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Bank of Russia innovations will create additional incentives for regions to enter the bond market

Accrual of reserves for loans granted to regions and municipalities

Applying the Russian Ministry of Finance's classification to the reservation of loans provided to regions and municipalities will prevent private banks from remaining in the lending market, but at the same time, it may stimulate the development of the market for regional and municipal bonds.

This year the Russian Ministry of Finance approved rules for assessing the debt sustainability of Russian regions that are based on three clear parameters: the relative debt load, share of interest payments in expenses, and expenses for servicing and repaying debt for the year relative to the amount of tax and non-tax revenues and non-target transfers. Regions will be divided into three groups by level of debt sustainability: high (green group), medium (yellow group), and low (red group). Regions have developed similar criteria for municipalities.

According to Interfax, the Bank of Russia is looking at the possibility of using this assessment to change the credit risk ratio for bank loans granted to regions and municipalities. It is also possible that this assessment will be applied to classify loans provided to yellow group borrowers as belonging to a quality category no higher than the third, and loans provided to red group borrowers as belonging to a quality category no higher than the fifth.

ACRA does not possess complete information that would allow us to reliably assess which regions belong to which groups because the debt repayment schedule is not centrally disclosed. Nevertheless, according to ACRA's assessment, six regions could be placed in the red group based on figures for 2019, while half or even just over half of the regions could be part of the green one.

The group of regions that could be characterized as having low debt sustainability last year accounted for 11% of bank debt (RUB 64 bln), while the potential members of the yellow group accounted for almost half of this debt (RUB 280 bln). However, our experience shows that loans granted to Russia's regions are usually part of the first or, in extreme cases, second quality categories, which allows banks to form reserves that do not exceed 1% of the loan size. If half of the loans are reclassified in accordance with the new rules, then the reserves required for them may grow significantly. For example, reserves stand at a minimum of 21% for third quality category loans and can reach 100% for the fifth quality category.

We have to agree that the credit quality of regions and municipalities differs, and this fact is reflected in our credit ratings. This difference should also be reflected in the cost of borrowing. However, regions that have restructured budget loans are restricted in terms of the rate at which they can borrow from banks (key rate plus 1 percentage point). Municipalities, the majority of which do not have budget loans from regions, are not subject to this limitation. Therefore, the potential difference between the cost of borrowing for regions from the red and green groups is less than 1 percentage point.

The market for lending to regions and municipalities is concentrated: the key lender, Sberbank, holds an 84% share of the total volume of loans provided to regional and local governments (data as of January 1, 2020). Taking into account the participation of other state-owned banks, private lenders have a less than 10% share of the market. It is probable that the new conditions will not suit the few private banks that are currently present in this market. They will not be interested

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in building up reserves without being able to change the interest rate to compensate for these deductions, and therefore the regional and municipal lending market will be almost fully occupied by Sberbank.

Borrowers who want to avoid depending on a key creditor can turn to the bond market. Coupon rates for placements have broken records this year: in May the Belgorod Region placed bonds at 5.9% amid a key rate of 5.5%. Furthermore, the presence of long-term debt at a low interest rate amounts to two out of three pass marks in the rules for assessing the debt sustainability of regions and municipalities.

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