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Russian regions to favor bonds

Russian regions' debt structure analysis

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- **For the first time in five years, budget loans refinance debt instead of bridging deficit**. At end 2016, the regions saw their debt to banks underperform their payables to budgets by RUB 157 bln, marking the first such instance since 2011. That said, not all of the regions have substituted their market debt with the budget one, particularly those with an unstable financial standing.

- **In 2017, repayment of budget loans is to exceed their issuance**. This year, the scheduled budget loan repayment stands RUB 20–30 bln above the amount of new loans to be given out by the Federal Budget. However, reverse refinancing and the need to bridge deficits will once again change the structure of regions' liabilities, and by end 2019, the share of market debt in their debt structure may run into 80%.

- **Short-term Federal Treasury loans have not abated regions' need for bank loans**. In 2014–2016, annual debt repayment and raising stood at around RUB 1 trillion, with spending seasonality and unavailability of Treasury loans each December creating an increased year-end demand for bank credit resources.

- **Regional bond placements may double in 2017–2019.** The potential volume of regional bond issuance aimed at refinancing bank debt and budget loans may amount to RUB 250–300 bln a year in 2017–2019. Bonds look more attractive than bank loans, being cheaper at the longer end even for the most leveraged regions. Offering bonds instead of taking out loans may save borrowers 2–3% in annual debt servicing costs within this period.

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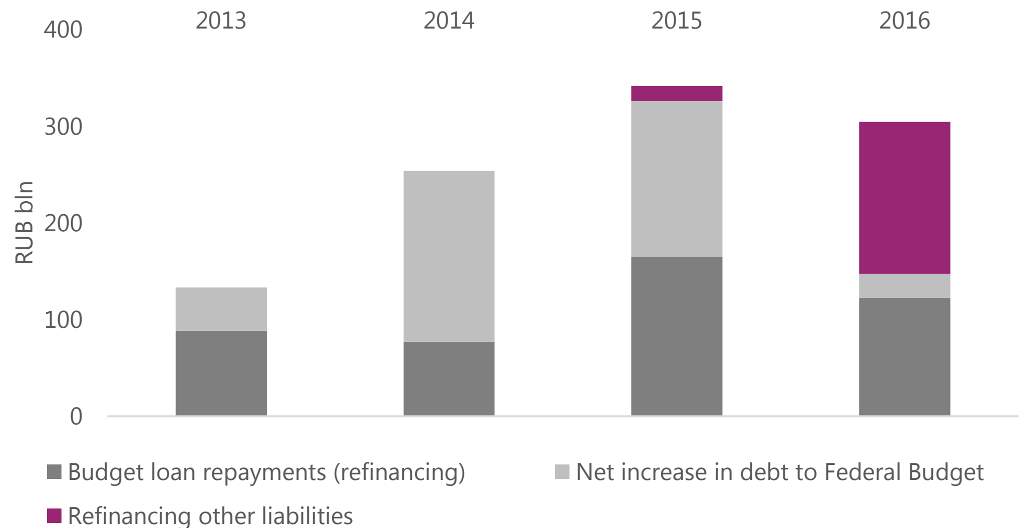
Budget loans helped refinance debt to banks in 2016

The Federal Budget provides loans to regions under an interest rate of 0.1% per annum for up to five years.

At end 2016, the Russian regions ran RUB 2 bln of budget deficit.

The amount of budget loans was relentlessly striving upwards in 2014–2016. Coupled with low deficit run by non-consolidated regional budgets last year, this allowed regions to change their debt structure. At end 2016, regions' payables to the Federal Budget exceeded those to banks for the first time since 2011. In 2016, the former expanded again almost by a quarter, while the latter shrank 16%. In other words, the year 2016 saw the entire budgetary system financing its deficit by budget loans, while those taken out of banks were being partially repaid.

Figure 1. Budget loans started to be used for market debt refinancing



Source: The Russian Ministry of Finance, the Bank of Russia, ACRA estimates

Starting 2014, when the amount of budget loans issued almost doubled, these loans were used by regional authorities not so much for substituting market debt, but more for financing current deficit and, consequently, for piling up this class of their liabilities while building up market borrowings. ACRA estimates that the proportion of budget loans allocated for expanding this liability ran into about 50% in 2014–2015.

The remaining share was spent mainly to refinance previous budget loans, as the total of loans repaid to the Federal Budget within this period approximately equals the difference between the volume of issued budget loans and the amount of the relevant debt increase. According to ACRA, market debt refinancing in 2015 absorbed some RUB 15 bln of budget loans, while by end 2016 the substitution volume ran into some RUB 150 bln.

Although the trend of substituting market debt with budget loans was seen across the entire budget system in 2016, certain regions proved either unable, or unwilling to take the opportunity and kept on building up market debt while reducing budget loan liabilities.

Some of these regions can hardly boast a financial standing strong enough to afford expensive debt. In particular, these are the Tambov, Pskov, Kirov, Ulyanovsk regions, the Perm Krai (which provided its companies with maximum profit tax benefits until 2016 and increased its budget loan debt twentyfold between 2013 and 2015), the Republics of Buryatia, Komi, Khakassia, and the Jewish Autonomous Region.

Market debt share will grow again in three years

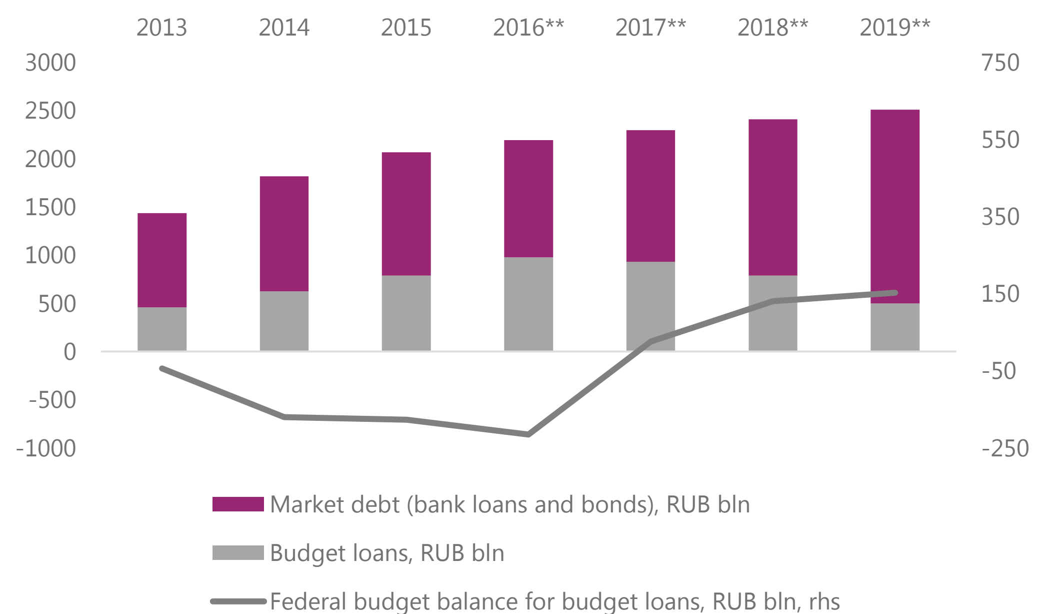
Be as it may, but the regional debt structure will face a reverse change (i.e. the share of market borrowings will increase), if the previously issued budget loans are not restructured (prolonged, provide the relevant additional agreements are signed). At the same time, the draft law on the Federal Budget submitted to the State Duma apparently contained no provisions allowing for such prolongation.

In 2013–2016, the Federal Budget envisaged giving out tree-year loans. Comparing volumes and tenors of budget loans issued in 2013–2016 with those of budget loans to be disbursed in 2017–2019 may help gauging the substitution effect of market loans over budget ones in an environment of moderately growing budget deficit (see Figure 2).

Although the current edit of the 2017–2019 Federal Budget law says nothing about the amount of budget loans maturing during this period, the balance of such loans issued and repaid (the amount repaid net of the amount issued) will be positive this year, by ACRA's estimates. This assumption is supported by the results of the draft law's first reading in the State Duma. So, in 2017, the regions will repay more budget loans than they will get, which is quite logical considering the fact that the current year is slated to see some RUB 200 bln of new budget loans given out, while around RUB 230–240 bln is expected to be repaid (the loans issued three years ago, i.e. in 2014). The balance is expected reach some RUB 130 bln by 2018 and further RUB 150 bln in 2019.

Budget loan restructuring is neither banned, nor restricted in terms of repayment schedule by the Budget Code. For example, a RUB 50 bln worth of budget loans issued in 2011 for road construction and maintenance was prolonged till 2025–2034 in 2015.

Figure 2. Regions to refinance budget debt*



*Net of Moscow city debt

**ACRA estimate

Source: The Russian Ministry of Finance, the Bank of Russia, the Treasury of Russia, ACRA estimates

Repayment of budget loans is one of sources used to finance deficit of the Federal Budget. If the latter is able to do without this revenue source, which brigngs in some RUB 250–300 bln per year, no dramatic increase in the share of market borrowings may take place.

Regions are facing persisting liquidity shortage

FTD stands for Federal Treasury Department.

Starting 2014, the Russian regions have been eligible for FTD loans to replenish their short-term liquidity balances. Previously, to bridge cash gaps they took put short-term loans from banks.

FTD loan:

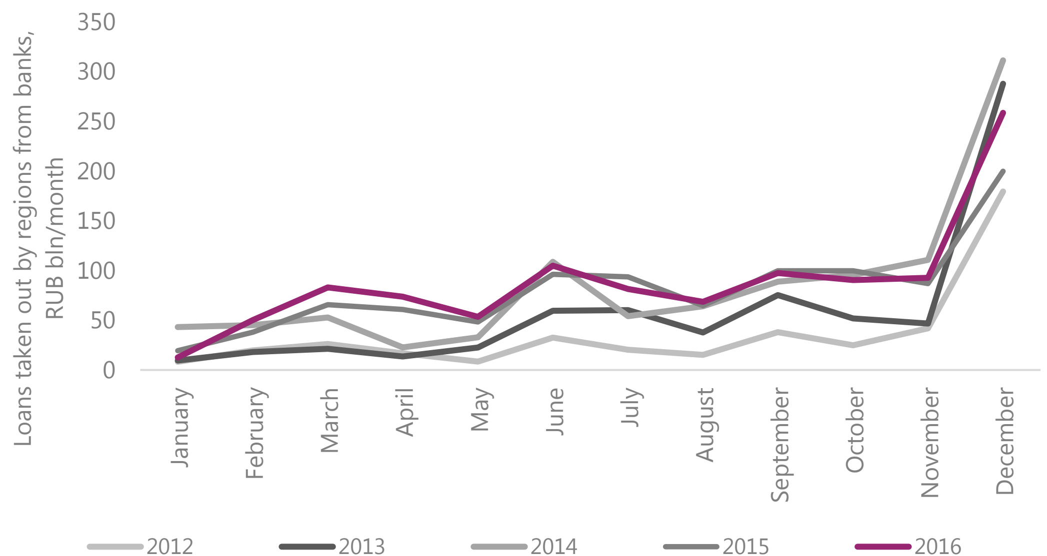
One of covenants is absence of deposits.

Size does not exceed the 1/12 of regional budget's revenues net of targeted transfers.

Term – 50 days.

Being practically gratis, FTD loans have a number of limitations. For instance, they have to be repaid not later than November 25 of the current year. But the year-end traditionally accounts for a significant share of regional budget expenditures. So in December, regions most proactively borrow from banks: in 2012–2016, they used to take out bank loans averaging RUB 54 bln in January–November, but as much as RUB 247 bln in December. In 2015–2016, when the FTD tool became most popular, the situation hardly changed much, with December seeing RUB 200 bln taken out of banks in 2015 and Rub 259 bln in 2016.

Figure 3. Regions borrow from banks mostly in December



Source: The Treasury of Russia, ACRA estimates

The decision to provide regions with short-term Treasury loans might have restrained the trend that started in 2013 and manifested itself in an explosive growth in the volume of short-term bank loans taken out and repaid, but it failed to reduce either this volume per se, or relevant interest expenses incurred by regional budgets. The average volume of bank loans in 2014–2016 has run into RUB 900 bln, with average yearly borrowing and repayment amounts over this period reaching RUB 1 trln. This means that debt does turn over annually within the budget system as a whole, but the situation varies dramatically depending on the region.

Table 1. Regions see no bank loan turnover reduction

	2010	2011	2012	2013	2014	2015	2016
Issuance, RUB bln	310	307	431	704	1030	973	1067
Repayment, RUB bln	-292	-225	-292	-454	-842	-893	-1191
Interest expenses, RUB bln	63.5	69	66	80	107	129	128

Source: The Treasury of Russia, ACRA estimates

Bonds are more preferable than loans

After the stagnation that was observed on the subsovereign bond primary market throughout 2015, the year 2016 brought with it a growth of both the number and volume of bond placements. The process was accompanied by an extension of the average issue term (net of amortization): with regards to loans, it stretched out to 6.7 years. For comparison, in the entire period between 2011 and 2015, this indicator only went up as high as 5.2 years. Total placements equaled RUB 158 bln. To put this into perspective, the average annual volume of placements over the 2011–2015 period amounted to RUB 108 bln, net of Moscow.

A less pronounced trend is being observed on the bank loan market. In the bank debt portfolio, the average term of loans issued to regional and municipal governments amounted to 2.2 years at year-end 2016, which constituted an increase against the previous years (1.8 years throughout 2011–2015, on average).

Table 2. In 2016, RF regions succeeded in extending their market loan terms*

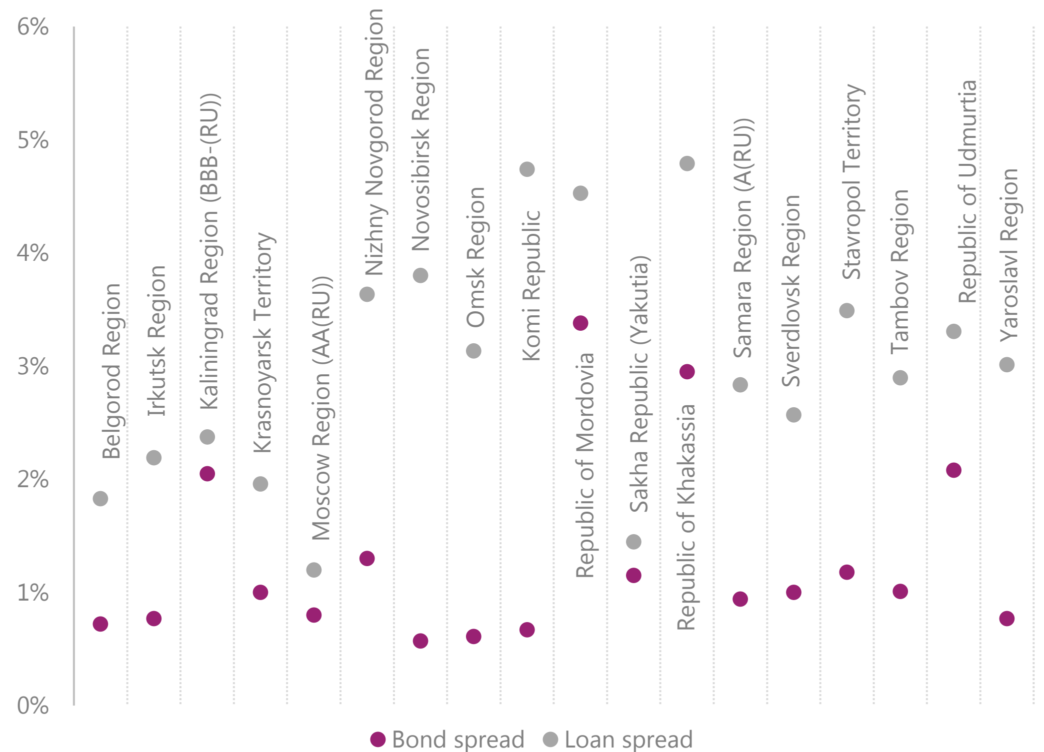
	Outstanding debt to banks at year-end, RUB bln	Average loan portfolio term at year-end, yrs.	Annual issues, RUB bln	Average term of new issues, yrs.
2011	367	1.36	60	4.92
2012	530	1.40	130	4.79
2013	816	1.79	118	5.65
2014	1,033	2.12	131	5.36
2015	1,135	2.13	99	5.12
2016*	1,034	2.24	158	6.74

*The amount of issued bonds is shown net of Moscow, but gross off municipal borrowings.

Source: The Russian Ministry of Finance, the Bank of Russia, cbonds.info, ACRA estimates

Bank loans remain the highest-in-demand market instrument used for deficit financing. Since 2013, their volume in the regional debt structure has been twice as high as that of government securities (net of Moscow). However, bond placement is a more profitable business both in terms of borrowing costs and maturities.

Figure 4. Spread between government bond index yield and rate of regions' coupon/loan agreement on date of placement/agreement execution



Source: The Moscow Exchange, cbonds.info, ACRA estimates

The average spread between the loan interest rates charged by banks to the above-listed regions and the yield of Russian government bonds (calculated by the Moscow Exchange) ran into 3.3% on the public procurement closing date in 2016. The spread between the coupon rate and the index yield on the placement date amounted to 1.2%. Average spread allows to strip the loan performance analysis indicator from over-time interest rate fluctuations.

Among those regions that placed bonds and attracted loans in 2016, the one with the highest cost efficiency in terms of bank borrowings was the Moscow Region (AA(RU)) with 1.20% spread, and the Sakha Republic with 1.45% spread.

The Komi Republic was ahead of the rest of the nation in terms of moneys it saved on placements versus bank borrowings: its coupon spread to the index yield ratio was more than 4% lower than the average interest rate spread.

For those regions that placed bonds in 2016, average system-wide interest savings amounted to 2.1% (net of borrowing costs). This is partially explained by the expected interest rate decrease in the medium and long terms.

Annual debt servicing expenses can be slashed by 2–3%

The average volume of bank loans maturing in 2017–2019 amounts to RUB 200 bln per year. However, ACRA does not believe that a total replacement of bank loans with bonds would be feasible. The above data shows that regions are badly in need of short-term liquidity, and FTD loans are unable to properly keep up with the demand. ACRA assesses the average share of short-term loans in 2010–2016 to be one-third of total bank debt, i.e. regions are capable of refinancing the other two-thirds (RUB 550 bln) with the help of securities.

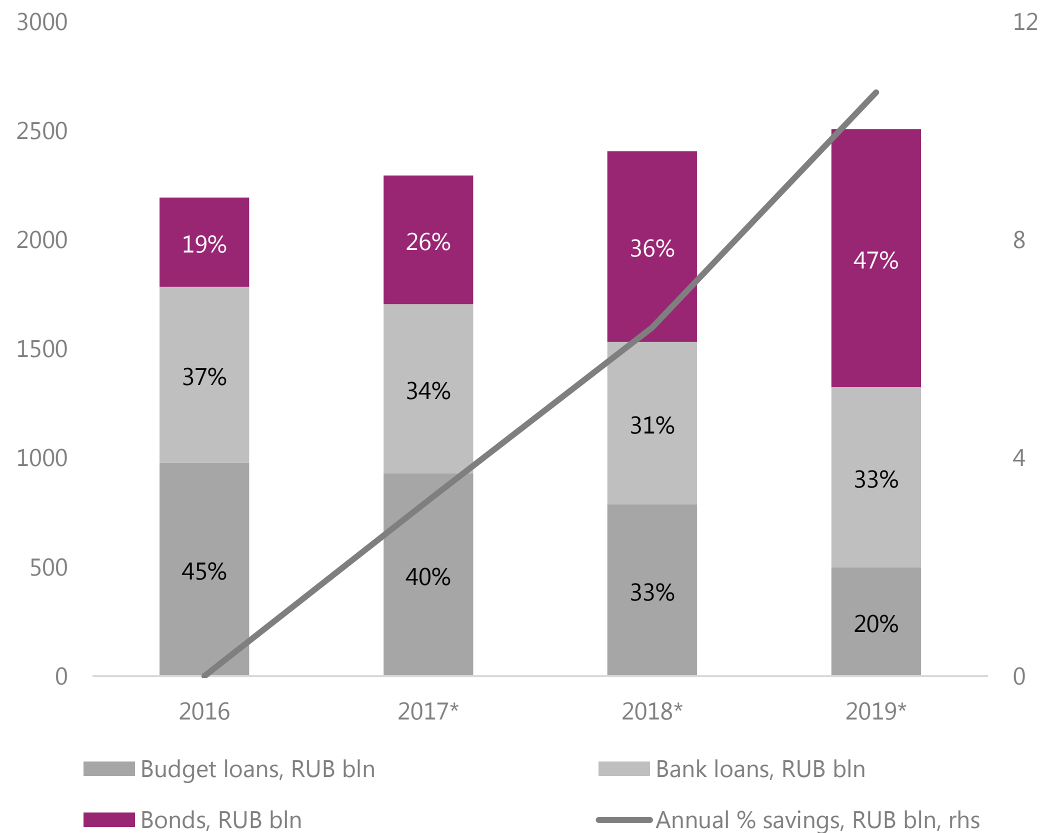
It also makes sense to use securities to refinance the delta between budget loans due (unless rolled over) and new budget loans taken out every year. All in all, by ACRA estimates, in the period between 2017 and 2019, Russia's regions will seek market refinancing for RUB 310 bln worth of budget loans. Allowing for this, placements could go up to RUB 250 bln in 2017 and up to RUB 300 bln or more in both 2018 and 2019.

It would take regions three to five years to convert their long-term bank debt and budget loan deltas into bonds.

For more on growing debt servicing costs, please refer to ACRA's June 23, 2016 research commentary "Regions Face Higher Cost of Debt and Increased Inequality while Repaying Federal Loans."

If the share of zero-interest budget loans goes down, interest expenses will inevitably be pushed up, which will take a toll on the creditworthiness of RF regions. However, if they decide to enter the bond market they could partially neutralize this effect by saving on debt servicing costs.

Figure 5. Potential for interest expenses savings for regions if bond placements pick up (net of Moscow debt)



* ACRA estimate

Source: The Russian Federal Treasury, ACRA estimates

Given the current key rate, ACRA estimates potential savings at RUB 3 bln for every year that budget and long-term bank loans are substituted with bonds, compared to the scenario of substituting budget debt solely with bank debt, i.e. 2–3% of annual debt servicing costs, on a cumulative total.

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