

# SPACE TO GROW OR THE LIMIT?

THE BANKING SECTOR IN 2023



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## TRENDS IN THE UNSECURED LENDING MARKET

- **The loan portfolio of Russian banks grew in all segments from January to July 2023** — total growth amounted to around 13%. The growth leaders were SME lending and auto loans.
- **Growth in the corporate segment is taking place amid an improvement in business activity indicators.** ACRA notes stable growth of the number of borrowers who took out loans in each of the first six months of the year. At the same time, monthly loan issuance volumes remain stable.
- **Loan portfolio growth rates may slow down in the second half of the year.** The main factor capable of limiting an increase in the size of the portfolio is the Bank of Russia's key rate hike. At the same time, the influence of new regulatory measures designed to restrict the growth of the population's debt load may be noticeable in retail lending.
- **The banking system's capital position remains stable.** Despite the rapid growth of assets, most credit institutions have retained a supply of capital to further increase their portfolios. The industry N1.0 was 12.3% as of July 1, 2023, which indicates that the Bank of Russia's regulatory easing in terms of compliance with macro premiums on average for the industry remain unused.
- **Rapid growth of the loan portfolio has led to a certain deficit of the client funds needed to finance it.** Despite the recovery of the inflow of funds of individuals, client liabilities only 70% financed loan portfolio growth. Banks partly compensated for the shortage of resources by intensifying the use of funds from various government agencies (primarily the Federal Treasury). In ACRA's opinion, a certain deficit of client funds will persist in the second half of the year, even if portfolio growth slows down as expected.
- **According to ACRA's estimates, banking sector profit will exceed RUB 2.6 tln in 2023, which is a record for the industry.** In the first six months of the year, credit institutions demonstrated growth of both net interest and net fee income, however, a substantial part of income was formed by profit from currency operations. At the same time, banks continue to grow loan loss provisions, which limits the potential profitability of operations.

## THE POTENTIAL FOR LOAN PORTFOLIO GROWTH MAY BE LIMITED

2023 is characterized by the development of a growth trend in lending in all major segments, as a result of which the loan portfolio before provisions increased by almost 13% in January to July.

Active growth of the loan portfolio, which began in 2022, continued in the corporate segment. Over the first seven months of this year, the size of the non-financial sector's debt increased by more than 13.5% (9% taking into account currency revaluation).

For more information, see ACRA's commentary [Business Activity Peaked in May](#) from July 6, 2023.

In particular, data on the number of issued loans is evidence of increased demand for borrowed funds in this segment. ACRA notes that the trend toward a monthly increase in the number of borrowers who receive loans is still in place. At the same time, indicators of the monthly volume of issued loans continues to be below the level recorded in 2021. In general, this situation reflects the decline in the average loan size, which to some extent may indicate that SMEs are responsible for the increased interest in borrowing.

ACRA notes that the corporate lending growth trend has developed against the backdrop of a generally stable operating environment. According to the Agency's estimates, in May 2023, the Expanded Index of Basic Industries exceeded the level of March of the previous year, which indicates fairly strong business activity, and this supported demand for new loans.

At the same time, ACRA admits that the growth of the corporate portfolio also stems from certain changes in cross-border cash flows, in which exporters did not sell foreign currency earnings in the domestic market (which may partly be the result of the continuing transition to using national currencies in foreign trade operations and the absence of a domestic market for selling these currencies), and preferred to use borrowed funds to finance current expenditures.

This situation is partly confirmed by limited growth in investments in fixed capital compared to in 2021–2022<sup>1</sup>, for example. This, in turn, may evidence that working capital lending is responsible for most of the growth in lending.

ACRA believes that growth in corporate lending will slow considerably in the second half of the year.

The Bank of Russia hiking its key rate has had the largest impact on the portfolio, which obviously results in a higher cost of borrowing and may have a negative impact on demand for credit facilities to finance investment projects (borrowers respond to a 12% key rate by putting off decisions to borrow).

At the same time, ACRA notes that in the past, rate hikes have not always had a negative impact on the volumes of issued loans. For example, the cycle of monetary tightening that began in 2021 did not influence borrower activity (growth of the loan portfolio of non-financial organizations was around 17% in 2021). In addition, if the main share of growth of the portfolio in H1 2023 was due to working capital lending because foreign currency earnings were not returning to the country, the need to attract borrowed funds may continue despite the increase in their cost.

However, if the discussed measures to change foreign currency regulation include more active selling of foreign currency revenues by exporters, then this may lead to a decrease in their interest not only in investment lending, but also in ruble-denominated working capital lending as a way of financing current expenses.

ACRA believes that regardless of the Bank of Russia's decisions on the rate, the growth potential for business activity in H2 2023 will be lower than in H1.

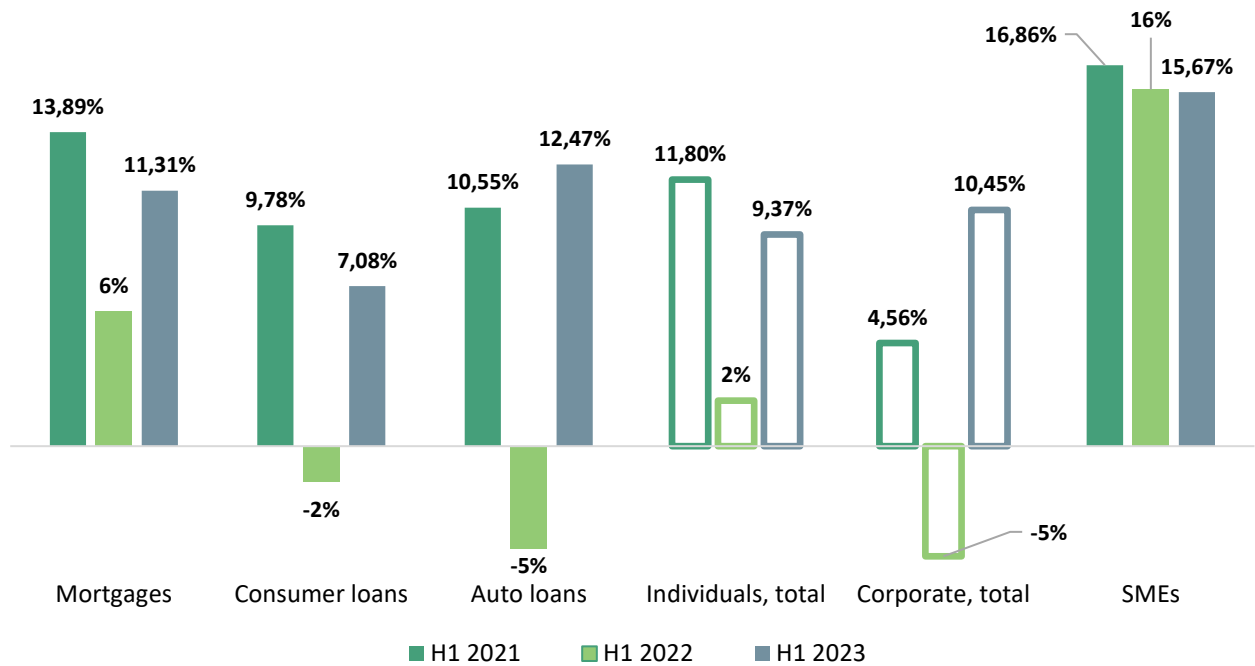
In ACRA's view, factors that could lead to a decrease in business activity include the depletion of available labor resources and restrictions on the further increase in government spending in the context of excess advances in the first half of the year.

Another factor constraining growth of the corporate portfolio could be the potential decline in the flow of funds into the system associated with the lag in the growth rate of client funds from the rate of increase in lending.

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<sup>1</sup> In the first quarter of this year, according to Rosstat, the growth of investment in fixed capital amounted to only 0.7% compared to the same period in 2022, while in the second half of the year an acceleration of growth was recorded.

Figure 1. All key lending segments recorded growth in H1 2023



Sources: Bank of Russia, ACRA

In the current conditions, total growth of the corporate loan portfolio may not exceed 15% in 2023 (excluding the impact of changes to the exchange rate).

In retail lending, steady portfolio growth in the first half of this year was observed for both unsecured and secured loans.

Consumer loan debt increased by 9.2% over 7M 2023, while the portfolio has stably grown by more than 1% since March. Growth in this segment is stimulated by increased consumer activity against the backdrop of rising household incomes, as well as banks' strong interest in development in this segment, which is one of the most profitable.

At the same time, banks that develop different areas of consumer lending have so far managed to avoid the negative impact of the business development restrictions imposed by the Bank of Russia, and this allows us to expect further development of the segment.

In ACRA's opinion, credit institutions will stick to their plans to increase consumer lending (the profitability of which largely allows them to compensate for the growing use of capital), at the same time as attempting to structure credit products so that they do not fall under the toughest restrictions.

In addition, demand for unsecured lending may be less sensitive to growth in the interest rate. On the contrary, price growth creates the conditions for increasing the size of loans.

Nevertheless, it is most likely that the segment will be unable to avoid a slowdown in growth, and a result, rates of increasing the size of the portfolio will be rather far from record levels. ACRA expects that the volume of unsecured consumer loan receivables will have increased by 15–20% by the end of the year, however, further tightening of regulations may stop this growth from topping 15%.

Mortgage lending is also gaining momentum, despite growing regulatory pressure. From January to July this year, the mortgage portfolio grew by 12.7%, while over the past 12 months it grew by almost 23%. The Bank of Russia notes more active provision

of loans without state support, which is partly due to a partial flow of demand into the secondary market.

According to ACRA, the potential for mortgage growth remains high both due to the continued low provision of the population with a sufficient number of square meters of housing per capita, and the state's intention to continue supporting the construction industry through the development of the housing market, including on preferential terms.

Growth of the key rate is an objective obstacle to the segment realizing its growth potential. In addition, from October 1, new, even higher premiums on risk coefficients for mortgage loans will come into effect. In particular, in the sector of loans secured by co-investment agreements, the tightening will affect loans with an initial payment of no more than 30% and all new borrowers with debt loads of at least 70%. For loans secured by ready housing, the new requirements will impact loans with relatively high LTVs.

At the same time, the Bank of Russia noted that in Q2 2023, the share of loans provided to borrowers with debt loads of higher than 80% amounted to around 40%, and the share of loans with initial down payments of less than 20% stood at 63% of loans secured by co-investment agreements and 44% of loans for ready housing.

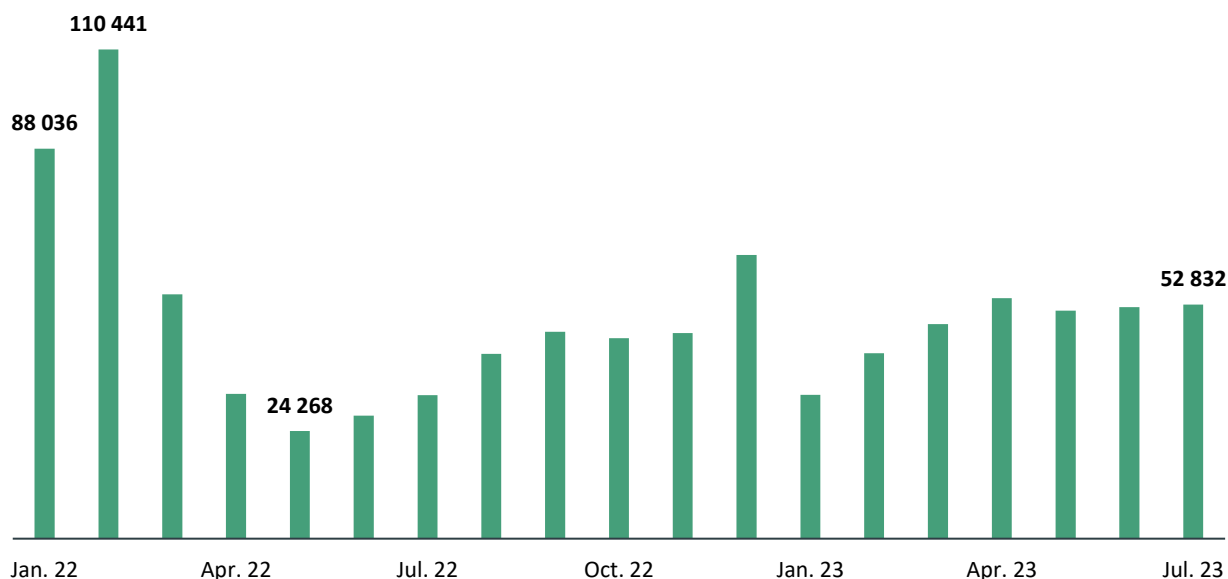
Taking into account the fact that ACRA considers it unlikely that housing prices will decline, which could offset the pressure of these factors on demand, the Agency expects the portfolio growth rate to slow down to 1% per month in Q4 2023, as a result of which annual growth will not exceed 20%.

Furthermore, ACRA expects that a significant slowdown in the growth rate of the segment will contribute to the start of active discussions between representatives of various government agencies, which may result in an extension of industry support measures.

The retail lending market leader in H1 2023 was the car-backed lending business that showed portfolio growth of over 18%. The key growth factor here is the gradual overcoming of supply shortages, including the shutdown of production by a number of foreign brands in Russia, as well as the disruption of import supply chains. In contrast to the beginning of the year, when the increase in the portfolio volume was mainly driven by growing car prices, in the following months, the impact of increased imports (primarily Chinese brands) and higher sales of cars made domestically and supported by the preferential program became more pronounced.

In ACRA's opinion, the prerequisites for maintaining rapid growth in car lending will remain in H2 2023. In particular, monthly sales of new cars and light commercial vehicles in Russia are still lower (often by multiple times) than sales that were recorded before March 2023. Therefore, the deferred demand for new cars is obviously continuing to grow, which creates conditions for further sales growth while maintaining high prices. In addition, unlike mortgages, the demand for car loans is less sensitive to changes in interest rates. Thus, even the potential subsequent tightening of monetary policy will not dampen the interest of potential borrowers. Due to these factors, growth of the car loan portfolio in 2023 may amount to 20–25% and high growth rates are likely in the early months of 24.

Figure 2. Car sales are still lower than they were in early 2022, units



Sources: Bank of Russia, ACRA

The main obstacle to the growth of car loans may be the depreciation of the Russian ruble. In 2023, sales of cars made in Russia account for less than 50% of their total number (65% in 2022). The dependence of the market on imported equipment determines the exposure of demand to the volatility in the foreign exchange market. However, ACRA expects that the negative impact of the ruble depreciation will be temporary, both due to the gradual recovery of domestic production and consumers' general interest in purchasing new cars.

## RESOURCE BASE: WILL HIGH DEPOSIT INTEREST RATES ADDRESS THE SHORTAGE OF CLIENT FUNDS?

Despite impressive growth of the total loan portfolio of Russian banks, the system maintains a stable capital position. Although the N1.0 ratio decreased from 12.7% to 12.3% in H1 2023, it still exceeds the minimum threshold, even irrespective of the Bank of Russia's easing measures. ACRA also notes that, excluding profit earned by credit institutions from foreign currency transactions, the ratio would be 11.6%.

Capital adequacy metrics vary significantly from bank to bank, however, 11 out of 13 systemically important credit institutions continue to operate without resorting to the permit not to fulfil macro premiums to adequacy standards.

Despite the tighter regulation of certain banking areas (for example, an increase in risk weights for certain categories of retail lending), the system can increase lending volumes without the risk of violating capital adequacy ratios. The ability of the largest banks to generate net profits will support the stability of their capital position, even if the sector manages to continue growing assets at a rapid pace.

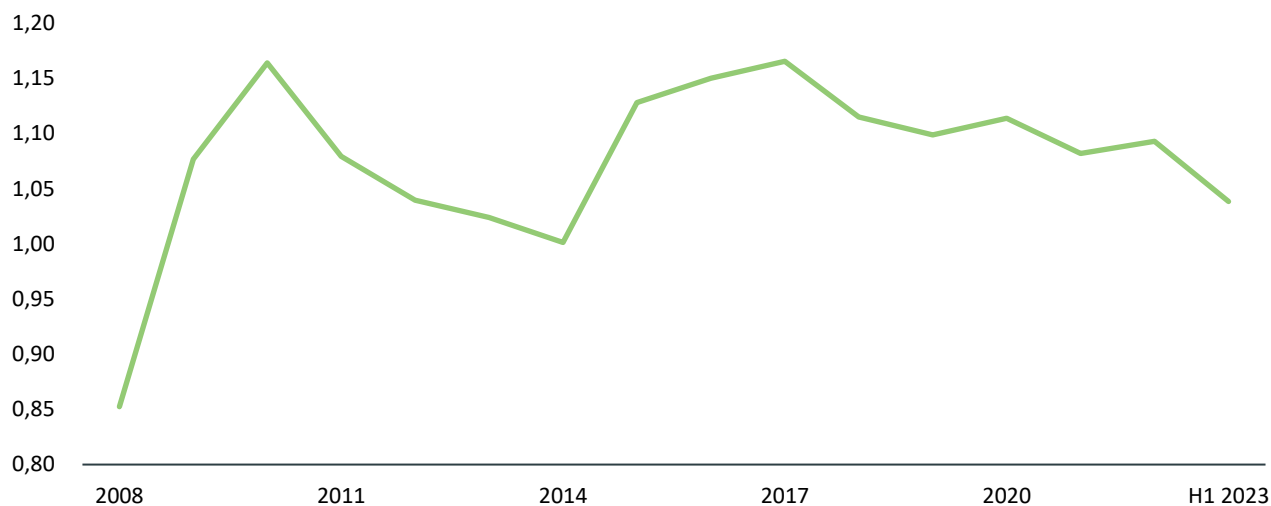
At the same time, H1 2023 reports showed that maintaining steady lending growth can be constricted not only by high rates and regulatory intervention, but also by a shortage of the resource base.

The rapid growth of the loan portfolio has led to a gap between the volumes of loans issued by banks and the funds attracted by them. The trend towards a certain shortage

of the resource base manifested itself back in 2022, which was primarily due to the instability of retail account balances, and this trend developed in H1 2023.

Amid RUB 10.6 tln growth of the total loan portfolio of the banking system in January–July 2023, client funds increased by RUB 9.7 tln, of which the inflow of public funds amounted to RUB 3.6 tln.

**Figure 3. Total loan portfolio coverage by client funds**



Sources: Bank of Russia, ACRA

At the same time, the inflow of funds from individuals (excluding escrow accounts) for the first six months of 2023 amounted to RUB 2.66 tln, which is a record high for the first half of a year, and for January–July, this indicator reached RUB 3.3 tln. According to the Bank of Russia, higher budget expenditures was the main driver of this growth.

Funds of corporations (excluding financial organizations) showed contradictory dynamics, having grown by only RUB 2 tln over the specified period, while their outflow was recorded in March, April, and June. The limited and unstable inflow of corporate funds may be a consequence of the fact that a significant portion of exporters' foreign exchange revenues is not returning to Russia and, as a result, is not credited to the accounts of non-financial organizations. Moreover, ACRA assumes that funds borrowed by non-financial organizations could be used to buy the assets of foreign companies withdrawing from the Russian market and, as a result, could be used to purchase foreign currency.

Under the current circumstances, credit institutions actively use Federal Treasury funds to finance their operations. The total amount of public funds on the balance sheets of banks grew by RUB 2.46 tln in H1 2023 an (almost 29% increase). As of the end of June 2023, this balance sheet item exceeded 8% of all obligations (about 7% as of January 1, 2023).

In ACRA's opinion, even with a slowdown in the growth of the loan portfolio, a certain shortage of client funds may persist in the second half of the year (the Agency expects the shortage to amount to around RUB 1 tln).

To cover this shortage, banks can, first, use some of their liquid assets (substituting, if necessary, the need for short-term liquidity with funds from state institutions), and second, begin to more actively raise deposit rates in order to strengthen the inflow of funds from individuals. It is worth noting that the amount of cash held by households in the summer of 2023 approached RUB 18 tln, which makes this source of replenishment of the resource base quite attractive. However, to drive the interest of potential depositors, banks may need to increase rates at a pace exceeding the growth of the key rate and rates on credit products. As a result, banks that continue to strive

to increase their portfolio in the second half of the year may have to sacrifice the profitability of their operations.

## NET PROFIT IS GOING FOR A RECORD

In H1 2023, most banks (including all the systemically important ones) recorded profits, which resulted in industry-wide net profit approaching RUB 1.7tln, and for January–July it amounted to RUB 2 tln, which gives reason to expect a record high for the entirety of 2023.

Banks managed to increase both net interest income before provisions and net fee income. The growth in interest income was relatively weak (1% year-on-year), while the increase in net interest income (about 50% year-on-year) was largely driven by banks' ability to reevaluate their liabilities amid a decrease in the key rate and a reduction of interest expenses in 2022.

As for the structure of the H1 2023 financial results, ACRA also draws attention to the significant influence of factors, which may be categorized as irregular to a certain extent, on the volume of profits.

On the one hand, a significant contribution to the financial results was made by income from currency transactions and, on the other hand, the ongoing creation of provisions for potential credit losses had a negative impact on the results for the period.

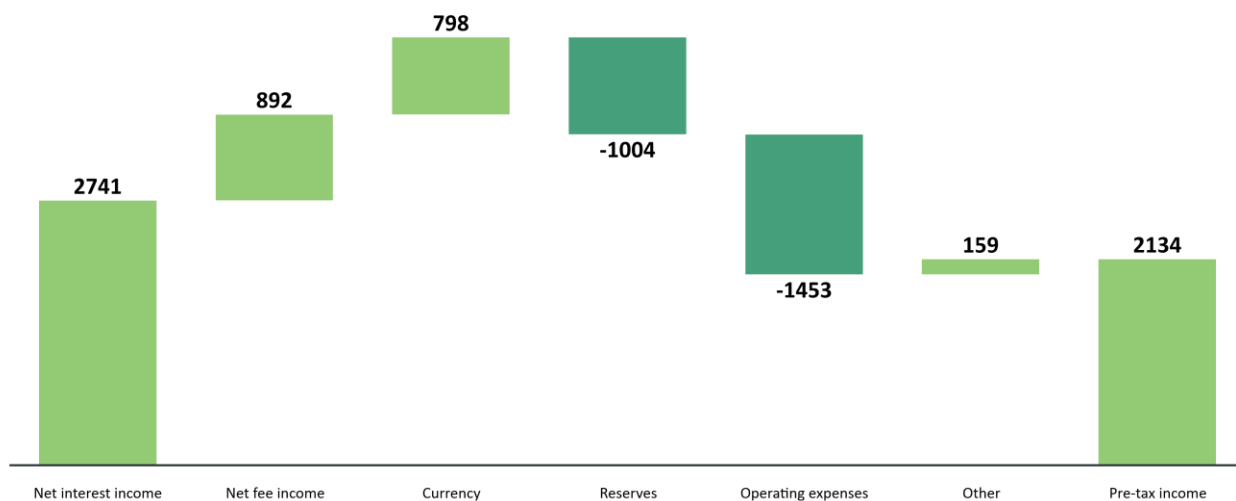
Banks' income from foreign exchange transactions in H1 2023 amounted to almost RUB 800 bln, while in the first half of last year there was a loss of RUB 1.3 tln. Moreover, this year banks have been profiting from these operations in both the first and second quarters. ACRA notes that due to the proactive reduction of foreign currency liabilities compared to assets in 2022, the gap between assets and liabilities denominated in foreign currency increased in the industry, which supports the preservation of a long currency position. Therefore, the fall in the ruble exchange rate against the dollar contributes to the banks' profits recorded in their financial reports, but it can impair the quality of assets.

In addition, profit from the revaluation of assets is not accompanied by a corresponding cash inflow at the reporting time, which, on the one hand, results in overestimation of the amount of equity and, on the other hand, requires the available cash to be spent in the event of dividend payments.

The volume of reserves created in H1 2023 exceeded RUB 1 tln (RUB 1.3 tln for the same period last year). ACRA notes that in the first half of the year there was no pronounced trend of fast dissolution of reserves accumulated during the period of a deteriorating operational environment, similar to H1 2021, when the decline in the cost of risk became a significant driver of profits for the year, which are currently at a record high for the Russian banking sector.



Figure 4. Income from currency transactions is offset by increased volume of reserves, RUB bln



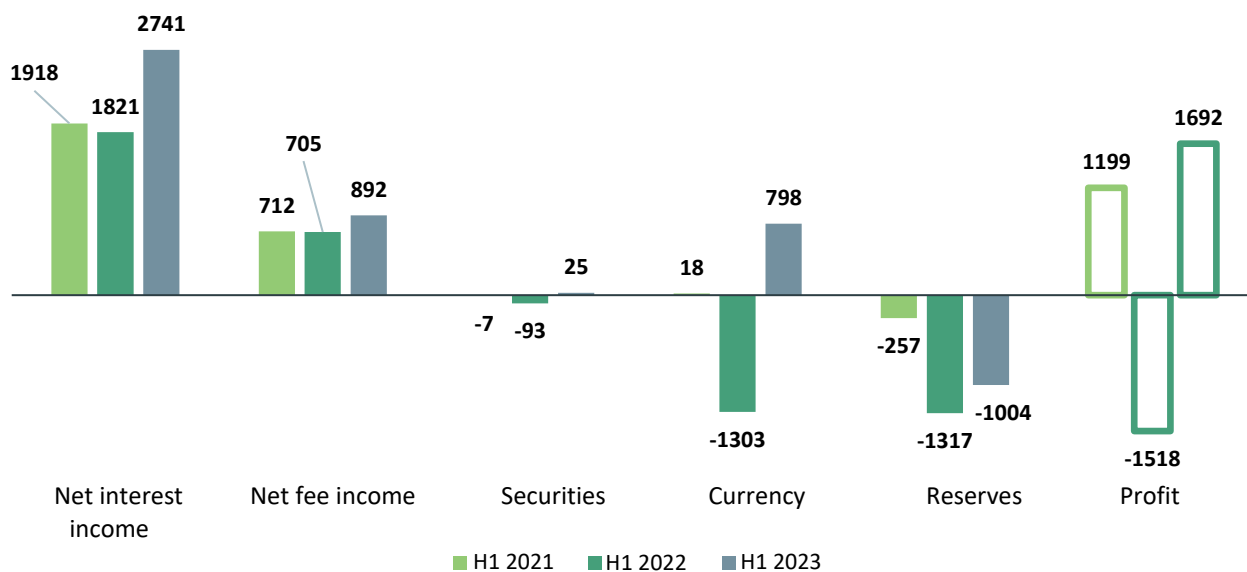
Source: Bank of Russia

In ACRA's opinion, a new profit record is highly likely in 2023. Even if the result of operations in the foreign exchange market is neutral, the continued ability of credit institutions to earn interest and fee income in an amount comparable to the indicator for the first half of this year will allow the sector to show a profit of over RUB 2.6 tln by the end of 2023.

As we noted above, a shortage of client funds may push deposit rates up, which will outpace the growth of loan rates and may reduce lending profitability. However, the ongoing fluctuations in the key rate will require banks and borrowers to adapt to the changing conditions for borrowing and lending and may cause unpredictable volatility in the net interest income of some banks in the second half of the year.

At the same time, unlike in 2021, sharp fluctuations in the interest rate did not lead to a drop in net interest income last year.

Figure 5. Banks are able to consistently earn interest and fee income despite the operational environment, RUB bln



Sources: Bank of Russia, ACRA

On the other hand, ACRA believes that as the economy recovers from last year's recession, the cost of credit risk will also decrease, thereby reducing the amount of provisions, which nevertheless will be higher mainly due to provisions for sanctioned assets. However, banks will continue to be profitable in the second half of the year even if the volume of reserves in H2 2023 remains at the level of H1 2023 and in the absence of income from currency transactions.

Summing up, ACRA expects the banking system's net profit to exceed RUB 2.6 tln in 2023. However, given the continuing volatility in the foreign exchange market and Russian banks' proven ability to make profits in H1 2023 amid the weakening of the national currency, the final result may turn out to be much higher.

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