved the draft law and banks are expected to receive injections in early 2015.

**Gazprombank: Cash vs. Debt**




*Source: Bloomberg, company data, RBI/Raiffeisen RESEARCH*

**RSHB: Cash vs. Debt**



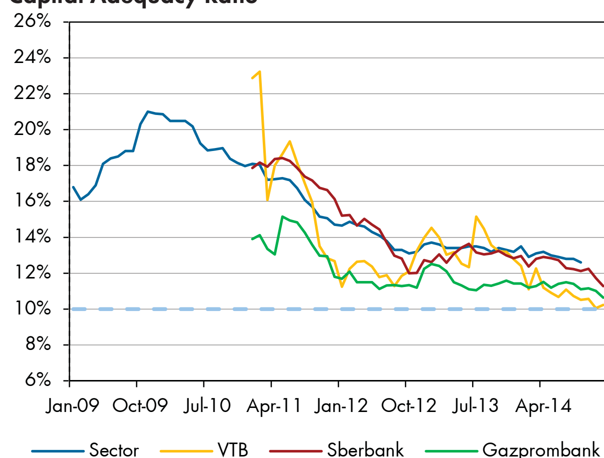

*Source: Bloomberg, company data, RBI/Raiffeisen RESEARCH*

- Additionally, the CBR allows banks to use the FX rate of previous quarter (Q3 2014) to value their assets in FX and banks also don't have to recognize mark-to-market securities losses.
- In order not to immediately impair their business models, banks involved in consumer lending are temporary allowed to charge rates above the stipulated limit for consumer loans.
- Counterparties that are affected by sanctions may not increase their loan loss provisions against claims that were impaired.
- The of minimum insured deposit amount has been doubled to RUB 1.4 mn (USD 23 thd).

**Still, in our opinion these measures are not sustainable and the capital problem that Russian banks are now facing is obviously bigger than back in 2008/09.** While the downturn has just started, only a stabilization of the RUB/USD exchange rate at current levels would actually be enough for many banks (e.g., VTB, Gazprombank) to breach the minimum capital requirements.

In December 2014, around 31% of VTB's interest-earning assets were denominated in foreign currencies and the bank published a CAR of 10.24%. Assuming that the bank's equity remains flat, the FX effect should be proportional to the "mathematical FX-driven" increase in assets and at the current exchange rate, CAR would drop to 9.5% at VTB and 9.7% at Gazprombank (with a minimum requirement of 10%).

**Capital Adequacy Ratio**




*Source: CBR, company data, RBI/Raiffeisen RESEARCH*

The Russian government has already reacted to this threat and has bought RUB 40 bn of Gazprombank's preferred shares and VTB, which was operating just slightly above the minimum capital requirement, also received RUB 100 bn from the National Wealth Fund. However, further potential losses may continue to erode the already tight capital buffers of Russian banks and we think that this trend will not reverse until the economic slump materially improves. Nevertheless, the CBR has proven its readiness to prevent a breakdown of its banking sector and we take comfort in this strong signal – at least with respect to the systemically important banks.

*Financial analyst: Michael Ballauf*

## Risk notifications and explanations

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