GAIDAR INSTITUTE FOR ECONOMIC POLICY

# RUSSIAN ECONOMY IN 2012
## TRENDS AND OUTLOOKS
## (*ISSUE 34*)

**Gaidar Institute**
**Publishers**
**Moscow / 2013**

UDC 330(470+571)
BBC 65.9(2Рос)-04

*Agency CIP RSL*



R95

**Russian Economy in 2012. Trends and Outlooks.**
**(Issue 34) – Moscow, Gaidar Institute Publishers, 2013. 548 pp.**

ISBN 978-5-93255-374-9

The review provides a detailed analysis of main trends in Russia's economy in 2012. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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ISBN 978-5-93255-374-9 

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## Russia’s Banking Sector in 2012

### Key trends

The Russia’s banking sector fully recovered after the economic crisis in 2012 and either caught up with some of the parameters of the preceding year, or its development even slowed down.

Total volume of bank assets grew up by 20.4% in 2012, whereas in 2011 they stood at 23.1% (*Fig. 55*). Nevertheless, the banking sector was growing faster in terms of volume than the economy, for the first time since 2009. Total bank assets to GDP increased from a level of 75–76%, which was stable over the last three years, to 79%. However, the volume of bank assets increased against the economy mostly in response to that growth rates in GDP nominal volume slowed down substantially, which almost halved in 2012 against the preceding year (from 20.5 to 11.8%).

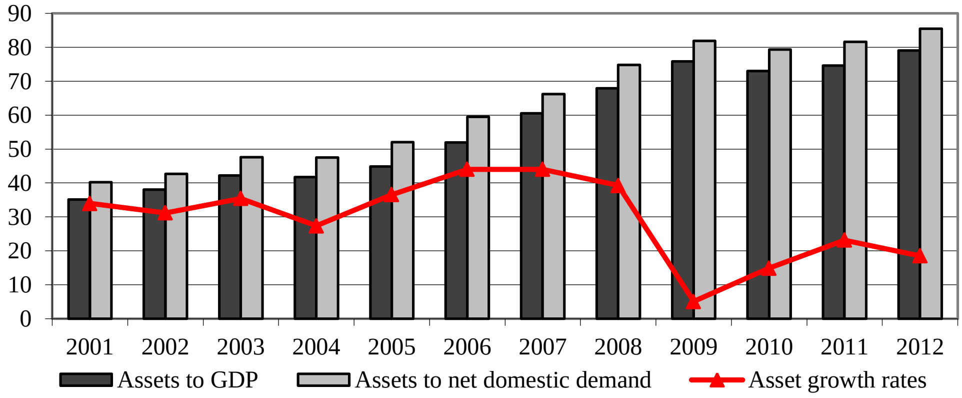


*Fig. 55*. Bank assets gain rates as percentage of the preceding year, and the ratio of bank asset volumes to GDP and net domestic demand[1], %

In 2012, the Central Bank of Russia increased its participation in promoting growth of bank transactions. In 2011, refinancing stood at 2.5 p.p. of total asset growth, i.e. under otherwise equal conditions bank assets would grow less by 2.5 p.p. without loans from the Central Bank of Russia, whereas in 2012 regulator’s loans reached 3.6 p.p.

The following changes took place in the resource build-up structure in the banking sector as compared to 2011 (*Fig. 56*). Borrowings from corporate customers decreased notably. Their share in the resource build-up structure of banks reduced from 30 to 14%, personal savings remained unchanged and stood at 28%, whereas the volume of bank deposits increased by 20% in nominal terms. At the same time, as noted above, the Central Bank of Russia increased its participation in and contribution to the build-up of bank resources from 13 to 18%. In addition, owners of banks increased their role. In 2012 their contribution stood at 12.5%

[1] Net domestic demand is calculated as GDP less net exports, and represents the estimation of domestic consumption in the economy.

against 9.2% in 2011. Nominal capital growth in the banking sector increased by more than 70%, almost by Rb 900bn in 2012 against a little bit more than Rb 500bn in 2011.

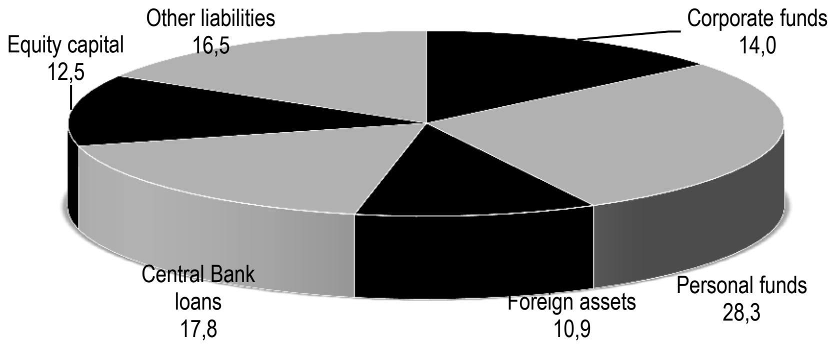


*Fig. 56.* Resource build-up structure in the banking sector (growth in liabilities and reduction in assets) in 2012, as percentage of total

The main outcome in the field of active bank transactions in 2012 became the replacement of corporate lending with retail loans. In 2012, banks allocated 37% of their built up resources to loans to enterprises and organizations as well as investments in corporate bonds against 46% in the preceding year, whereas retail lending received more resources than in 2011, 28% against 23% (*Fig. 57*).

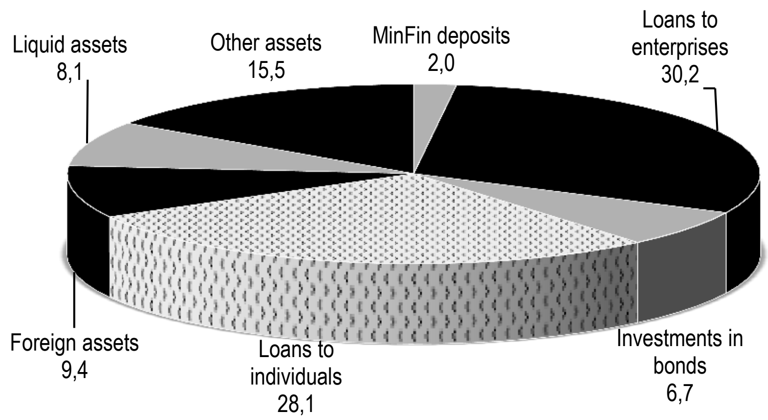


*Fig. 57.* Resource utilization structure in the banking sector (growth in assets and decrease in liabilities) in 2012, as percentage of total

Retail segment bank transactions in 2012

The year of 2012 featured the following trends in the relationship between banks and individual customers:

1. Household consumption level became more dependent from bank lending.
2. Household disposable incomes experienced a heavier load in servicing debts owed to banks.
3. Household savings rates reduced.

***Higher dependence of individuals on loans***

Growth rates in the retail segment of bank lending in 2012 reached maximum values in the post-crisis period. In the summer of 2012, annual (over 12 months) growth rates of individual (household) debts owed to banks reached 44%, whereas the growth slowed down to 39% at the end of the year. Debts under unsecured consumer loans increased most, by 57%, whereas debts under other types of loans grew moderately, by 35% for housing loans (incl. mortgage loans) and by 24% for car loans.

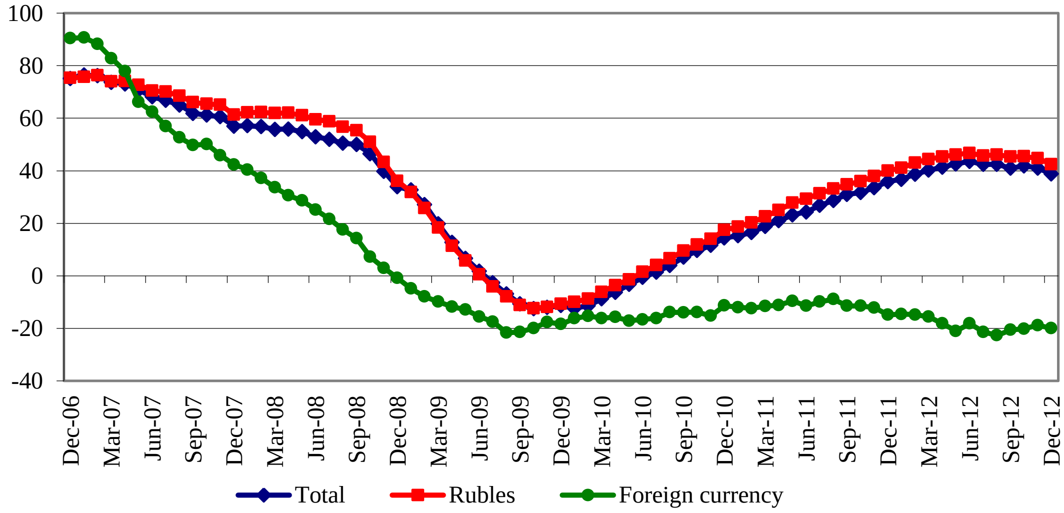


*Fig. 58*. Growth rates in retail loans over 12 months, %

Individual (household) debts owed to banks grew with volumes of new loans. In 2012, banks extended a total of Rb 7.2 trillion of retail loans, i.e. 33% more than in the preceding year. The ratio of new loans to households consumer spending (the sum of retail sales volume, expenses on food service, and paid services) exceeded the pre-crisis level (22% in 2007 ) to finally amount to 25.6% at year end. Furthermore, it used to reach 27% in Q2 2012. It means that one in four rubles which individuals spent for consumption in 2012 was borrowed from the banking sector.

It is the growth in debt burden on income and assets of households that gives rise to concern in terms of bad debt risks and, consequently, financial sustainability of banks, rather than credit portfolio growth rates – loans grew faster prior to the crisis. For instance, the ratio of total debts under bank loans to income of households already exceeded a maximum of 17.8% during the crisis in September 2008 to reach 21.5% at the 2012 year end.

In addition, the current debt service burden (the sum of mandatory principal payments plus interest payments) on household disposable income was growing. All in all, in 2012 this parameter reached 9.6%, being comparable with the same US parameter (10.6% at the end of Q3 2012). The Financial Stability Review published by the Bank of Russia in September provided different data on debt burden on household disposable income. According to the foregoing data, debt burden on households used to reach 20% in certain quarters during 2012. Our data differ from that of the Central Bank of Russia in the following. To estimate the amount of principal payments, we use the amount of retail loans matured in the period under review. It is this information that banks use to solvency of a particular borrower, whereas the Bank of Russia took into account total amount of repayments, including early repayment of loans. Thus, the parameter provided in the Financial Stability Review can be used to estimate actual debt load, whereas our estimates show the amount of scheduled debt load. It should be noted that such method is comparable with the estimates made by the US Federal Reserve System[1].

***Reduction in household savings rate***

In 2012, the relationships between banks and individuals (households) saw breaking changes. Retail bank deposits grew at a slower rate against retail loan debts owed to banks throughout the entire period of the year. Thus, the household sector, which traditionally was the principal source of resources for banks, turned into net borrower. Over a period of 11 months net household savings in banking system reduced almost by Rb 700bn. It was only the seasonal December growth in retail bank deposits that restored status quo. All in all, the inflow of retail bank deposits to the banking sector was equal to the growth in loan debts, both parameters showing a value of Rb 2.3 trillion at the year end.

It was only in the crisis-hit year of 2008 when the growth in bank retail loans grew mush faster in nominal terms than bank deposits over 11 months (at that time this parameter exceeded Rb 800bn over 11 months). In 2008, however, it was caused by withdrawals of retail bank deposits in response to impending large-scale crisis in the banking system. In the period between September and October 2008 alone individuals withdrew more than Rb 540bn of deposits with banks. The year of 2008 still remains the only year when individuals played a role of net borrowers against the banking sector.

During 2012 the transition to net retail borrowing took place quietly without any signs of panic on the side of retail bank depositors, thereby speaking for changes in the savings behavior of households and transition to a loan-based consumption model which was more evident than in the period when retail lending was booming in 2006–2008.

Formally, the growth in retail bank deposits in 2012 was equal to that of loan debts, both parameters amounted to Rb 2.3 trillion. However, from the one hand, a major part of the growth in retail bank deposits was caused by interest accruals: in 2012 banks paid Rb 665bn of interest on retail accounts, accounting for about 30% of growth in the retail deposit base. On the other hand, a part of the extended retail loans were one way or the other discharged from banks' books. Overdue bad debts are often sold to collector agencies, a part of loans are subject to refinancing, e.g., mortgage loans through the instruments offered by the Agency for Housing Mortgage Lending (AHML).

In other words, actual inflow of household money to banks was notably less, whereas the increase in debts was more, than the observed growth. To that end, it is safe to say that in 2012 individuals ceased to be creditors to the banking sector by turning into net borrowers.

[1] DSR (debt service ratio) also includes scheduled loan repayments only.

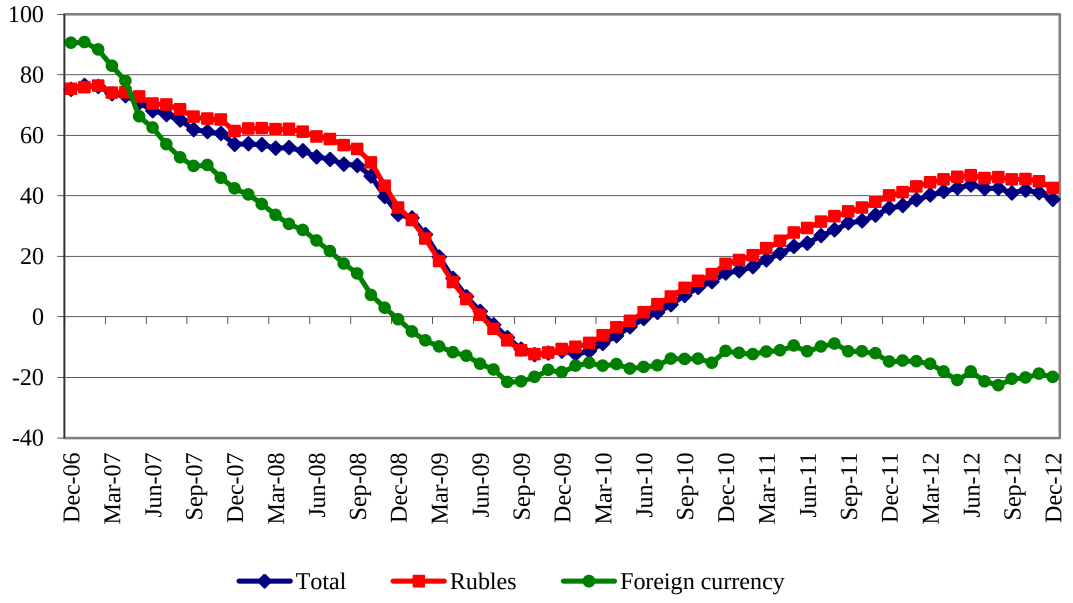


*Fig. 59.* Retail bank deposits growth rates over 12 months, %

However, growth rates in the deposit base remained stable, ranging between 19 and 21% over the last two years. The household savings rate in bank deposits and cash in decreased insignificantly from 8.4 to 8.2% in 2012 against 2011, however, a shift from cash to bank deposits was observed in the personal savings structure. Retail bank accounts and deposits accounted for 6.6% of disposable income in 2012 against merely 6.0% in the preceding year.

This was quite likely caused by growth in interest rates on retail bank deposits which almost throughout the entire year were stable, increasing by 1–2 p.p. the officially registered inflation level. In addition, retail bank deposits in foreign currencies increased in response to highly volatile ruble exchange rates. The growth rate in this type of savings was almost equal to the growth rate in ruble bank deposits at the year end.

### Relationship between banks and corporate customers

The following trends were observed in the relationship between banks and corporate customers in 2012:

1. Slower growth rates in corporate lending.
2. Reduced growth rates in corporate account balances.
3. Increased nonperforming assets in the corporate sector.

Growth in corporate loan debts owed to banks slowed down in 2012. Growth rates of the corporate segment in the lending market dropped to 14% in 2012, after a 24% growth in corporate debts at the 2011 year end. Furthermore, the retail segment almost caught up with the corporate one in terms of nominal volume of growth in corporate debts in 2012: corporate debts increased by Rb 2.5 trillion, whereas individual debts by Rb 2.3 trillion.

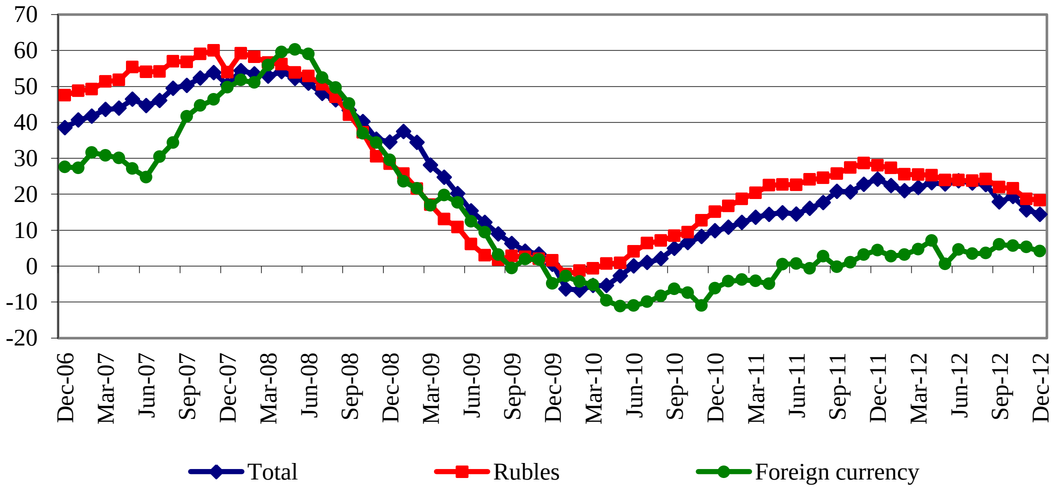


*Fig. 60.* Corporate loans growth rates over 12 months, %

The quality of corporate debts owed to banks improved gradually throughout the entire year. The volume of loan loss provisions increased merely by 3.5% while the amount of overdue debts by 9.9%. As a result, a share of overdue debts in total corporate debt reduced (from 4.8 to 4.6%), and the ratio of provisions to loan debts from 8.3 to 7.5%) during the year. However, these parameters still remain much worse than the minimum values observed prior to the crisis, when overdue debts accounted for less than 1% and the volume of provisions for about 3% of total lending volume.

Corporate funds growth in bank accounts saw significant changes during 2012. In 2011, balances on corporate accounts and deposits stood at 25%, whereas in 2012 they dropped below 10%. This process took place partly together with slowdown in lending. However, the presented data show that growth rates of bank account balances slowed down at a higher rate than loan debt volumes. In 2012, corporate borrowers left on the banking sector's accounts less than 50% of growth in loan debts against about 70% in 2011.

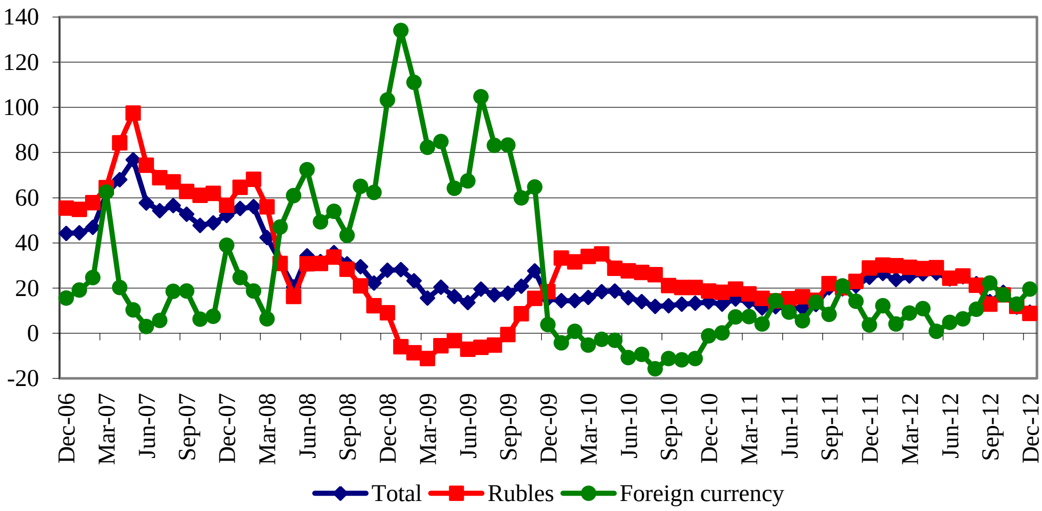


*Fig. 61.* Corporate funds growth rates in the banking sector over 12 months, %

It was bank term deposits representing nonperforming corporate assets withdrawn from the current economic turnover that began to account for most of the corporate funds available in the banking sector. They accounted for no more than 50% of total corporate customers' funds throughout the entire year. Moreover, most of corporate bank term deposits had a maturity of more than one year. Bank term deposits with a maturity of more than one year accounted for 42.4% of total deposits for nonfinancial organizations and 57.6% for financial institutions, which means that many enterprises and organizations preferred bank long-term deposits to investments in their production development, in spite of the fact that weighted average yield on bank deposits for corporate customers was fairly moderate in 2012. All in all, average value of a business entity's bank deposit stood at 5.8% p.a. during the year.

### Foreign transactions in the banking sector

The balance of transactions with nonresidents in the banking sector kept changing in favor of net allocation of foreign assets at the 2012 year end. The volume of foreign liabilities increased by $31bn and foreign assets by $35bn[1] during the year. Thus, banks' net investments in foreign assets increased by $4bn (from $46bn to $50bn) during the year, being much less than in the preceding year, when banks' net foreign assets amounted to $24bn[2].

The growth in net foreign assets in 2012 was accompanied by shrinking of net foreign exchange position in the banking sector, i.e. foreign exchange assets exceeded foreign exchange liabilities. Net foreign exchange position decreased by $12bn during the year.

Mixed dynamics of net foreign assets and foreign exchange position in the banking sector resulted from growth in domestic foreign exchange savings deposited in the banking sector. Russian customers' deposits in their foreign currency accounts exceeded by $25bn foreign exchange loans they obtained from banks. Retail deposits accounted for most of it (about $17bn). Thus, capital outflow from banks over the last few years was a response to higher demand for foreign exchange savings on the side of their customers, because foreign exchange loans inside the country have long lost demand in the required volume. This is the main difference between the current situation and that in the period between 2008 and 2010, when the dynamics of net foreign assets banks corresponded to the dynamics of foreign exchange position in the banking sector, because growth in investments in foreign assets was caused by the intention of some of the large banks to maintain a positive foreign exchange position.

Moreover, this situation stultifies to a large extent a potential recurring of the growth strategy in the banking sector which was widespread prior to the crisis: accelerating credit expansion inside the country by borrowing cheap (in foreign exchange values) resources from foreign financial markets. Today, when changes in the policy of the Bank of Russia gave rise to uncertainty in midterm dynamics of the ruble exchange rate against other foreign currencies,

[1] Hereinafter in the section the data on foreign assets and foreign exchange assets are presented as adjusted for FX swaps with the Bank of Russia. FX swaps are referred to as Bank of Russia's loan to a bank in exchange for foreign currency delivery. The transaction is performed at a pre-determined rate depending on a interest rate on the provided assets.

[2] It should be noted that due to methodological differences the dynamics of banks' foreign assets and liabilities in bankers' books not always correspond to statistics on balance of payments. For example, our analysis takes no account of Vnesheconombank transactions, which is not regarded as credit institution, but its transactions are recognized under "banks" item in the balance of payments. In addition, today banker's books make it impossible to quickly assess the volume of nonresident investments in the banking sector's capital.

neither banks, nor their customers are ready any longer to assume foreign exchange risks in the volumes typical of the period between 2005 and 2007, thereby bringing into focus the issue of sources for growth in the banking sector in the midterm perspective.

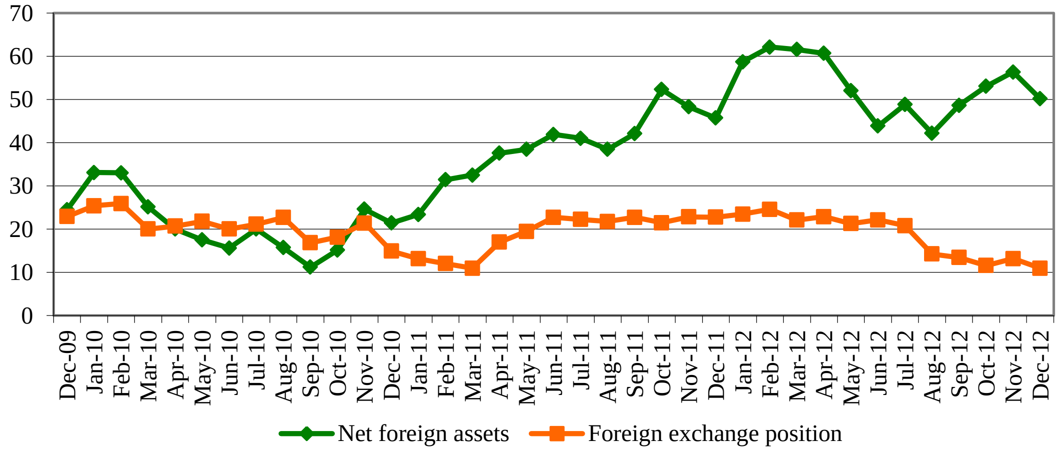


*Fig. 62.* Net foreign assets and foreign exchange position in the banking sector, billions of US dollars

### Strengthening state influence on the banking sector

The banking sector's large dependence on the budgetary policy manifested itself again in 2012. For the second year in a row state finances created an artificial issue of bank liquidity. It means a combination of two processes, namely federal budget surplus accumulated in the Reserve Fund, and comparable in volumes operations on the placement of government securities in the domestic financial market.

Let us consider in detail the functioning of this mechanism. The dynamics of money supply is governed by three basic types of operations of the Bank of Russia: operations with reserve assets (in particular interventions in the domestic foreign exchange market), budget operations (mostly accumulation of budget balances on accounts with the Bank of Russia, including the Reserve Fund and the National Wealth Fund), and operations providing liquidity to commercial banks (banking system refinancing).

In 2012, the Bank of Russia conducted minimum foreign exchange interventions. A total of $7.6bn of interventions were conducted during the year ($12.4bn in 2011). In general, in 2012 interventions in the domestic foreign exchange market contributed Rb 229bn to the money supply (increase in M0 money stock), according to the Bank of Russia. In addition, the Bank of Russia's reserves increased by another $22.5bn through other operations with reserve assets (except for interventions in the domestic foreign exchange market). This value includes the placement of government Eurobonds in foreign exchange ($7bn), revenues from the sale of a share in Sberbank to non-residents (about $5bn), foreign currency swaps with Russian banks ($9bn).

Money supply reduced in response to accumulated surplus (non-spent) national revenues in accounts with the Bank of Russia. Though in 2012 federal budget was reduced to nil balance (budget deficit amounted to merely Rb 12bn, according to preliminary estimates), balances on government bank accounts increased considerably, including but not limited to additional borrowings in the domestic market and external markets. Balances on federal government authorities' accounts with the Bank of Russia increased by Rb 959bn during the year. Given the funds of the constituent territories of the Russian Federation, government agencies resources in the Bank of Russia increased by Rb 1.1 trillion. This value represents a direct deduction from the money supply, because this money were withdrawn from the current economic turnover.

To compensate for cash outflow to state administrative bodies' accounts with the Bank of Russia, refinancing of the banking system should be accelerated. In 2012, the Bank of Russia's requirements to institutions increased by Rb 1.5 trillion.

In accordance with the Federal Law "On the Federal Budget for 2013–2015" (Annexes 43 and 44), the situation may recur, because domestic and foreign debts and the Reserve Fund will grow simultaneously time in 2013 and beyond.

Virtually, public borrowings in the domestic market act as an alternative for the financial sector to lending to the nonfinancial sector of economy, thereby preventing the real sector from increasing its resource base which in involved in both current economic turnover and capital investments. This makes banks reduce their resource base and have a need for more single-source refinancing.

It should be noted that scheduled borrowings will discount much less funds from lending within three years to come than in 2011. For example, if total corporate and retail lending grow by 17–18% annually, new government borrowings in the domestic market in 2013–2015 would account for 10–15% of credit portfolio growth against 25% in 2011.

### Banking regulation

Bank of Russia's stricter requirements to risk assessment for selected categories of assets and the resulting reduction in capital adequacy of banks became a key issue for banks in 2012. Capital adequacy in the banking sector kept decreasing throughout the post-crisis period. As early as the 2011 year end, capital adequacy fell to reach the pre-crisis level (14.7% as of 01.01.2012 against 14.6% as of 30.09.2008 ) from maximum values of 20–21% reached late in 2009 in response to state support to banks amidst the crisis. By 01.01.2013 it fell to 13.7%, with the acceptable threshold being 10%.

On the one hand, reduction in capital adequacy reflects growth in bank lending and accelerated growth of working bank assets. During the crisis owners of banks accumulated a substantial safety bag thanks to state support, which can absorb different risks the banking sector is exposed to. Accumulation of banks' capital slowed down in response to the transition to recovery growth in the banking sector whose adequacy ratio began to decline against an increase in business loans and other active bank transactions.

However, banks' profitability remains far below the pre-crisis level. Return on investments accounts for 20% p.a. against 25–30% in the period between 2006 and 2007, thereby leading to a relatively poor attractiveness of banking business for investors and discouraging owners from recapitalizing credit institutions without dire need.

On the other hand, the Bank of Russia tightened gradually the bank capital regulation in an effort to encourage bank owners to increase their capital in order to strengthen financial sustainability of the banking sector and prevent lending from being accelerated too fast, above all, unsecured consumer loans and higher-risk segments of corporate borrowers.

As a result, in 2012, though growth rates in equity capital of banks increased by more than 1.5 times (from 11% in 2011 to 17% in 2012), capital adequacy kept declining in 2012. The amount of risk weighted assets increased by 25% during the year, according to the Bank of Russia capital adequacy ratio calculation method, against a total growth rate in assets stood at about 20%.

Scale-up risk factors for borrowers who have no credit rating and fail to disclose their credit record, were introduced in the summer of 2012, which "cost" banks almost 0.5 p.p. of capital adequacy ratio. In 2013, the Bank of Russia plans to introduce higher risk ratios for tight unsecured retail loans, thereby making additional contribution to the reduction in capital adequacy, if banks can't further increase their equity capital.

For example, beginning with July 1, 2013, retail loans at higher interest rates will be included with higher ratios into the capital adequacy ratio calculation formula. Interest rates of more than 25% p.a. will be regarded as higher interest rates for ruble loans. The multiplying ratio will be set to 1.1 (i.e. such loans will be regarded as being exposed to a risk which is 10% higher than that for "cheap" loans) for up to 35% p.a., 1.4 for 35 to 45% p.a., 1.7 for 45 to 60% p.a., and 2 for more than 60% p.a.. In other words, banks will have to double their capital adequacy in case of most tight loans. To fully assess the effect of such measure on the situation in the banking sector, a more extensive information on specific banks is needed against that provided by the Bank of Russia. Based on the available bank financial statements as of the end of Q3 2012, 43 banks had more than 25% p.a. of average yield on retail loans. In other words, these banks will certainly face either capital adequacy reduction, or have to revise their interest rate policy. In practice, since most banks have at least one tight loan, the foregoing measure will definitely have an effect on many banks which will have to either reduce their yield on retail loans, or seek extra sources to increase their capital.

### Banking sector development prospects in 2013

In 2013, potential sources of growth in the banking sector will be concentrated within this country. External capital inflow to the Russia's banking sector is unlikely for domestic reasons, rather than because unfavorable conditions in external markets. Gross external loan inflow, which is small though, kept going throughout the entire post-crisis period. The Russia's banking sector should not count on the external world as a source of financing in the mid-term perspective, because of highly volatile ruble exchange rate, lack of efficient foreign exchange risk tools in the Russia's financial market, and reluctance of banks and their customers to assume such risks.

Consequently, the mid-term development of the Russia's banking sector will be based mostly on domestic sources of financing which basically comprise the two segments: 1) the state and the Bank of Russia as regulator in the banking market and, consequently, 2) the private sector.

Possible reliance on the private sector as potential source of financing for the banking sector implies higher effectiveness of Russian banks as financial mediators who are able to convert national savings into investments. However, the key risk here is growing erosion of money supply sources from the banking sector which has been observed over the last few years, thereby leading to deficit of resources required for further growth in lending. This issue resulted in liquidity deficit in the banking sector and growing dependence on short-term refinancing from the Bank of Russia.

This issue stems from outside the banking sector, after all, from bank customers' decisions on allocation of their own financial assets, which are directly related to a degree of their confidence in the national banking system. Allocation of financial resources in accounts and deposits in the national banking system (or liabilities of Russia's banks) is an option for assets in the non-bank corporate sector and households. Alternative options are investments in liabilities of other sectors: the state (purchase of government securities), the Central Bank of Russia (accumulation of the national currency in cash) and the external world (purchase of any foreign assets, including foreign currencies in cash). As an alternative to banks, the process of converting savings into investments may pass through different forms of non-bank financial mediators. In addition, cash outflow from the national banking system may result from growth in current payments to the state (taxes) and the external world (payments for imported goods, and foreign debt service).

According to our estimates, the following situation would remain in 2013. Growth in loans to the non-bank sector (corporations and households) of the economy would be combined with stagnation in the demand for M2 money stock and, consequently, wider gap between bank loans to the economy and the deposit base of banks. In its turn, the financial sector would have a depressive effect on economic growth amidst a relatively low for Russia inflation and stagnating demand for money.

According to our estimates, in 2013 assets in the banking sector would grow within a range of 15 to 17%, loans to corporate borrowers 12 to 15%, whereas retail lending may increase by 25–30%. Growth in the deposit base would most likely be limited by nominal growth rates in gross output, which would not exceed 10–12% during the year amidst relatively stable oil prices and absence of external inflation shocks. Thus, monetary authorities would further increase their role in creating bank liabilities banks. In addition, Russia's Government intentions to promote economic growth through different types of stimulation programs would be able to strengthen state-owned banks position as most likely mediators in the transfer of public resources to target economic sectors.