September 14, 2017

# Poor asset quality to remain the key risk of Russian banks' creditworthiness decline

## Analysis of Russian banks' asset quality



- **The share of bad loans in the banking system is around 12-15 per cent.** Despite recovering economy, the share of bad loans in the banks' balance sheets has been continuously increasing since 2013. At the same time, the official level of problem loans is at its maximum for the last ten years. ACRA assesses the share of loans overdue for more than 90 days at 5.7 per cent of the total loan portfolio; however, restructured loans and borrowers with low creditworthiness constitute the major risks. We expect the level of problem loans to stabilize in the next 12-18 months.

- **Assets of privately owned banks pose the highest risk.** As a result of implementing aggressive business models and postponing solutions to old problems, the share of bad loans in the portfolios of private banks now exceeds 15% and the provisioning ratio is only 38%. Risks associated with assets of government-owned banks are primarily related to large-scale lending to highly risk-prone industries and to a substantial share of non-core assets: 107% and 18% of core capital, respectively. Activities of foreign banks' subsidiaries are primarily marked by minimum credit risk level.

- **Low coverage of bad loans by provisions is the key short-term risk for a creditworthiness decline of Russian banks.** In the banking system taken together, a little over half of bad loans are provisioned (51.7 per cent). The aggregate potential negative effect of one-time bad loans impairment recognition is assessed at RUB 2.5 trillion; such one-time recognition may cause a drop of banking system's capital adequacy to the regulatory minimum. A more conservative position of the Bank of Russia regarding bad loans provisioning ratio may represent a challenge for banks in the next 12-18 months, and may have a negative effect on their creditworthiness and credit ratings.

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## Problem loans in the banking system are at their peak since early 2010

*Problem loans are loans overdue for more than 90 days (NPL90+); impaired but not overdue debt with highly probable termination of servicing in the next 12-18 months; forcedly restructured debt for the lack of which the borrower would face difficulties in servicing financial obligations; IFRS data and ACRA assessments of the bank's management reporting are used.*

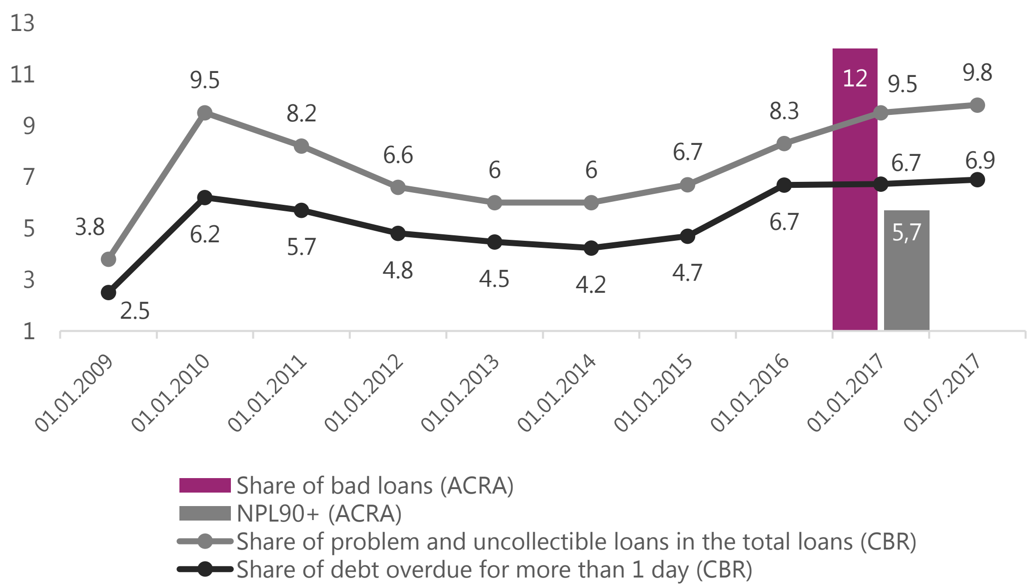
*NPL90+ - loans overdue for 90 or more days according to IFRS data.*

According to ACRA estimates, bad loans accounted for 12% in the total loan portfolio of the entire banking system[1] as at early 2017. Whereas ACRA's rating analysis covers top 30 largest groups of related borrowers (top 50 in individual cases) or 50%-60% of the loan portfolio, the actual share of bad loans is in the range of 12-15 per cent. The share of loans overdue for 90 days and more (NPL90+) is at 5.7%. The banks analyzed account for over 90% of the aggregate loan portfolio of the entire banking sector, hence, our assessment are representative.

Share of bad and unrecoverable loans (classified into quality category 4 and 5 according to the requirements of Regulation No.590-P[2]) in the total amount of loans, which stood at 9.5% as at early 2017, is the closest official indicator for the level of bad loans in the banking sector. As there are no historical management reporting data from the rated banks regarding the quality of loans, we believe acceptable to use data from the Bank of Russia to assess the dynamics: the above-mentioned indicator climbed from 8.3% as at January 1, 2016 to 9.8% as at July 1, 2017.

Considering these data as well as ACRA analysts' observations with respect to changes in the performance of individual large loans, we believe that bad loans in the banking system are at their peak since early 2010. The technical effect of the loan portfolio decrease (primarily corporate loans) can explain it only partially; the fundamental factors for deterioration of the situation are stronger: the share of bad loans has been continuously growing since early 2013 despite the emerging economic recovery. We expect the share of bad loans to stabilize in the next 12-18 months, primarily by virtue of renewed lending growth and improvement in creditworthiness of companies in specific industries.

**Figure 1. Asset quality of Russian banks over time**




Source: CBR, ACRA estimates

[1] The analysis was performed using IFRS and management reporting data (for the period from September 2016 to March 2017) of banks rated by ACRA.

[2] Bank of Russia Regulation No.590-P dated June 28, 2017 "On the Procedure for Making Loss Provisions by Credit Institutions for Loans, Loan and Similar Debts".

## Asset quality of private banks is worse

The loan portfolio quality of Russian private banks is assessed by ACRA as weak: this is the only group of credit institutions with the share of bad loans exceeding 15% as at early 2017 (15.6%). We believe that the key reasons for the situation are (1) more aggressive business models; (2) less conservative risk-appetite due to the need to maintain the market share, with state-run banks consistently strengthening their positions; (3) "legacy" of previous crisis periods: some loans issued in previous years have been restructured five or more times by early 2017. The latter is also common for state-run banks; however, their negotiating capacity turned out to be stronger in many cases, which resulted in changes in loan characteristics or implementing problem loan restructuring solutions on relatively better terms (for the creditor).

The gap between the share of NLP90+ and problem loans is also telling: it is around 10% for private banks. These hidden, least-provisioned risks are very likely to materialize should operating environment adversely change or overall negative trends emerge in the economy. At the same time, these loans are the most sensitive assets to materialization of the "regulatory" risk, i.e. tightening of requirements by the Bank of Russia with respect to claims with signs of impairment.

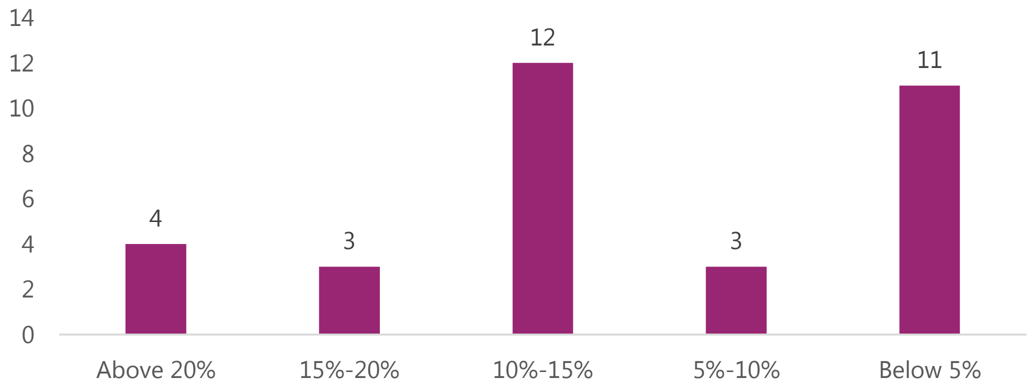
**Table 1. Asset quality indicators by groups of banks**

| | State-run banks | Privately-owned banks | Subsidiaries of foreign banks |
|---|---|---|---|
| Problem loans | 11.1% | 15.6% | 9.5% |
| NPL90+ | 5.5% | 6% | 6.2% |
| Lending to risk-prone industries (% of core capital) | 107.3% | 102.8% | 30.5% |
| Related-party lending (% of core capital) | 30.7% | 27% | 1.1% |
| Non-core assets (% of core capital) | 17.8% | 10% | 0% |
| Top 10 borrowers concentration (% of capital) | 148.3% | 158.6% | 174.4% |

Source: ACRA estimates

At the same time, lending activities of state-controlled banks are marked by the most pronounced focus on financing highly risk-prone industries (real estate construction, development, and lease businesses) – outstanding loans to these sectors exceeded the core capital amount (107.3%). This indicator for private banks also exceeds 100% proving that cost of risk (as well as financial results and capital) of banks is more vulnerable in the period of economic downturn.

**Figure 2. Rated banks grouped by share of bad loans**




Source: ACRA estimates

Asset quality of government-owned banks deteriorates also due to relatively high share of non-core assets in their balance sheets (17.8 per cent of the core capital). These assets are either property received as a result of exercising rights to security under issued loans that eventually turned into bad, or investments into non-core assets (real estate and non-controlling shares in non-financial companies). The key risk inherent in these assets is their questionable valuation resulting in artificially high capital and quality degradation (ability to absorb unforeseen losses).

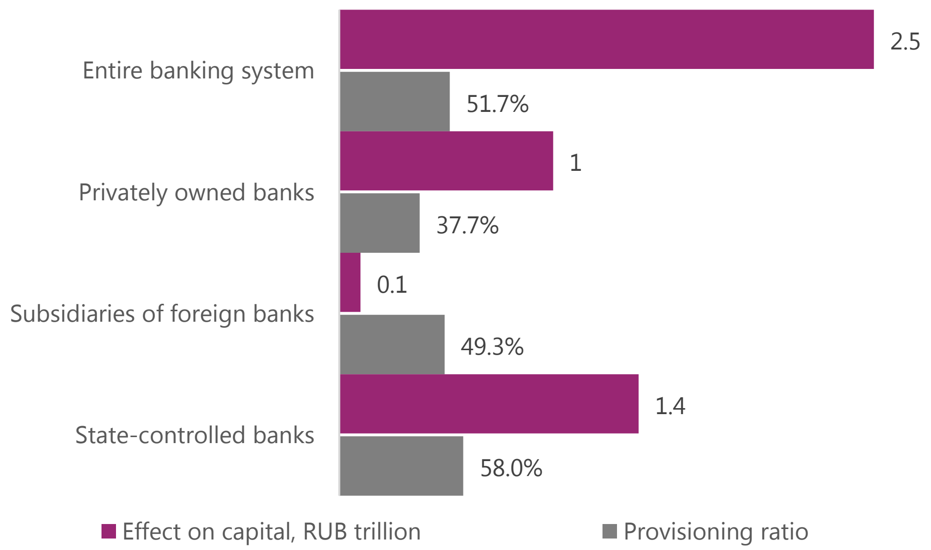
On the other hand, extremely conservative risk strategies and tight industry restrictions applied by the majority subsidiaries of foreign banks are the reason they have their asset quality indicators significantly better than the market average. The minimum gap in overdue and problem loans is the evidence that the level of hidden and deferred risks is limited. Foreign banks on average utilize three times less capital to finance construction and real estate industries (30.5 per cent); they essentially have no non-core assets in their balance sheets; and, understandably, related-party lending is almost non-existent.

## Poor provision coverage of bad loans is the key risk of creditworthiness decline

ACRA assesses the aggregate potential negative effect of one-time bad loans impairment recognition at RUB 2.5 trillion. In the regulatory context, this means a decrease of core capital adequacy ratio (N1.2) from the current 9.4 per cent to 6.2 per cent in a stress scenario (very close to the set threshold of 6 per cent).

The share of bad loans taken individually gives no clear answer to the question of the creditworthiness decline magnitude of a bank if an adverse scenario materializes in the operating environment or if regulator's opinion on credit risk assessment of loans changes. In this context, the coverage ratio of bad loans by loan loss provisions is more important.

**Figure 3. Coverage of bad loans by provisions**




Source: ACRA estimates

In the banking system taken together, a little over half of the bad loans are provisioned (51.7 per cent). How security provided by the borrower or a third party under the loan is recorded in accounting has the major depressing effect on this indicator. At the same time, common practice in Russia and individual cases of large credit risk materialization studied by ACRA demonstrate that more often than not a pledged item is significantly overvalued (it is particularly true for real estate property), and its liquidity is hard to assess realistically. As a result, if a bank enforces security to cover its loss from the loan, a significant time lag arises in selling the pledge (extending to years in some cases), which is economically equal to recognizing a close to 100 per cent loss.

ACRA's study shows that private banks appear to be the most vulnerable in the context of potential creation of additional provisions for bad loans: they demonstrate the lowest coverage level in the industry at 37.7% (potential effect on capital of RUB 1 trillion). The situation at state-run banks is somewhat better (58%) but the effect on capital in nominal terms is more substantial (RUB 1.4 trillion).

We note that amid low coverage of bad loans by provisions the pace of creating additional provisions and the ability of owners to compensate for losses by new high-quality capital will be crucial for the bank's financial stability. Gradual provisioning (including recovery of income-generating assets) within three to five years amid stable operating environment may represent a scenario exerting no additional pressure on the bank's creditworthiness.

According to ACRA methodology, bank's asset quality indicators are taken into consideration as part of the risk profile factor (loan portfolio quality sub-factor) as well as indirectly as part of capital adequacy factor using cost of risk stress testing assumptions. In our opinion, regulatory risk stemming from a more conservative position of the Bank of Russia regarding bad loans provisioning ratio has increased substantially over the last year, and it will represent a challenge for credit institutions in the next 12-18 months. Therefore, in our rating analysis we apply more conservative assumptions to stress test the cost of risk, and thus, in specific cases we do not exclude that they might have an adverse effect on credit ratings and their outlook.

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