Russian Banks Face Rough Going This Year

By Standard & Poor's

Low oil prices and the weak Russian ruble will continue to take their toll on the financial health of Russian banks this year, in our view. Standard & Poor's Ratings Services expects asset quality to continue to deteriorate in 2016 for the Russian banking sector. We expect credit costs (new loan loss provisions) of 3.5%-4.5% of gross loan books will be needed this year to cover loan losses that the banks are likely to face. This could further weaken their capital positions. For that reason, we cannot exclude the possibility of downgrades on certain Russian banks this year, as reflected in our negative outlooks or negative CreditWatch placements on 31 out of the 37 we rate.

In the past two years, the Russian ruble depreciated by almost 60% against U.S. dollar, which weakened the capital adequacy of Russian banks considerably because about one-third of their assets is denominated in foreign currencies. Furthermore, the depreciation is not only directly hurting the debt-servicing capacity of the bank's borrowers with debt denominated in U.S. dollars and other foreign currencies, but is also indirectly hurting some economic agents via a pass-through of the currency weakness to domestic prices. Although large export-oriented enterprises largely benefit from the weaker local currency, we estimate the banking sector's lending exposure on such borrowers doesn't exceed 30%-35% of the systemwide corporate loan book, while the credit quality of the rest is under pressure. What's more, low earnings of banks, driven by depressed economic conditions and still-high funding costs, are likely to restrict their internal capital generation and increase the need for new injections of capital from shareholders.

Overview

- We expect Russian banks to face further deterioration in asset quality this year, with nonperforming loans reaching 23%-25% (including restructured loans) under our base case scenario.
- In our view, most Russian banks are less than adequately capitalized and will only manage to break even in 2016.
- We still consider the government to be supportive to the Russian banking sector, but unlikely to provide another big rescue package.
- Of the Russian banks we rate, 31 out of 37 carry negative outlooks or are on CreditWatch with negative implications, indicating that negative rating actions are much more likely than positive ones.

We believe that the pressures will continue to gradually wash away smaller banks and those with aggressive risk-taking policies, part of a long-term trend in the Russian banking sector. Since 2008, the 10-largest banks in the system have boosted their market share, organically and through mergers and acquisitions (M&A), to about 70% from about 55% in total assets. In the next three to five years, we believe, the Russian banking sector will become more concentrated, and number of banks will gradually decline.

Our ratings on Russian banks already incorporate the economic risks of operating in Russia, such as elevated credit risk and high dependence of the economy on commodity prices. We expect further negative rating actions we take to be predominantly prompted by asset quality deterioration, weakening capital, and, for small and midsize banks, tighter liquidity.

HARSHER OPERATING CONDITIONS

Operating conditions for Russian as well as for many banking systems in Europe, the Middle East, and Africa (EMEA) might further deteriorate this year, we believe. In Russia, lower oil prices have weakened economic growth prospects, exacerbating ongoing structural weakness. According to Standard & Poor's latest oil price assumptions, Brent will likely average $40 a barrel this year and $45 in 2017. Real disposable income is set to fall further, depressing consumer demand, while economic uncertainty and the high cost of credit weigh on investment. Standard & Poor's base-case assumes a contraction in GDP by 1.3% in 2016.

We expect the deterioration in banks' asset quality to continue in 2016, with problem loans (overdue more than 90 days and problem restructurings) potentially reaching 23%-25% of the total loan book. That compares with 9.1% for loans overdue by more than 90 days, excluding restructuring, at year-end 2015. We still believe that larger players, especially those with access to the various mechanisms of government support and committed owners, are in a better position than smaller banks to weather the difficult operating conditions. Small and midsize banks are likely to suffer more from deposit outflows and rapidly deteriorating asset quality.

ANOTHER SIZABLE RESCUE PACKAGE IS UNLIKELY

We note that the Russian government remains supportive toward the banking sector. Last year, the government spent Russian ruble (RUB) 816 billion, or about 1% of GDP, to recapitalize domestic banks. The amount of financing disbursed for financial rehabilitation of failed entities reached RUB1 trillion in 2015. That said, we believe that in the future the government will make capital support available only for larger financial institutions and might be less eager to support financial rehabilitations.

The government will be less keen to disburse additional funds for direct capital support because of the state's weakening fiscal position due to low oil prices. In contrast, we are increasingly likely to see noncash solutions, such as the relaxation of regulatory requirements, or the transfer the bad assets off a bank's balance sheet, or various mechanisms of cost sharing with private investors. In particular, the recently announced idea to introduce bail-in mechanisms for Russian banks might be implemented sooner rather than later. This would allow the government to share the costs with depositors in case of bank failures, and would promote increased risk awareness among the bank's clients. If introduced, this mechanism could also accelerate the shift of deposits to larger financial institutions that are perceived to be stronger. At the same time, this could be the first step of implementation of orderly liquidation mechanisms of larger entities in case of their failures.

INCREASED CREDIT COSTS LOOM

We expect high credit costs of 3.5%-4.5% of gross loan books (or about RUB2.5 trillion to RUB3.0 trillion) for all Russian banks. That level, we believe, reflects deteriorating operating conditions and our expectations for loan losses. We foresee anemic loan growth of at most 10% (net of currency revaluation) in 2016, in an environment of economic recession and still high credit cost. We also expect limited demand from corporate borrowers and a continued moderate deceleration in the retail segment.

As economic recession continues and credit growth decelerates, weaknesses in some banks' prior underwriting will likely manifest themselves. We consider that high single-borrower and related-party exposures are exacerbating asset quality risks for many banks.

By comparison, we assume that problem loans--overdue more than 90 days including distressed and restructured loans--could climb and make up 23%-25% of total bank loans throughout 2016. As economic recession continues and credit growth decelerates, weaknesses in some banks' prior underwriting will likely manifest themselves. We consider that high single-borrower and related-party exposures are exacerbating asset quality risks for many banks.

Additional provisioning needs are therefore likely to become one of the make-or-break factors for the profitability of many banks this year. Under our base-case scenario, we estimate that the net interest margin of Russia's largest banks will likely fluctuate between 3.0% and 3.5% on average in 2016. We project systemwide return on equity will hover around 1% in 2016, down from 15% in 2013 and 4.2% in 2014, but potentially trend up moderately in 2017. However, our scenario remains highly dependent on Sberbank's performance, as it dominates the banking system. Although we expect most Russian banks to break even in 2016, the risk of losses is still high.

CORPORATE ASSET QUALITY IS VULNERABLE

Corporate loans were the major source of asset quality deterioration in 2015, and overtook retails loans as the previous impetus. We expect that corporate loans will continue to weaken asset quality this year, mostly from borrowers in domestic demand-driven sectors like real estate and construction (including infrastructure construction), and trade, as well as small and midsize enterprises. We observed that many corporate defaults in bank portfolios in 2015 were caused by contractors or subcontractors of various investment projects, which might be the source of defaults this year as well. This might indicate the vulnerability of companies involved in various government-related projects, especially in infrastructure construction, energy, commodity sectors.

RUSSIA'S RETAIL LENDING SEGMENT IS FACING ANOTHER DIFFICULT CHAPTER

As for retail loans, we expect credit costs to remain high, at approximately 6.0%-6.5% for 2016, although with greater variation depending on the type of product mix. We believe that secured retail loans will take a hit, although to a lesser extent than unsecured consumer loans.

Table 1. Russian Banking Sector Key Metrics

(Bil. RUB)	2013	2014	2015e	2016f
Banking loan portfolio*	40.535	52.116	57.511	63.262
Retail deposits*	16.958	18.553	23.219	25.541
New loan loss provisions to gross loans (%)§	1.7	2.9	5.0	4.5
New loan loss provisions on corporate loans (%)§	1.2	3.1	4.9	4.2
New loan loss provisions on retail loans (%)§	4.0	4.2	5.2	6.3
Return on equity (ROE, %)	15.0	4.2	-0.9	1.0
Net interest margin (%)	4.7	4.5	3.2	3.5

*e--Standard & Poor's estimate. f--Standard & Poor's forecast, net of foreign currency revaluation impact. *Growth forecast excludes potential impact of the revaluation of foreign currency assets and liabilities. §Unweighted average new loan loss provisions charged for the period to average gross loan books of 30 largest Russian banks under IFRS. Sources: The Central Bank of Russia, Standard & Poor's.*

The sharp deterioration in asset quality for retail loans stems from rapid credit expansion in 2010-2013, together with a decline in households' payment capacity, caused by falling real incomes amid the economic recession. As a result, we expect nonperforming loans (NPLs; loans overdue by more than 90 days) as a share of all loans to grow this year in the retail segment. We estimate the NPL ratio for the retail portfolios of the 30 largest Russian banks under International Financial Reporting Standards (IFRS) to rise to 10%-11% in 2016 from about 9% on Dec. 31, 2015 (see table 2).

Although the level of household debt in Russia is relatively moderate, at just above 13.3% of GDP at the end of 2015, compared with 37% in Poland, 24% in Brazil, and 39% in China, the penetration of mortgage and other collaterized lending in Russia is low. Yet, because of Russia's higher nominal interest rate, household debt service is also higher than that of many peers. What's more, household debt burdens are unevenly spread across the country: they are extremely high in some regions and very low in others.

In response to adverse market conditions and thinning capital buffers, most Russian banks trimmed their retail loan books, especially of unsecured products, by about 9% during 2015. We estimate that retail loans in Russia will unlikely demonstrate positive growth in real terms (net of inflation) in the next 12 months. We expect banks' retail financial performance to continue to feel the squeeze for the rest of 2016, and even report losses in some cases.

We view the risk of asset deterioration as greater for banks that specialize in retail that have an undiversified business model. In our opinion, because of consumer lenders' general undercapitalization and lack of competitiveness, large universal banks (especially state-owned ones) could take market share from consumer finance players owing to their more-diverse business models and continuing support from major stakeholders. We believe that to hold onto market share and lending growth, most retail monoline banks might either shift their strategies toward innovative products or move toward a universal banking concept, given that the current macroeconomic conditions and market saturation has left little room for them to continue to grow sustainably in their traditional area.

EARNINGS ARE UNLIKELY TO BOOST CAPITALIZATION

We believe that most Russian banks are not adequately capitalized to meet their elevated provisioning needs. In our opinion, most Russian banks would need to be more strongly capitalized to maintain their credit quality.

Banks' weak profitability and the limited capacity of their shareholders to provide additional capital cannot compensate for a fall in capitalization ratios, in our opinion. We project that the most-affected banks will be those with a share of foreign currency-denominated loans substantially above the system average of about 30%-35%. Furthermore, we anticipate that those banks with a share of foreign currency-denominated loans in their portfolios at the system average level or higher will also experience pronounced pressure on credit quality. These banks will have to create additional reserves in 2016, which will in turn erode already weakened capitalization. Although regulators might allow for some relaxation in the calculation of regulatory metrics as a temporary response to potential market shocks, the economic pressure on capital will remain, in our view.

We believe that secured retail loans will take a hit, although to a lesser extent than unsecured consumer loans.

We expect Russian banks' key financial performance metrics, namely net interest margins and net profits, to remain weak in 2016 after they eroded significantly in 2015. We believe Russian banks' profits are suffering from slow loan growth, higher provisioning, and a slow recovery in margins--not to mention volatile equity and currency markets.

AS THE LANDSCAPE CHANGES, WILL COMPETITION GROW?

We expect to see a declining number of banks in the system, which will become even more concentrated. That's because of mergers and acquisitions (M&A) activity and the failure of small and midsize institutions.

Table 2. Russian Banks Retail Asset Quality Metrics

(%)	2014	1h2015	2015e	2016f
NPL ratio*	5.8	7.4	9.3	10.7
Consumer finance	8.3	8.5	9.7	11.2
Credit cards	8.6	9.8	11.4	12.9
Mortgage	1.9	2.4	2.5	2.7
Auto loans	6.4	7.3	8.4	8.8
Credit cost§	4.2	4.4	5.2	6.3
Consumer finance	5.8	6.3	6.8	7.4
Credit cards	6.5	8.1	9.4	9.8
Mortgage	0.6	1.0	1.3	1.5
Auto loans	2.7	3.2	3.6	3.8

*e--Standard & Poor's estimate. f--Standard & Poor's forecast. *Unweighted average share of loans overdue by more than 90 days in the gross retail loan books of the 30 largest Russian banks under IFRS. §Unweighted average new loan loss provisions on retail loans charged for the period to average gross retail loan books of 30 largest Russian banks under IFRS. Source: Standard & Poor's.*

M&A activity

As in 2015, we expect M&A to drive consolidation in the banking sector in 2016 among large banks and small entities, under pressure from the banking regulator and deteriorating market conditions. We note that a number of midsize banks have grown quickly by becoming involved in the financial rehabilitation of failed banks, with the support of long-term funding from the Deposit Insurance Agency for financial rehabilitation. We expect this process to continue in 2016, although at a slower pace. On the other hand, we already see the growth of risks in the banking sector from what we consider overly aggressive non-organic growth of a few midsize players.

Failure of small and midsize financial institutions

We expect the Central Bank of Russia to continue to withdraw banking licenses, mainly of small and midsize banks, in a process that started in 2013 and that we expect to continue this year. In 2015, about 90 banking licenses were withdrawn. On the other hand, Of the 676 licensed players in the banking system (as of Feb. 1, 2016), the 10 largest hold about 70% of total sector assets. This means that license revocation should have a limited impact on the sector as We expect failures among small and midsize banks to continue through 2016. We believe that the most vulnerable banks are those with a narrow market focus and large concentrations in assets or liabilities. Also, such banks usually have business models driven by relationships, which might turn out to be fragile under tough operating conditions. Also, as the central bank continues to clean up the sector, customers are becoming more nervous, with smaller institutions suffering from confidence sensitivity.

At the same time, although the number of banks is set to decrease, the consequences for competition is uncertain. We believe that the competitive landscape will depend more on how many large, healthy, and well-capitalized players will be remain in the system.

NEGATIVE RATING ACTIONS ARE LIKELY

The unweighted average rating for Russian banks is about at 'B', which is among the lowest in EMEA, and reflects our view of the risky environment that is undermining banks' financial fundamentals through the economic cycle. Of the 37 Russian banks we rate, 31 of the long-term ratings carry negative outlooks or are on CreditWatch with negative implications, reflecting the generally tough operating conditions in Russia and, in many cases, the banks' individual weaknesses.

We expect that the most likely reasons for any downgrades of Russian banks this year will stem from:

- Rapid deterioration of their capital positions, with insufficient support from shareholders or the government to shore up capital;
- Weakened asset quality, especially for those with very concentrated loan books, where one or two significant credit events might sharply elevate provisioning needs; or
- For smaller and midsize entities, tightening liquidity and funding, caused by undiversified funding bases and confidence sensitivity.

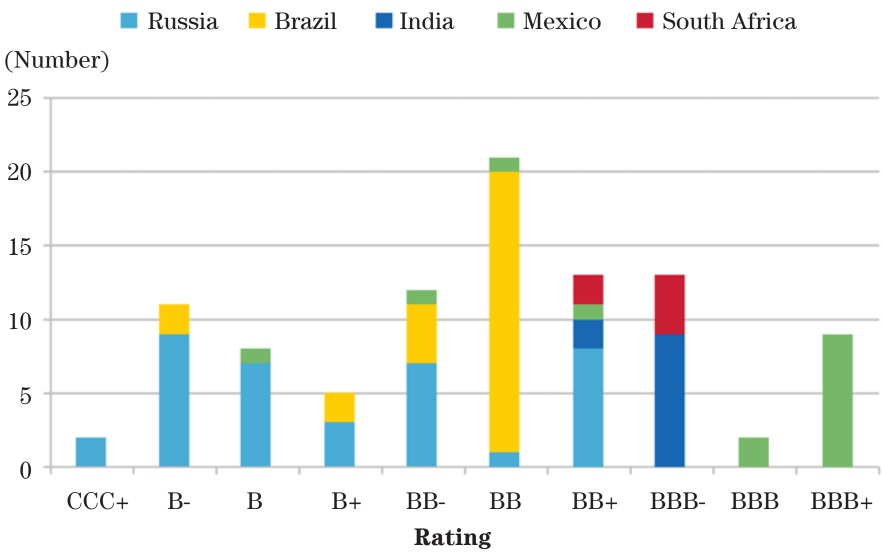
The extent of the downgrades will largely depend on the degree of deterioration of the banks' financial and commercial profiles, mainly relating to asset quality or the banks' ability to absorb credit losses and raise necessary capital. Possible debt restructuring or an inability to meet debt obligations could result in ratings being lowered to 'SD' (selective default) or 'D' (default).

We expect to see a declining number of banks in the system, which will become even more concentrated.

On a systemwide level, the downgrades of Russian banks might follow from our decision to revise our Banking Industry Country Risk Assessment for Russia to an even lower category. That may occur if we determine that economic risks have risen or that funding profiles have deteriorated. For those banks that benefit from government support (such as large government-related entities and systemically important institutions) a sovereign downgrade might also result in negative rating actions on Russian banks, indicating a reduction in the government's ability to support them.

At the same time, should some banks successfully withstand the external pressures, maintaining adequate capitalization and successfully managing asset quality, we might revise the outlooks back to stable. However, upgrades in the next 12-18 months are very unlikely. Ratings stability will depend on the extent of efforts by individual banks to sustain their financial and commercial profiles--especially asset quality and liquidity--and tighten their risk management controls.

Ratings distribution of Russian Banks Comparing to some other countries



Ratings as of March 17, 2016.
Source: Standard & Poor's