The Russian banking sector: between instability and recovery[2]

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Russian banks seem to be slowly emerging from the country's 2014–15 economic and financial crisis, which had been triggered by the oil price plunge and Western sanctions. While the economy has recovered from the recession and macroeconomic stability has been re-established (including record-low inflation), GDP growth is still modest. Lending has gone from a crisis-driven credit crunch to a retail-driven recovery, while deposits, buoyed by sustained confidence, have expanded. However, some medium-sized private banks, burdened by legacies of mishandled crisis-triggered takeovers of smaller outfits, collapsed in the second half of 2017, delaying the overall improvement of credit quality, profitability and capital adequacy. In reaction, the central bank nationalized and bailed out these systemically relevant players and established a "bad bank" to more effectively control restructuring procedures. While credit risk and related-party lending risk remain serious, shock-absorbing factors are ample and have further accumulated (including high foreign currency reserves, sizable net external assets and a solid fiscal position).

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Russian banks seem to be slowly emerging from the country's 2014–15 economic and financial crisis. This brief study analyzes these developments, focusing in particular on the banking turbulences of the second half of 2017 and how they have been overcome.[3] Section 1 outlines the macroeconomic background. Section 2 first deals with overall banking developments and then focuses on structural elements of turbulences in some medium-sized private banks in the second half of 2017. The measures taken by the Central Bank of the Russian Federation (Bank Rossii – BR) to address these failures are gauged in section 3. Section 4 gives an assessment of current Russian banking risks and shock-absorbing factors. Section 5 concludes with an outlook.

1 Macroeconomic background: from mild recession to modest growth amid sanctions

In 2015, the near-halving of the oil price (Urals grade crude, annual average) to USD 51/barrel coupled with the imposition of Western sanctions in the context of the Ukrainian crisis[4] pushed Russia into recession, with GDP declining by 2.8%. However, the ruble's flexible exchange rate (from November 2014) protected the profitability of the resource sector as well as budget proceeds (expressed in rubles), since lower U.S. dollar-denominated oil revenues were compensated for by the ruble's devaluation. Yet the slide of the ruble also fueled inflation, which, after spiking in early 2015 (April: 16.4%), slowly declined, given weakened demand as

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[3] *This article is an update of Barisitz (2015). It thus covers the period from around mid-2015 to early 2018 and provides an outlook.*

[4] *The strongest restrictive measures imposed include tight limits on the access of large Russian state-owned banks (SOBs) and state-owned enterprises (SOEs) to EU and U.S. capital markets and bank loans. As a consequence, many Russian credit institutions and firms have been effectively cut off from financing on Western markets.*

well as the BR's resolute monetary policy response. After the key rate (the repo auction rate) had been sharply raised (to 17%), it was very gradually lowered. Although the oil price declined further by about one-fifth in 2016, Russia's GDP growth practically stabilized that year (–0.2%), probably helped again by the flexible exchange rate (–10% depreciation of the annual average against the U.S. dollar), as well as by a modest fiscal stimulus. Inflation fell to 5.4% at end-2016.

Buoyed by the oil price's moving back up by one-quarter in 2017, private consumption and fixed capital formation were the driving forces of the ensuing recovery, which, however, has been relatively modest so far (2017 GDP growth: +1.5%). This is because of a persistently weak investment climate, even if some institutional parameters appear to have improved in recent years.[5] The BR upheld its strict monetary policy stance (key rate: 10% at early 2017), and inflation further receded to one of its (so far) lowest levels (end-2017: 2.5%, end-March 2018: 2.4%), helped by an oil price rise-triggered partial revaluation of the ruble. As the BR's inflation target of 4% continued to be clearly undershot, the monetary authority cautiously reduced its key rate, which in mid-April 2018 stood at 7.25%. Not least due to sanctions and forced deleveraging, Russia's relatively low external debt declined and at end-2017 came to 32% of GDP (EUR 424 billion). After reaching a trough in early 2015, the country's international reserves (including gold) recovered and eventually exceeded the level they had held prior to the crisis of 2014–15. At end-2017, they stood at 28% of GDP (mid-May 2018: EUR 386 billion). The latest round of U.S. sanctions (of early April 2018) against individual Russian businessmen and their enterprises is also punishing non-U.S. firms for doing business with these players. As a result, the ruble depreciated by about 5% and uncertainty (temporarily) increased.

2 Banking developments

2.1 From credit crunch to a hesitant, retail-driven lending recovery

The weakening recession, followed by the return to economic growth, as well as the authorities' successful macro-stabilization efforts contributed to a turnaround in lending, even if credit activity is yet humble overall. While total loans (to resident sectors, excluding the interbank sector) still declined by a cumulative 17% in 2015 and 2016 (in real terms and exchange rate-adjusted), they recovered to a growth rate of 5% at end-March 2018 (year on year) (see table 1). Like before the crisis of 2014–15, retail lending has been volatile (2015–16: –19%, in real terms and exchange rate-adjusted) and is now leading the credit recovery (end-March 2018: +13% year on year). Mortgage loans, meeting high pent-up demand for housing, increasingly dominate retail lending (Bank Rossii, 2018, pp. 15–16). Mortgage loans' share in total household loans rose from 35% in mid-2015 to 43% at end-March 2018. Meanwhile, loans to enterprises (2015–16: –15%) are still in sluggish terrain (end-March 2018: +2%). While the share of foreign currency-denominated loans in total loans to enterprises spiked at end-2015, reaching almost one-third, this share declined to 20% at end-March 2018. The share of foreign currency loans in retail credit is negligible. Benefiting from continued high real interest rates, deposits started to expand in 2016 and grew by 7% by March 2018 (year on

[5] *Thus, Russia is reported to have substantially improved its ranking in the World Bank's Doing Business Report from 2010 to 2017, namely from 124th to 35th place (Titov, 2017).*

year). Weak lending, coupled with depositors' sustained confidence, drove down the loan-to-deposit ratio from 108% at end-2015 to 95% two years later; a turnaround now appears to be happening, though (Khromov, 2018b, p. 21).

The recession in 2015, followed by economic stagnation in 2016, and the lack of new lending pushed the nonperforming loan (NPL) ratio from 8% (narrow definition) and 16% (broader definition, including doubtful loans)[6] to 10% and 18%, respectively, between mid-2015 and end-2016. NPL ratios have since largely remained at this elevated level. The likely positive effect of the economic recovery that started in 2017 on credit quality was probably offset by the instability triggered by the insolvencies of three medium-sized private banks that year. The build-up of loan-loss provisions has continued to lag somewhat behind NPLs of the narrow definition and to reach but half of NPLs of the broader definition (Vasileva, 2017, p. 5); at end-March 2018, provisions came to 9.6% of the value of total loans. The banking sector's liquidity appears to have stabilized,[7] and another sign that the crisis conditions are waning comes from the reversal of credit institutions' net position vis-à-vis the BR: whereas in mid-2015, the sector's net liabilities to the monetary authority still came to 7% of the sector's total balance sheet value, this changed to a net claim position of 3% at end-March 2018. Sanctions and forced deleveraging contributed to driving down banks' foreign debt from 11% of their total liabilities in mid-2015 to 7% at end-2017.

Supported by higher net interest margins, banks' profitability has been gradually recovering from its low point reached in late 2015,[8] but has remained modest. The sector's return on equity (ROE) rose from 2.3% at end-2015 to 14.4% in mid-2017, before receding to 8.5% at end-March 2018. The weakening of overall profitability in the second half of 2017 was influenced by the banking turbulences already mentioned (see the following subsection). As table 1 shows, banks' aggregate capital adequacy ratio, which had declined to 12% in the second half of 2017, came to 13% at the end of the first quarter of 2018.

2.2 Banking recovery burdened by turbulences in 2017

The most important factor that put pressure on profitability in the second half of 2017 was a substantial increase of loan loss provisions and other asset write-downs. This was because of restructuring measures launched in August and September 2017 for Otkrytie Bank and Binbank, and in December for Promsvyazbank; all three were private domestically-owned banks (Khromov, 2018a, p. 21). By asset size, Otkrytie was the eighth, Promsvyazbank the tenth, and Binbank the twelfth largest Russian credit institution. Together, the three players accounted for about

[6] *For details about the respective narrow and broader NPL definitions, see explanations in footnotes 2) and 3) of table 1. For a more elaborate discussion of these matters, see Barisitz, 2013.*

[7] *Thus, among other indicators, the ratio of liquid assets to short-term obligations rose from 133% in mid-2015 to 175% at end-March 2018.*

[8] *While the banking sector's aggregate profits remained positive throughout the crisis period, if temporarily descending close to zero, many banks made losses. In fact, (majority state-owned) Sberbank, well-managed and the country's largest bank by far (27% of total sector assets at end-2017), has generated the lion's share of sector profits in recent years and benefited from the crisis-triggered flight to safety. And so have some of the largest foreign-owned banks, which have also earned satisfactory profits. VTB (Vneshtorgbank, state-owned), the country's second-largest bank (16% of total assets) has posted much weaker profitability. Meanwhile, a large number of smaller and partly medium-sized banks' earnings dipped into the red. Numerous unviable outfits were wound up by the BR (see below).*

Table 1

Russia: selected banking sector stability indicators

	End-2014	End-2015[7]	End-2016	Mid-2017	End-2017	End-March 2018
	%					
Credit risk						
Total loans (annual real growth, exchange rate-adjusted)[1]	+1.5	–11.3	–6.1	–3.5	+1.8	+4.5
Loans to households (share in total loans)	29.7	26.3	28.6	29.5	31.1	31.6
Nonperforming loans (as a share of total loans including interbank, narrow definition)[2]	6.8	8.3	9.5	9.8	10.0	10.8
Nonperforming loans (as a share of total loans, including interbank, broader definition)[3]	13.6	16.5	18.0	17.8	17.5	17.7
Market and exchange rate risk						
Foreign currency loans (share in total loans)	18.3	23.6	16.7	15.5	14.5	13.5
Foreign currency deposits (share in total deposits)	29.6	34.3	27.2	25.4	23.5	23.5
Liquidity risk						
Total deposits (annual real growth, exchange rate-adjusted)[4]	–1.6	–0.4	+0.7	+6.5	+10.1	+6.5
Loan-to-deposit ratio	123.8	108.2	102.5	97.1	95.2	96.3
Banks' external assets (share in total assets)[5]	13.7	16.1	12.7	13.1	11.0	11.3
Banks' external liablities (share in total liabilities)[6]	10.7	9.6	7.4	6.7	5.7	6.0
Profitability						
Return on assets	0.9	0.3	1.2	1.7	1.0	1.0
Return on equity	7.9	2.3	10.3	14.4	8.3	8.5
Shock-absorbing factors						
Capital adequacy ratio (capital to risk-weighted assets)	12.5	12.7	13.1	12.9	12.1	13.0
Tier 1 capital ratio N 1.2 (Basel III)	9.0	8.5	9.2	9.4	8.5	10.0
Loan-loss provisions (ratio to total loans)	6.5	7.8	8.5	8.6	9.3	9.6
Memorandum items						
Total banking sector assets (ratio to GDP)	98.0	99.5	93.0	91.2	93.6	89.6
Share of majority state-owned banks in total banking assets	56.6	56.3	56.0	..	61.5	..
Share of majority foreign-owned banks in total banking assets	13.9	13.9	13.0	13.0	12.3	12.2
CPI inflation (year on year, end of period)	11.4	12.9	5.4	4.4	2.5	2.4
Total number of operating credit institutions	834	733	623	589	561	542

Source: Central Bank of Russia, Raiffeisen Research, OeNB calculations.

[1] *Loans and other placements with nonfinancial organizations, government agencies and individuals.*

[2] *Share of problem loans (category IV) and loss loans (category V) according to CBR regulation no. 254 (CBR 2004).*

[3] *Share of doubtful (category III), problem (category IV) and loss loans (category V) according to CBR regulation no. 254 (CBR 2004).*

[4] *Deposits and other funds of nonfinancial organizations, government agencies and individuals.*

[5] *Funds placed with nonresidents, including loans and deposits, correspondent accounts with banks, securities acquired.*

[6] *Funds raised from nonresidents, including loans from foreign banks, deposits of legal entities and individuals.*

[7] *Data for 2015 are subject to regulatory forbearance measures and therefore may not be fully comparable to other data.*

7% of total banking assets at end-2016. Also, they were highly interconnected with other financial institutions, and therefore considered "too big to fail," as opposed to numerous other players. In the restructuring process, considerable amounts of overvalued high risk assets were detected in these banks, pushing the sector's total loan loss provisions up to a level equaling that attained in the financial crisis of 2008–09. In this connection, the persistence of "pocket banks" and of "connected lending" or "related-party lending" in Russia has to be emphasized. As explained in Barisitz and Lahnsteiner (2010, p. 84), pocket banks tend to function as de facto extended financial departments or treasury accounts of owner firms or businesspersons.

While the BR has been combating such practices in recent years (see section 3), they obviously still exist.[9]

Flawed business models, over-ambitious and speculative growth strategies and the misrepresentation of asset quality feature among the most common shortcomings that led to the bank failures mentioned above (World Bank Group, 2017, p. 17). Periods of rapid asset growth had been typically linked to attracting deposits with very high interest rates and/or to important acquisition activities. Such acquisitions of other troubled credit institutions suffering from the recession or from their own overly risky decisions were in some cases even supported by public financing.[10] In such cases, the authorities' crisis response strategy apparently included promoting or accepting mergers between individual "healthy" and "sick" banks. However, public assistance provided by BR soft loans via the Deposit Insurance Agency (Agentstvo po strakhovaniyu vkladov, ASV) did not always serve to clean up the acquired outfit as intended. Rather, BR financial support seems to have been, at least partly, invested into purchasers' own business schemes (Khromov, 2018a, p. 22; Triebe, 2017). Public financial means turned out to be at least partly wasted, structural shortcomings remained unattended, and, following major liquidity problems, the above three systemically relevant banks were eventually nationalized and bailed out. In order to overcome regulatory weaknesses, the authorities subsequently strengthened the bank resolution framework (see section 3). In any case, the three important bailouts point to some continued fragility in Russia's banking system.

3 The central bank's measures to combat instability and support recovery in the sector

The overcoming of the crisis of 2014–15, including substantial recapitalization measures for the largest banks in 2015 (as explained in Barisitz, 2015, p. 77–78) allowed the BR to cancel regulatory forbearance in January 2016. However, it continued its policy of delicensing unviable banks, which resulted in a further reduction of the total number of banks in the country by 255 (or 32%), from 797 in mid-2015 to 542 at end-March 2018 (table 1). The banks taken out of the market were mostly relatively small players that had violated capital requirements, had been involved in connected lending or asset skimming and/or had been facing money laundering charges.

In June 2017, the authorities established a special Banking Sector Consolidation Fund (Fond konsolidatsii bankovskogo sektora – FKBS) to replace the less efficient open rehabilitation mechanism hitherto practiced. The FKBS, wholly owned and financed by the BR, allows the central bank to provide direct equity capital

[9] *The persistence of the above problems also reflects the fact that the BR's move from traditional detailed compliance-oriented supervision to proactive qualitative risk-based supervision is still ongoing. As Governor Nabiullina pointed out in a recent interview, the bulk of remaining adjustments in this direction should be completed in the course of 2019 (The Banker, 2017, p. 105).*

[10] *For instance, Otkrytie Bank had taken over privately-owned Trust Bank (32nd largest in terms of assets) in late 2014, when the latter was approaching insolvency. Otkrytie had also received long-term public financial support for cleaning up Trust Bank. In late 2016, Otkrytie agreed to buy the troubled insurance company Rosgosstrakh. In 2014, Binbank acquired five struggling entities of the Rost Group and a local arm of PrivatBank, a Ukrainian bank, as well as controlling stakes in Uralprivatbank and MDM Bank a year later. Promsvyazbank came to the rescue of floundering Avtovazbank. These steps were reportedly encouraged and partly funded by the BR (Euromoney, 2017, p. 12; Fitzgeorge-Parker, 2017, pp. 85–86).*

injections to banks (equity-based approach) – but only after wiping out shareholders' equity capital – instead of channeling below-market rate loans via the ASV (loan-based approach) (IMF, 2017, p. 15).[11] In this way, it is aimed to reduce moral hazard and a possible waste of resources associated with insufficient public control over financial assistance handed on to "healthy" banks entrusted with restructuring "sick" ones. The authorities hope to avoid a repetition of unnecessarily expensive bailouts, such as happened with Otkrytie or Binbank. Through the FKBS, the BR acquired ownership and took operative control of Otkrytie, Binbank and Promsvyazbank. Preliminary estimates of the BR put the total recapitalization costs of the three systemically relevant banks at EUR 14 billion to EUR 16 billion, of which about EUR 9 billion have already been spent.[12] As a result of the nationalizations, the share of majority state-owned banks in total sector assets is estimated to have risen to over 60%. While Otkrytie and Binbank are to be merged, cleaned up, turned into a competitive universal bank and privatized in a few years' time, the authorities have decided to transform Promsvyaz into a specialist public credit institution for servicing the defense industry and state procurement.

4 Assessment of current banking risks and shock-absorbing factors

4.1 Credit risk

From late 2015 to end-2016 credit quality further deteriorated and remained at a relatively high level in 2017 and early 2018 (NPL ratio according to narrow definition: about 10%, according to wider definition: 18%, see table 1). Although there are currently no substantive indications of further bank insolvencies, insolvencies like those that happened in the second half of 2017 could counteract the continuing economic recovery and keep the NPL ratio high. Apart from that, the quick bouncing back of retail lending (after a sharp contraction in 2015) may raise concerns about looming over-indebtedness among households.

4.2 Connected or related-party lending risk

While the BR has been quite rigorous in weeding out relatively small unviable banks, also on account of connected lending activities, it has obviously been less successful in uncovering or promptly dealing with dubious practices in some medium-sized or large banks, as the cases of Otkrytie, Binbank and Promsvyazbank show. This may have been influenced by some moral hazard generated by the latter banks' de facto status as "too big to fail." In any case, wiping out shareholders' equity and tightening controls on financial assistance can help reduce the loss of public resources in the context of bailouts, although it raises questions as to the impact of the further increased size of the state sector. Also, there appears to be no guarantee that mispriced assets do not unexpectedly "emerge" in other cases.

[11] *In addition, the BR launched a new emergency liquidity facility with expanded eligible collateral to support banks in case of distress.*

[12] *Taken together, the bailouts of these three private credit institutions, which all happened in the second half of 2017, constitute the largest bank bailout package in Russian and CESEE history. According to the BR governor, Elvira Nabiullina, immediately taking over failed banks' equity would have cost 25% to 30% less than the previous soft loan-dominated strategy (Financial Times, 2018). The authorities reportedly also plan to set up a "bad bank" to absorb and resolve the nonperforming assets of banks under restructuring (Russland Aktuell, 2018).*

4.3 Exchange rate and liquidity risk

While these types of risk are less important than those mentioned above, the volatility of the oil price and of the ruble exchange rate as well as unevenly distributed liquidity across the banking sector may give rise to temporary instability. Sanctions-related restrained access to Western financial markets for large Russian enterprises and banks appears to play less of a role now than immediately after the imposition of the restrictive measures in 2014–15, given that the Russian economy, for the time being, seems to have "adjusted" to the sanctions. That said, the newest U.S. punitive measures (of April 2018) may impact profitability of some important Russian corporations and thereby indirectly dampen banks' earnings and render them financially somewhat more fragile.

4.4 Shock-absorbing factors

Shock-absorbing factors have remained relatively strong overall in recent years, albeit not without pockets of weakness. While NPLs have increased, loan-loss provisions have also increased, although they still somewhat lag behind NPLs of the narrow definition. Capital adequacy has decreased in the second half of 2017 by 1 percentage point, before recovering again to 13% at end-March 2018.[13] However, the authorities have ample possibilities should further recapitalization exercises become necessary. General government gross debt came to 13% of GDP at end-2017.

The loan-to-deposit ratio is by no means excessive, depositors remain confident. Another factor providing a cushion are credit institutions' net external assets (5% of total assets at end-March 2018). The fact that SOBs account for the majority of Russian banking assets (about two-thirds) implies that the authorities are directly responsible for the survival of most of the largest players, which may uphold confidence in uncertain times. Russia's foreign currency reserves (including gold) expanded by about one-fifth from mid-2015 to mid-May 2018 and command a solid level (EUR 386 billion or 28% of GDP or 15 import months of goods and services). The country's current account surpluses have slightly risen in recent years (2017: 2.5% of GDP), as have private capital outflows (2017: 2.0% of GDP). Finally, Russia sustains a sound fiscal position (2017: federal budget deficit: 1.4% of GDP), most recently buttressed by oil price rises (Q1 2018: federal budget surplus: 1.5% of GDP), as well as a sizable net investor position (about 17% of GDP).

5 Outlook

While the bank insolvencies of the second half of 2017 have raised concern and possible further turbulences cannot be ruled out, such instability would be highly unlikely to take on systemic proportions. The 25 top private domestically-owned banks – disregarding the bailed out nationalized players – make up about 15% of total banking assets and pursued quite diverse strategies during the crisis years (starting with the big, renowned and rather cautious Alfabank). With over 60% of the banking sector controlled by SOBs, and with state-owned corporations among the largest depositors in the sector, the Russian authorities can go a long way encouraging public players to support the smooth functioning of the banking system (Solanko, 2017). While the state's predominant role in the sector may be a drag on competition and innovation, it can certainly help upholding economic stability.

[13] *The regulatory minimum capital adequacy ratio (N1.0) for banks in Russia is 8.0% (Bank Rossii Instruction No. 139-I).*

The BR's policy of delicensing unviable smaller outfits will probably continue in the next one to two years and may curb the total number of banks by approximately another one hundred. Unless unexpected events intervene (like another sharp and durable decline of the oil price or a severe escalation of geopolitical tensions and sanctions), economic recovery should bolster the fledgling lending recovery and have a positive impact on credit quality. Unless there is a rise in economic uncertainty, some further interest rate cuts in 2018–19 may be possible, which would also lend gentle support to the recovery. While the state has strengthened its positions in the sector in recent years, committed foreign-owned banks (FOBs), who – in contrast to many others – stayed in Russia through the crises of 2008–09 and 2014–15,[14] may also have expansion potential. However, as mentioned above, the still overall weak investment climate currently prevents a stronger recovery of the economy, including of the banking sector.

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[14] *FOBs account for about 12% of total banking sector assets in Russia. Their share has marginally declined since mid-2015 (13%). Among the FOBs that can boast a seasoned track record in the country feature UniCredit (Italy), Raiffeisenbank (Austria), Rosbank (Société Générale, France) and Citibank (U.S.A.).*