During the first half of 2017 the Russian banking system was characterized by slow growth of the loan portfolio and the level of deposits, stable capital adequacy and asset quality metrics and improving profitability indicators. However, these figures are unevenly distributed in the system where more stable and favorable figures are attributed to big state-owned banks.

The Central Bank of Russia (CBR) carried on with its work on structural reforms for the banking system and, at the same time, it continued to toughen the general supervision procedures. Despite the fact that the number of revoked licenses per quarter decreased as compared with previous years, the process of license revocation continues.

Recent financial problems of the second largest (as of August 2017) private bank, Otkritie Bank, can have adverse effects on the position of other Russian private banks and, as a result, the market share of state-owned banks is set to increase.

The concentration of the Russian banking system keeps increasing with the share of the top-50 banks by assets having reached 89,5% by the end of 2Q 2017 as compared to 87,9% a year ago (see graph 1).

In addition, the state-owned banks and banks owned by state-owned corporations remain dominating the system with the share of the top-5 government related banks equal to 56% of total assets as of the end of 2Q 2017. The Agency expects this share to increase further in the following years due to a persistent hike in revocation of licenses, decreased level of trust in private banks and acquisitions of private banks by government-related financial conglomerates. An example of the latter, is the recent purchase of 99% of shares of Bank Peresvet in June 2017 (which is going through the financial recovery procedure) by the Russian Regional Development Bank controlled by the state-owned oil company Rosneft. In

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1 Sberbank, VTB, Gazprombank, VTB-24 and Russian Agricultural Bank.

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addition, the start of the financial recovery procedure in the second largest private bank, Otkritie Bank, in August 2017, de facto means that the bank accounting for around 3.4% of total assets of the banking system will be temporarily controlled by the CBR.

Due to the general vulnerability of the Russian economy, western sanctions and high competition from the side of the government related banks, the share of foreign banks reached historically low levels. Banks with 100% foreign ownership were 67 and accounted for only 6.6% of total assets by the end of 2Q 2017, as compared to 75 and 8.5% of total assets by end-2016. Even though we do not expect a substantial withdrawal of big foreign banks from the Russian market in the following years, we believe that their share in total assets of the banking system will be gradually reduced.

Capital adequacy metrics remain solid: capital adequacy ratio and Tier 1 capital ratio stood at 12.9% and 9.4% respectively as of the end of 2Q 2017 and kept rising during the last 18 months (see graph 2). However, the level of these ratios should be seen with caution given a slight decrease during June and July 2017 and negative dynamics of these metrics in some big Russian banks.

Total banks’ assets increased by 2.2% in 1H 2017, while total credit to the economy increased by 1.8%. The key drivers of these dynamics were loans to individuals and unsecured consumer loans. The former increased by 3.8% during this period partially supported by government led programs in the mortgage and car loan sectors. Loans to legal entities increased by only 1% as a result of the fragile recovery in the Russian economy.

The quality of banks’ assets remains stable with the share of overdue loans to legal entities and individuals standing at 6.5% and 7.8% respectively by the end of 2Q 2017 as compared to 6.2% and 8.1% by end-2016 (see graph 3). The share of “bad quality loans” (IV and V quality categories according to the CBR classification) also remained stable at 10% over 1H 2017 (see graph 4). The Agency does not expect significant changes in the asset quality by the end of the year. At the same time, the implementation of the financial recovery procedure in big private banks can reveal “hidden” defaults and, thus, it could affect general market statistics.

Profitability ratios kept improving along 1H 2017 reaching 1.7% and 14.4% for ROA and ROE respectively, which are the highest metrics since 3Q 2014 (the latest quarter before RUB devaluation) (see graph 5). Such a positive dynamic was mainly driven by lower loss provisions and an increase in commission and fee income (see graph 6). At the same time, most of the profit is still generated by Sberbank (37% of total profit of the banking system), while 28% of the banks remain loss-generating entities. This high disproportion in profit distribution leads to increased risks for the banking system stability.

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The liquidity position of the sector remains satisfactory, with key ratios standing at elevated levels along 2017 as compared to 2016 (see graph 7). As with profitability metrics, we notice high disproportion in the liquidity distribution. While state-owned banks benefited from the recent wave of license revocations, private banks became very vulnerable to sudden funds withdrawals from corporations and individuals. This led to a sharp increase in the amount of funds raised by banks from the CBR via REPO transactions in August 2017.

The funding base in 1H 2017 was characterized by a gradual increase in the share of funds from individuals which reached 30.8% of the banks’ overall funding base as well as continued decrease of interest rates levels which reached a minimum since the beginning 2014. Overall, the amount of funds from individuals increased by 4.3%, while deposits and current accounts from corporates increased only by 0.6% during the first half of 2017.

3. BANK REGULATION AND LICENCE WITHDRAWALS

In 1H 2017 the CBR continued working on the three key reforms initiated in 2016 (see our previous reports2): centralization of the supervision procedures, creation of a two-layer banking system and establishing a new mechanism of financial recovery procedure.

The centralization of the supervision procedures was aimed at increasing personal responsibility of the CBR employees and eliminate the conflict of interest currently existing in the regional branches of the CBR3. The process started in June 2017 and shall be completed by the end of 2018. According to the Agency’s opinion, this reform can increase the efficiency of the CBR supervision, however, it can also have an adverse effect on small regional banks.

The splitting of the types of banking licenses to “universal” and “basic” (for small banks) was finally approved in May 20172. The transition period given to the banks will last until the end 2018. In our view, the banks electing to have a “basic” license will face the potential withdrawal of funds from big local enterprises and individuals. Moreover, these banks could also run into new regulatory risks related to concentration prudential normative ratios.

After several years of providing soft loans to existing banks in order to achieve the recovery of troubled banks, the CBR officially recognized this mechanism as ineffective due to a rather frequent misuse of the provided money, overextended period of recovery and excessive amount of provided funds (see graph 8). In 1H 2017 the Banking System

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3 The number of employees and amount of financing provided to the regional branches of the CBR depend on the number of local banks supervised by the branch. Withdrawal of licenses of local banks leads to a decrease of the funding provided to regional branches. Therefore, the employees of the latter have a motivation to ease supervision even if the supervised banks are involved in suspicious transactions.
Consolidation Fund (BSCF), as well as its management company in form of a separate unit of the CBR, were created. Furthermore, in August 2017 a new mechanism of financial recovery was implemented for Otkritie Bank. The Agency will keep this case on watch as it creates a new precedent in the Russian financial system and it most certainly will have further implications in the sector and the overall economy.

Apart from these three structural reforms, the CBR continued its policy of strengthening the routine supervision practices and implementation of more strict punishments for fraud in the banking business. These measures include more detailed checks and even re-estimation of the collateral value by the employees of the CBR and the distribution of the so called “black list” of borrowers which are “not recommended” as a counterparty for banks. In addition, the CBR imposed a lifetime ban from banking activities on the individuals involved in the intentional bankruptcy of a bank.

Moreover, the CBR continued to reform industries related to the banking sector, such as audit, banking IT-security and credit rating agencies. Altogether, these reforms should increase the reliability of the services provided to banks; however, they could also lead to a substantial increase in their operating costs.

The levels of key prudential ratios remained unchanged during 1H 2017, while some changes in the calculation of these ratios were completed. For example, to avoid an increase in risky not secured loans the CBR increased the risk weights for loans issued with an excessively high interest rate.

Apart from regulatory changes, the CBR continued its routine procedure of license revocation. In 1H 2017, 23 licenses were revoked as compared to 45 during the same period of 2016 (see graph 9). Most of these cases were related to small Russian banks, with the exception of two relatively big and important banks: Tatfondbank and Ugra Bank whose licenses were revoked in March and July 2017 respectively. These banks occupied the 42nd and 34th positions by assets before their licenses were revoked. In addition, the CBR implemented new measures of banks financial recovery: Bank Peresvet went through a bail-in procedure in April 2017 (converting customers’ deposits into subordinated debt), while the financial recovery procedure with participation of the BSCF was started in Otkritie Bank in August 2017.

4. OUTLOOK

For 2H 2017, the Agency does not expect loans to grow as fast as they did in 1H 2017: 4% for loans to individuals and 1% for corporate sector loans. The former will be supported by government led programs in mortgage and car loans, while the latter will suffer from the sluggish growth of the economy.

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We expect an improvement in profitability indicators by the end of 2017, while capital adequacy and levels of overdue loans are likely to remain stable. Nonetheless, NPLs may show a slight increase due to the financial recovery procedures in place in some big banks.

According to our opinion, the procedure of licenses revocation will continue at a slower pace in the following quarters. At the same time, the Agency expects that some big private banks will be at risk of suffering liquidity shortages and be subject to regulatory action at least until the end of the year. This will support further consolidation of the banking sector and growth in the share of state-owned banks.

Finally, we consider that the Russian banking system remains heavily dependent on external conditions, such as developments in the price of oil and the dynamics of western sanctions.