

February 24, 2016

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## Banks suffer record expenses on borrowings from Bank of Russia

Analyzing the cost of funding in the banking sector

**Banks incurred record-breaking expenses on the funds borrowed from the Central Bank of Russia.** On the back of the high key rate and significant volumes of refinancing, Russian banks incur impressive interest costs. Since 2008 the Bank of Russia has made RUB 1.7 trillion from these transactions.

**The regulator's funding remains the most expensive** source next only to the bond market. In 2014 and 2015, The Bank of Russia's refunding operations negatively affected the financial performance of the banking sector.

**Banks find it increasingly difficult to offset the cost of refinancing provided by the Bank of Russia.** The traditional carry trade strategy on the bond market has been a loss-maker in recent two years on a system level.

**Focusing on the regulator's funding** makes the business models of banks more vulnerable to market shocks. Remaining in the system are players with a considerable share of regulator's funds in their liabilities.

**The level of borrowings from the Bank of Russia will be going down in 2016** and stabilize at the level of 4-5% of the banking sector's cumulative liabilities. This will have a positive effect on the funding portfolios of lending institutions and will relieve pressure on their financial results.

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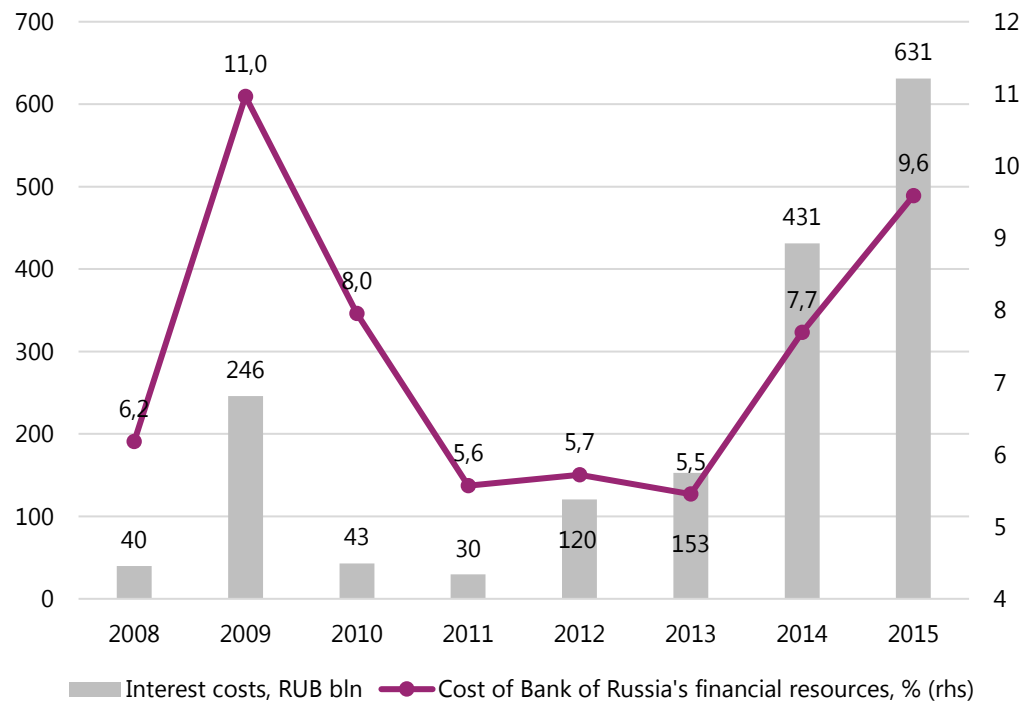
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## The cost Bank of Russia's funds is close to maximum

As estimated by ACRA, the cost of regulator's financial resources for Russian banks was 9.6% p/a in 2015. In absolute terms the interest expenditures on Bank of Russia's refinancing transactions exceeded RUB 631bn, setting a historical record. Overall, since 2008 the Bank of Russia has made RUB 1.7 tr from the refinancing of lending institutions.

**Figure 1. Cost of refinancing by Bank of Russia**



Source: ACRA estimates

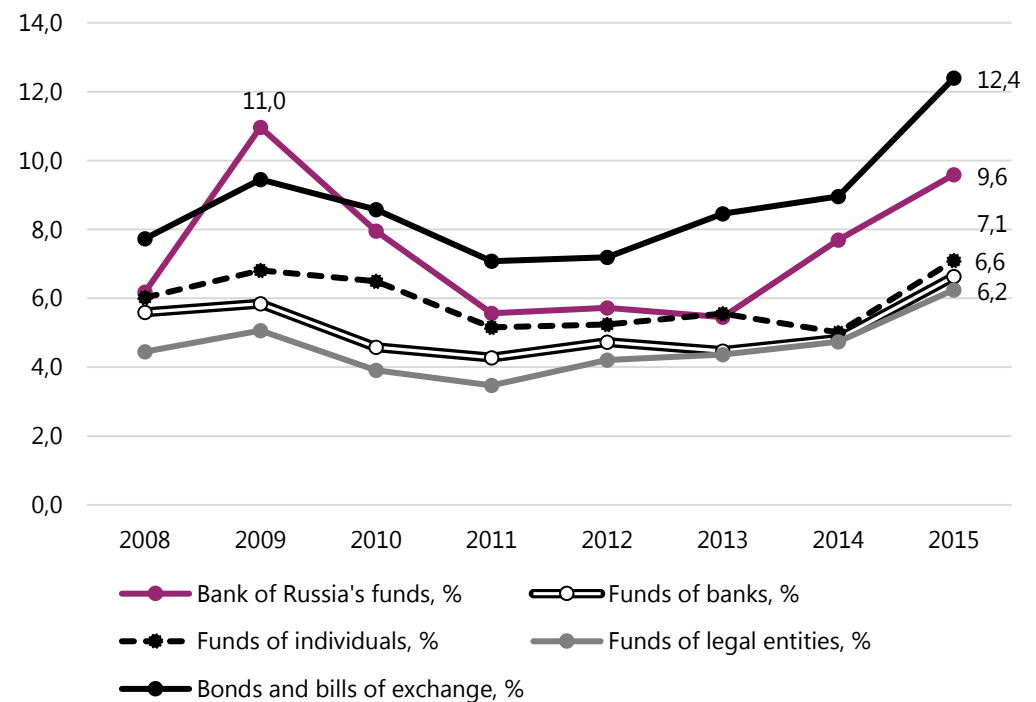
The main reason for the growing cost of regulator's funding is the historically high key rate set by the Bank of Russia throughout most of the year 2015. Interest rates on Bank of Russia's instruments are derivatives of the key rate, so the interest expenses of the banking sector on these transactions depend on the key rate dynamics.

The peak of regulator's claims on lending institutions fell on the beginning of 2015 (RUB 9.3tr as of January 1, 2015). Coupled with the high cost of such funding, that factor sent the interest expenditures on these transactions up 46% y-o-y. Just for comparison: banks paid similar interest to the regulator for the entire period of 2008-2013.

## Financial borrowing from the regulator is a lame alternative to traditional funding

While being affordable for a wide circle of banks, the Bank of Russia's financial resources are the most volatile (in terms of cost) and expensive source of funding, save for the capital market. During the entire period of the active use by banks of Central Bank's loans and REPO transactions the cost of such operations exceeded the levels typical of classic financial borrowing (from legal entities and individuals). Only interest costs incurred by banks were recognized in the analysis, excluding overhead and administration costs involved in financing borrowing.

**Figure 2. Funding of banks: cost estimation**



Source: ACRA estimates

Besides its costliness, the given source of funding is characterized by high volatility in times of economic instability: its steep upward trend could be observed in 2009 and in 2014-2015. Against this backdrop the strategy of banks to replace market funding by regulator's financial resources appears rather risky.

As estimated by ACRA, in terms of negative impact upon the banking system's financial stability a threshold of concern is the average annual share of Bank of Russia's funds in total liabilities exceeding 10%.

**Table 1. The role of Central Bank's funds in the structure of banking sector's financial business**

	2008	2009	2010	2011	2012	2013	2014	2015
Share in interest costs, %	3.9%	16.7%	3.4%	2.3%	6.9%	7.0%	15.7%	14.3%
Average annual share in liabilities, %	2.9%	9.5%	2.3%	1.7%	5.7%	6.3%	<b>10.4%</b>	<b>10.2%</b>

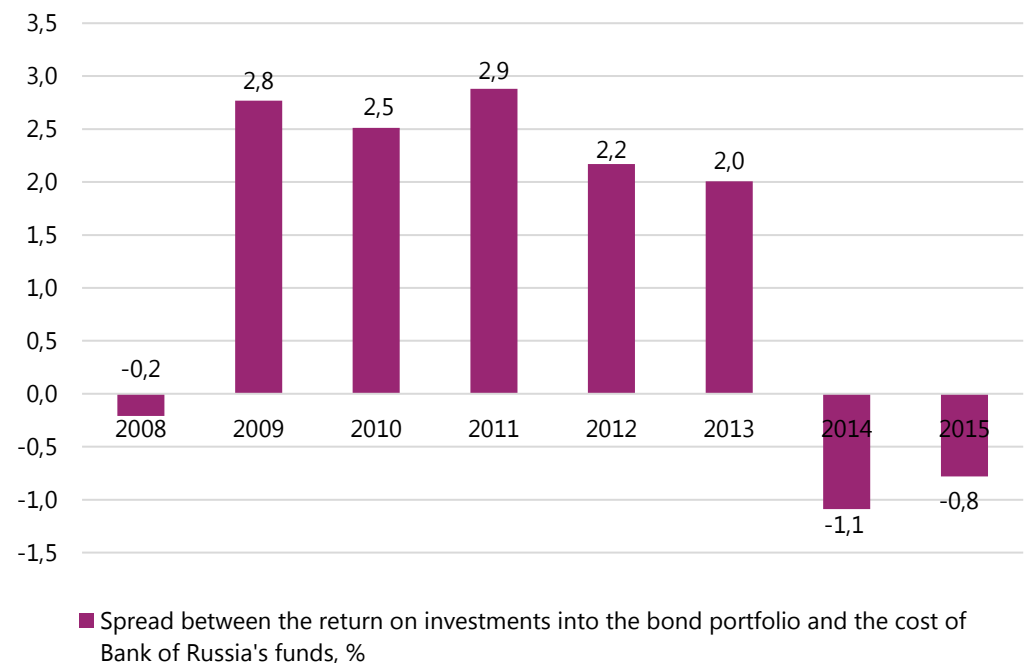
Source: ACRA estimates

## Carry trade is unrewarding

Under a low lending activity of banks refinancing transactions by the Bank of Russia gradually stopped playing the role of traditional funding replacement: a relatively high level of interest rates on the bond market made popular the strategy of making money from the difference in the cost of REPO transactions with the Bank of Russia and the return on debt instruments from the Lombard list.

ACRA calculations demonstrate that shunting was economically justified in 2009-2013. In 2014 and 2015, however, the spread on these transactions slid to the negative domain, which put extra pressure on the sector's financial results.

**Figure 3. Funding of banks: cost estimation**



Source: ACRA estimates

The strategies of banks may differ greatly, as regards the structure of their bond portfolios, both in terms of issuers and duration, so this could still be profitable business for some players. A more gainful strategy is fraught with higher market risks, though, thus negatively affecting the financial resilience of a financial institution.

ACRA expects that as inflation slows down during the next half year, the Bank of Russia may get back to the policy of key rate reduction. But this can only partly lower the cost of financial resources, since more than a third of all funds were borrowed for the term exceeding 180 days. On average, across the banking system, the spread between the return on investments in the bond portfolio and the cost of Bank of Russia's funds will be close to zero.

## A high share of funding from the regulator cripples the credit quality of banks

Pursuant to the reports of lending institutions posted on the Bank of Russia's website, as of January 1, 2016 there were 25 banks with the share of regulator's funding in total liabilities exceeding 20%. ACRA believes that focusing on one of the funding sources (including the Bank of Russia's refinancing transactions) makes the bank's business model more vulnerable to system market shocks. In some cases this can testify to problems with financial borrowings from other sources.

The growing volume of borrowings from the regulator negatively affects the net interest income and the financial results of banks as a whole, since this funding is characterized by high and volatile costs.

**Table 2. Banks with maximum share of expenses on Central Bank's funds**

		Interest expenses on Central Bank's funds in 2015, RUB bn	Share in interest costs in 2015, %	Bank of Russia's funds as of Jan. 01, 2016, RUB bn	Share of Central Bank's funds in liabilities, %
1	CentroCredit	1.85	52.6	8.99	13.9
2	BFA Bank	3.34	44.8	27.78	32.3
3	National Standard Bank	1.44	35.9	15.45	34.0
4	IBSP	1.39	35.8	8.51	16.7
5	Sovcombank	9.21	34.9	180.72	37.9
6	Bank of Moscow	42.47	34.7	210.79	14.7
7	INTERNATIONAL FINANCIAL CLUB	2.39	32.9	19.61	19.9
8	BALTINVESTBANK	2.09	29.9	-	0.0
9	VTB Bank (reg. #1000)	143.17	26.8	1,519.26	18.8
10	Bank Saint Petersburg	8.21	24.7	84.45	16.8

Source: ACRA estimates

As estimated by ACRA, the volume of borrowings from the Bank of Russia in 2016 will be going down and stabilize at the level of 4-5% of the banking sector's total liabilities. The main reasons are the high cost of financial resources and limited need for supplementary funding against the backdrop of stagnant lending activity. Cuts in financial borrowings from the Bank of Russia will have a positive effect on the funding portfolios of lending institutions and will relieve pressure on their financial results.

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