June 13, 2018

Russian banking sector starves for capital injections from the Central Bank to revive

Overview: capital adequacy of Russian banks

- **Rehabilitation potential of the banking sector is limited.** Slow growing loss absorption buffer, from 5.3% in 2017 to 5.8% by 2022, will limit banks' ability to improve asset quality in the next 3–5 years. On the other hand, a substantial cleanup of the sector from problem assets has been carried out by induced interventions from the Bank of Russia acting through the Banking Sector Consolidation Fund (BSCF). The experience obtained in 2014–2016 forced banks to apply stricter approaches to borrowers in order to avoid possible losses.

- **Concentration of banks' balance sheets on high-risk assets is being dissolved.** Growing structural surplus of liquidity, which has been seen in the sector since late 2017, coupled with a weak economic growth expected by ACRA at 1.5–1.7% until late 2021, will, most likely, force banks to allocate free funds into low-risk assets[1]. It will drive capital adequacy up, regardless the expected decline in returns (ROAA of about 1%, ROAE of not more than 10%).

- **Large-scale loan losses are compensated by external injections.** A colossal recapitalization carried out in 2017 to cover problem assets of the largest banks impaired the sector's financial result (IFRS losses amounted to RUB 300 billion, which drove the capital generation back into the critical zone (-86 bps)) and, in the next two years, will continue to affect the sector, albeit not so much heavily. Until 2021, the sector's averaged capital generation ratio (ACGR) is expected to remain low (about 70 bps), while the IFRS Tier-1 CAR will not exceed 11.4%. It is explained by the fact that the number of banks stably generating capital is low, and it indicates the real need for further state support to cover losses under the remaining problem assets.

- **Stricter regulations and competition push down investment appetite to banking business.** The need to uphold capital at a level high enough to comply with regulatory requirements to reserves for problem assets has driven down the share of dividends in the financial result of profitable banks (except Sberbank) from 81–84% in 2015–2016 to 56% in 2017. Prevalence of state-owned banks and low economic potential also keep investments away from the banking business.

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[1] According to the CBR, over the last five years, the ratio of credit risk weighted assets to total assets has dropped two-fold down to 28.3%.

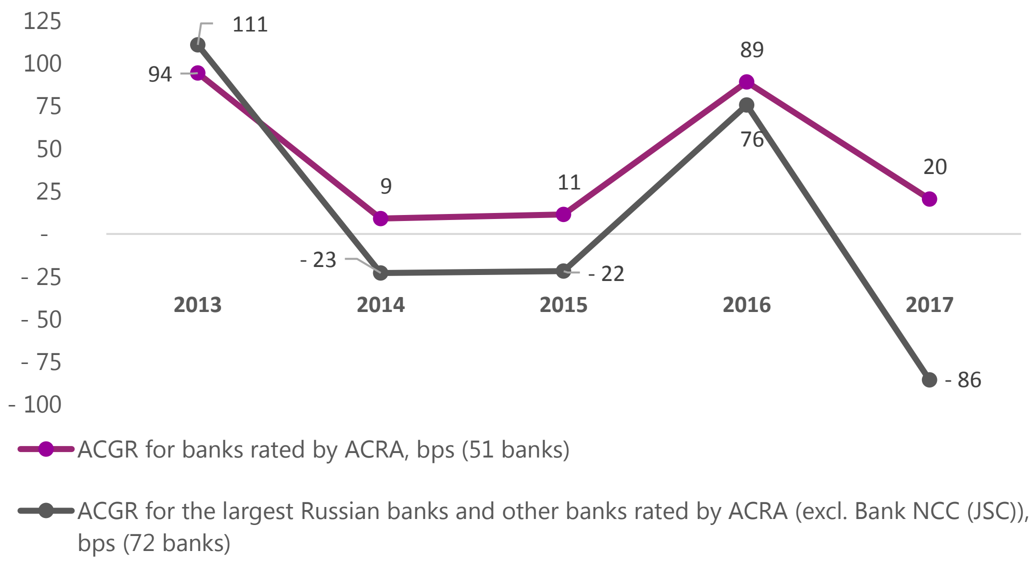
Banks are unable to generate capital

ACGR means averaged capital generation ratio. It is calculated for each period as a ratio of profit or loss adjusted for donated assets recognized in the profit and loss statement, irregular income, dividend and net share buyback to risk-weighted assets (RWA). The ACGR is averaged for the last five years (see Methodology for Credit Ratings Assignment to Banks and Bank Groups under the National Scale for the Russian Federation for details).

According to ACRA methodology, capital adequacy is a credit rating factor playing a key role for banks. In order to assess capital adequacy of a bank, ACRA calculates ACGR to figure out bank's own capacity to generate capital. Taking into account the highly volatile operational environment in the Russian banking sector, the historical horizon applied by ACRA in ACGR calculations is five years.

In 2017, the ACGR calculated for the largest Russian banks[2] dropped from 76 bps to –86 bps, i.e. from the satisfactory zone into the critical one (from 89 bps to 20 bps for banks rated by ACRA). The main reason for that is extremely high losses (RUB 1.45 trln) recognized by the largest banks that undergo rehabilitation administered by the BSCF. Recapitalization carried out to increase reserves for problem assets resulted in the total sector's loss of about RUB 300 billion under IFRS. Accordingly, the ACGR calculated for the entire banking sector for the period from 2013 to 2017 decreased from 55 bps to 7 bps (from 64 bps to 42 bps for banks rated by ACRA).

Figure 1. Capital generation in 2013–2017



Source: ACRA

Without ACRA adjustments (i.e. before dividend payments and transactions in treasury shares whose contributions to the ACGR formula were comparable in 2017), the ACGR amounted to 42 bps (against 7 bps, with ACRA adjustments) for the last five years. It indicates a weak capacity of the banking sector to extend active operations without losing financial stability.

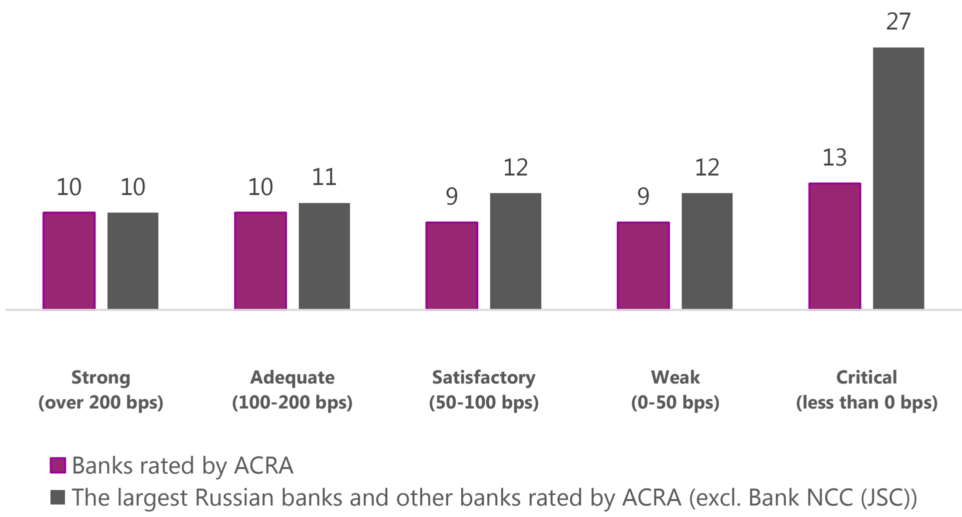
On the other hand, the share of dividend payments in the financial result of profitable banks decreased from 81–84% in 2015–2016 to 56% in 2017 (without Sberbank, whose share in the total sector's dividend payments amounted to about 45%). Such trend may indicate a forced (temporary) refusal of shareholders from dividend in order to support the capital level high enough to meet the regulatory

[2] Banks (excluding Bank NCC (JSC) due to its specificity) whose assets amounted to 89% of the total assets of the banking system as of December 31, 2017.

requirements in respect of capital reserves for problem assets. Moreover, in accordance with IFRS 9 introduced in early 2018, banks are required to maintain a comparably larger capital cushion.

The share of banks that have been generating capital stably (i.e. capital generation capacity assessment is 'adequate' or 'strong') over the last three years is 21% of all credit institutions under review (36% of the sector's assets). 62.5% of banks under review (46% of the sector's assets) entered the critical zone (capital generation ratio below 0 bps) at least once over the last three years. The above indicates a volatile operational effectiveness of banks and the sector's need for external injections. However, in ACRA's opinion, the owners' investment appetite to the banking business is still waning, while the role and support of the state, on the contrary, is growing.

Figure 2. ACGR by bank group in 2013–2017



Source: ACRA

Russian banking sector will continue to skid in the next 3–5 years

According to ACRA forecast, until late 2021, the average weighted ACGR of the banking sector will not exceed 40 bps, which means 'weak' capital generating capacity for most Russian credit institutions and confirms that the sector will continue to skid in the next 3–5 years. Such expectations are also underpinned by the following factors:

– Banks will further increase their reserves to cover remaining problem loans (according to ACRRA estimates, such reserves will amount to at least RUB 500 billion in 2018–2019);

– Increased ratios will be established for certain banking operations; IFRS 9 was introduced for credit institutions in early 2018;

– Deferred credit risks will occur in certain industries (mostly in the construction and real estate industry);

– Possible deterioration in the financial standing of the largest corporate borrowers due to further tightening of sanctions by Western countries;

Russian banking sector 2021 outlook is presented in ACRA's analytical paper [Tougher operational environment to hinder Russian banks in generating higher earnings]() dated February 26, 2018.

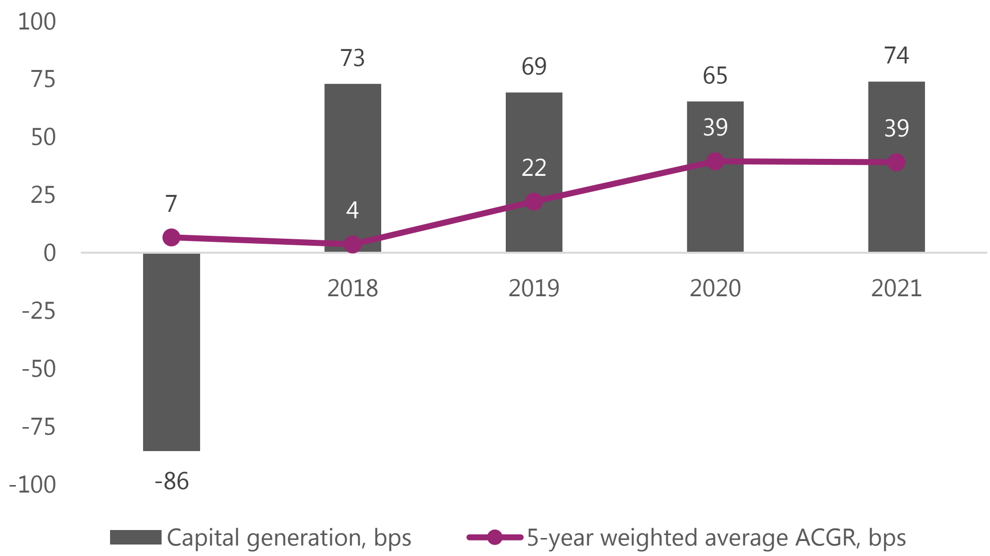
– According to ACRA estimates, NIM will decline from 4% in 2017 to 3.3% in 2021, amid sliding interest rates;

– Weak demand for loans, coupled with the expected slow growth of the national economy (1.5–1.7% until 2021 inclusive), and induced allocation of free cash in low-yield assets due to a structural surplus of liquidity;

– Underdeveloped fee (risk-free) business;

– Dividend payments, regardless of their moderate share (about 40%) in the financial result.

Figure 3. Banking system's ACGR outlook, bps



Source: ACRA

On the other hand, in the period until 2021, the major contribution to the sector's profitability and capital generation will continue to come from the largest state-owned banks (first of all, Sberbank, a locomotive of the banking sector) and a range of large-sized private players and foreign subsidiary banks with high creditworthiness (i.e. rated by ACRA at A-(RU) or higher).

Problems of Russian banks will remain the state's headache

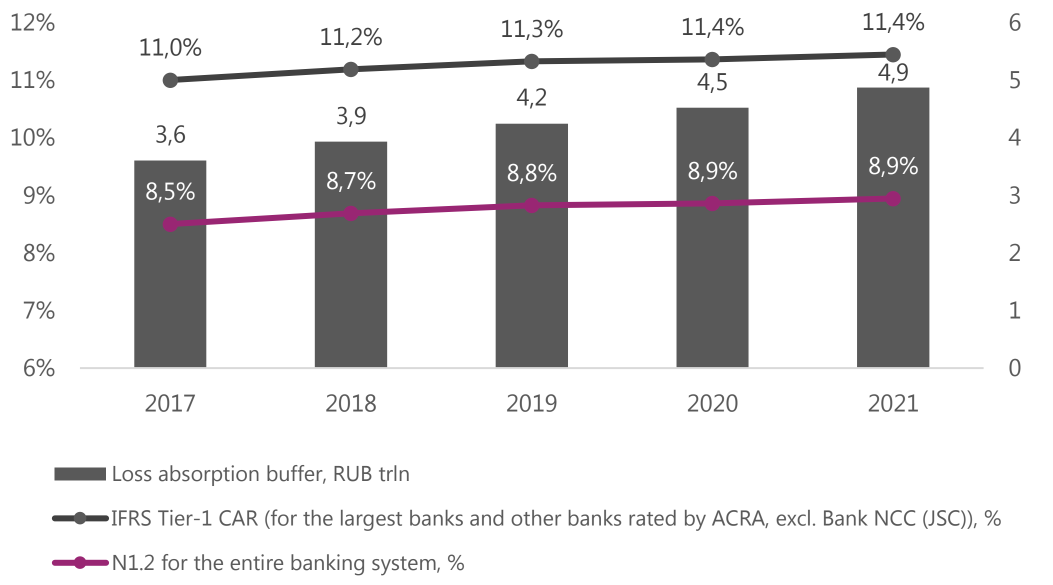
Belated revelation of giant holes in the capital of major credit institutions in 2017 could be shocking for the Russian banking sector, but for the support of about RUB 1.5 trln from the Bank of Russia. After such recapitalization, the sector's capital adequacy remained at the acceptable level (as of December 31, 2017, Tier–1 CAR was 11%, against 11.5% as of December 31, 2016).

On the other hand, the above factors contributing to 'weak' capital generation (in the next five years, the sector's ACGR will remain low—70 bps on average) will continue to restrict the growth of capitalization. According to ACRA forecast, Tier–1 CAR of the banking sector will not exceed 11.4% by late 2021, while the regulatory ratio N1.2 will be in the range of 8.5–8.9% (which is caused by an approach to risk-weighted assets more conservative than the Basel standards) against the regulatory minimum of 6% (without surcharges).

Loss absorption buffer is a decrease in the common capital of a bank where the capital adequacy ratio reaches the regulatory minimum (6% for IFRS capital adequacy).

In case owners' dividend strategies remain unchanged and no further capital injections take place, except for banks being rehabilitated, in the next five years the Tier-1 CAR loss absorption buffer will grow from RUB 3.6 trln to RUB 4.9 trln (from 5.3% to 5.8% of risk-weighted assets). At the same time, ACRA ignores the scenario of significant liberalization of risk appetite by banks until late 2021, regardless of the structural surplus of liquidity and the sliding profitability.

Figure 4. Capital adequacy forecast



Source: ACRA

In the short term, an average Russian bank will be unable to recover on its own; therefore, the sector will need an external support. On the back of waning investment interest in banking business, the state remains the main source of funding.