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The review provides a detailed analysis of main trends in Russia's economy in 2014. 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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### **3.9. The Russian banking sector in 2014**

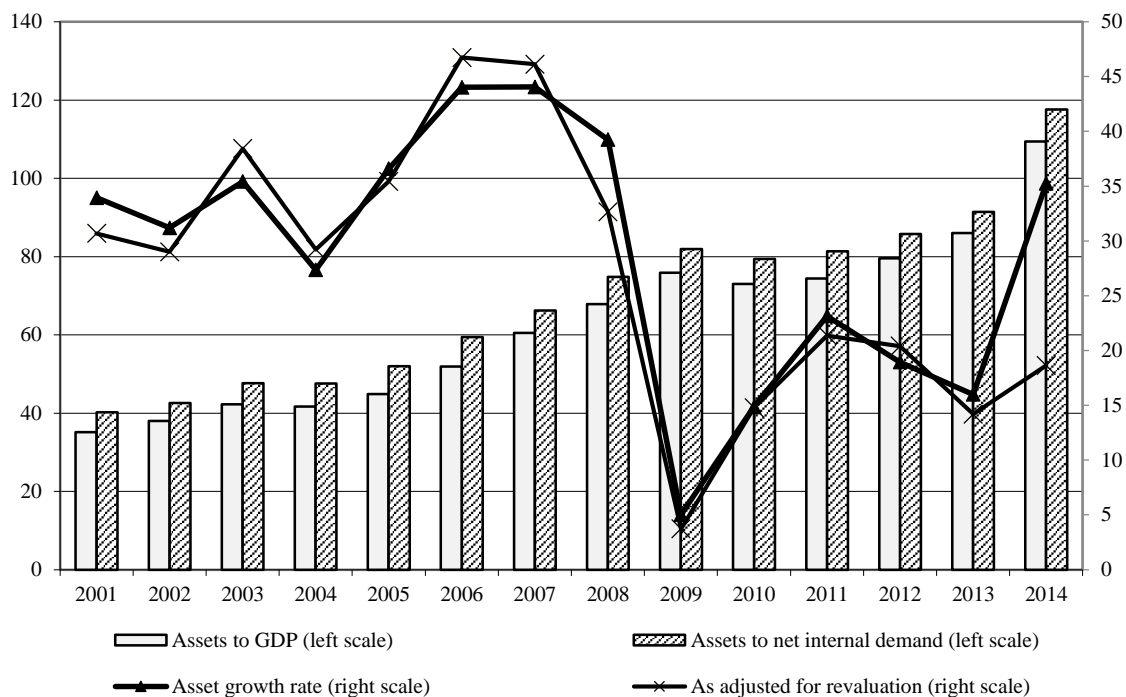
#### **3.9.1. Key trends**

The Russian banking sector approached the beginning of 2015 on the edge of a full-scale systemic crisis. The key negative trends had formed a long time previously and continued to worsen throughout the year. The worsening of the economic dynamics and the decline in income of a wide range of economic agents adversely affected both the resource base of the banking sector and the quality of bank assets. During the last months of 2014, the situation, in monetary terms, deteriorated significantly, and this manifested itself mainly in a sharp decline in the national currency exchange rate, an increase in the demand for foreign currency assets and associated problems with bank liquidity. It is obvious that the toughening of the Bank of Russia's interest-rate policy in December 2014, resulted in a cessation of lending and, possibly, considerably worsened the quality of assets, however, the final reports of the banks for 2014 have not yet fully reflected the increased risks on active transactions.

The nominal growth of the banking sector assets in 2014 had increased considerably compared with that in several previous years, primarily due to the revaluation of foreign currency assets. The nominal value of the banks' total assets for the year increased by almost 30%. Excluding the effect of the revaluation of foreign currencies against the ruble, the rate of growth of bank assets in 2014 remained at the level of the previous year - about 15%.

The high nominal rate of asset growth resulted in a significant increase in the ratio of the overall size of bank assets to that of the Russian economy. For the first time in Russian history the size of the banking sector exceeded the annual GDP in nominal terms, having reached 109% of GDP. However, this was due more to the turn of events than to the banks' own activities. One factor we have already noted is the devaluation of the ruble. The rate of growth of the banking sector was additionally supported by state aid, in the form of refinancing by the Central Bank of the Russian Federation and deposits by the Russian Ministry of Finance. Without that support, the growth of bank assets in 2014 would not have exceeded 9-10%.

In 2014 the revocation of bank licences intensified with the licences of 85 credit institutions being revoked, including 61 banks entitled to attract deposits from individuals. This process, the so called "cleaning" of the banking sector, started from the appointment of E. Nabiullina as the Chairman of the Central Bank, in summer 2013. From July to December 2014, 29 licences were revoked, including those of 25 banks attracting funds from individuals. During 2014, licenses were revoked much more actively (considered as monthly averages) than in the second half of 2013 - over 7 licences per month versus less than 5. The termination of the activities of these organisations obviously did have a certain negative effect on the dynamics of bank assets, but this effect was actually fairly insignificant. The total assets of the banks whose licences were revoked in 2014 were, as of the last reporting date before the termination of their rights to continue activity, Rb 432bn, i.e. less than 1% of the total assets of the banking sector as of the beginning of 2014. Mostly, it was small banks that were closed, with the average value of the assets of the credit institutions whose licences were revoked in 2014 being Rb 5bn, and the maximum value - Rb 40bn.

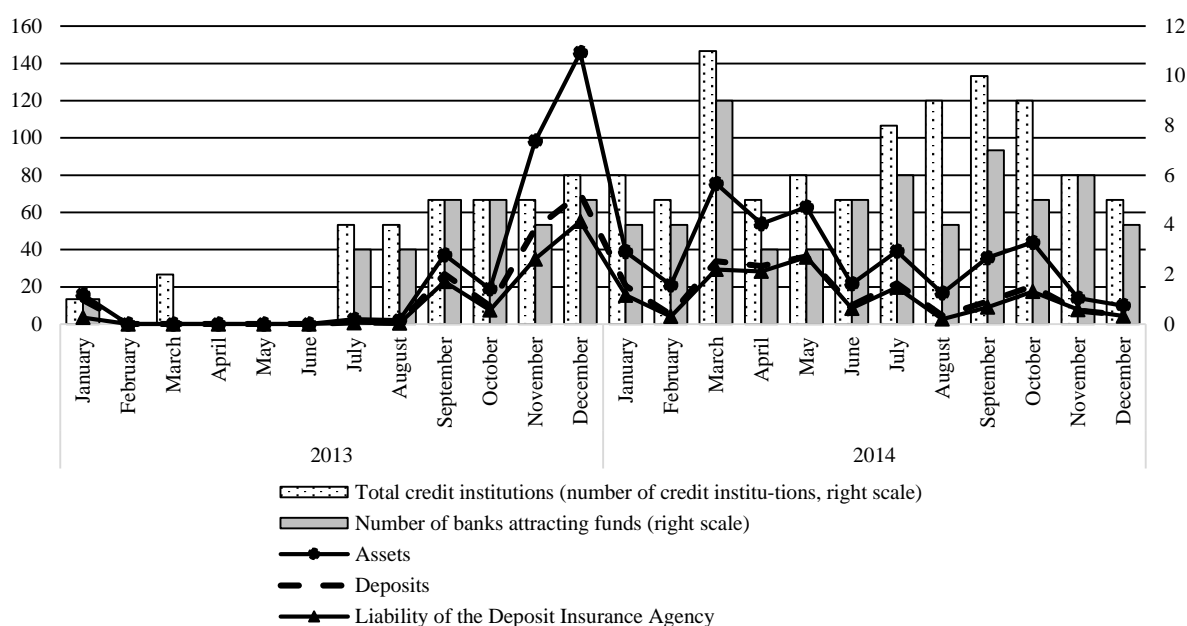


**Note.** Net internal demand is calculated as GDP without net exports and constitutes an estimate of internal consumption and accumulation in the economy.

*Source:* the Bank of Russia, Rosstat, IEP estimates.

*Fig. 50.* Growth rates of bank assets and the ratio of bank assets to GDP and net internal demand, %

The larger banks were subjected to a regimen of financial rehabilitation. The most notable decisions for the sanitation of banks in 2014 were made in respect of Trust, and Mosoblbank, amongst others. But even despite the fact that, in 2014, the largest of the problematic banks avoided licence revocation, the intensive dynamics of removing the smaller ones from the market resulted in the exhaustion of the Mandatory Deposit Insurance Fund. The size of the Fund as of 1 January 2015 was Rb 84bn (Rb 65bn if the reserve for payments on insured events is excluded). In early 2014 the Fund had stood at Rb 140bn while in early 2013 – Rb 203bn. In total, during last year, the banks which were closed paid over Rb 200bn to depositors, while in 2013 the corresponding figure was Rb 104bn, and for all previous years of the Agency’s activities - the total of only Rb 73bn. The money remaining in the Mandatory Deposit Insurance Fund is now unable to cover the Agency’s liabilities to the depositors of any one of the 20 largest banks.



Source: the Bank of Russia, IEP estimates.

Fig. 51. Key characteristics of the revocations of bank licences in 2013-2014

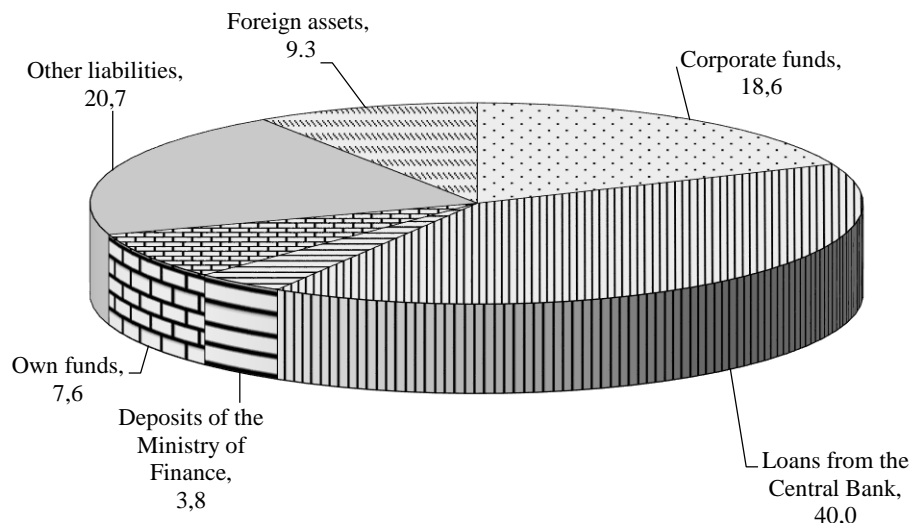
The key risks for the banking sector, the realisation of which have gradually increased throughout 2014, can be divided into the following three groups:

1. the risk of reducing the resource base and the associated liquidity of the banking sector;
2. the risk of deterioration in the quality of assets;
3. the risks associated with a shortage of own funds.

In 2014, a dominant role in the dynamics of the resource base of the banks was played by the funds of the Central Bank and the Ministry of Finance - the regulators of the money market, and these funds accounted for 40% of the increase in the resources of the banking sector. Two out of the three traditional sources of growth in bank resources stopped performing this function in 2014. Deposits by individuals and debts to foreign creditors were decreasing, requiring the diversion of additional resources rather than allowing any replenishment of their resource base by the banks.

An additional resource for banks in 2014 was the reduction in investments in foreign assets. It would be reasonable to argue that the entire repayment of the banks' foreign debts was financed through the reduction in this category of bank assets.

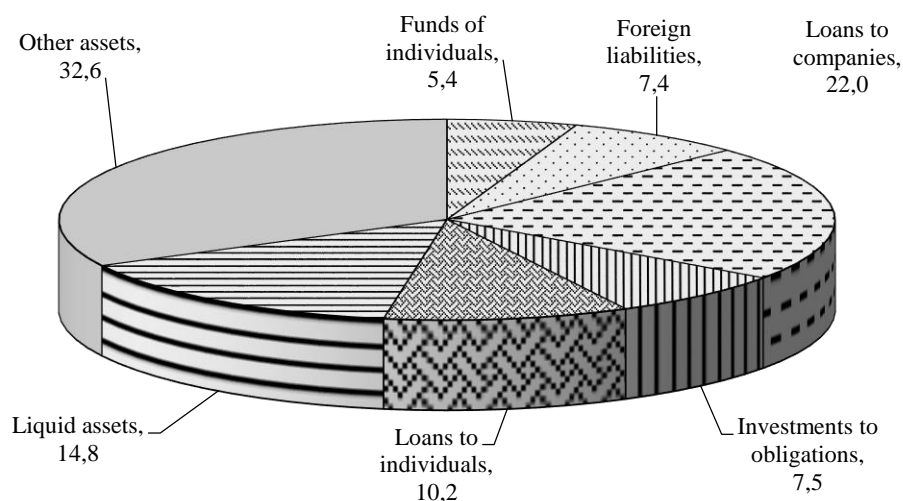
The changes in the distribution of assets within the banking sector evidence the slowdown of the growth in the loan portfolio. Only 30% of financial resources redistributed by the banks were allocated to increase the overall debt of individual and corporate borrowers, versus 60% in 2011–2013, including 10% for loans to individuals (in 2013 - 31%) and 22% for corporate loans (in 2013 - 29%). About 13% of the resources were allocated to repay debts to foreign creditors and to return the deposits of individuals. At the same time, as has already been noted above, the repayment of such foreign debt was effectively financed by the foreign assets themselves.



Source: the Bank of Russia, IEP estimates.

Fig. 52. The structure of the resources of the banking sector (increase in liabilities and decrease in assets) in 2014, as % of the total

The significant proportion of ‘other assets’ can be explained by a growth in the debt liabilities used in repo transactions and an increased involvement of the banks in transactions with derivative instruments. None of these items of the balance sheet can be attributed to a particular counteragent sector because the banks’ reporting does not require their more detailed classification. Furthermore, the liquid assets of the banks were increased considerably through the creation of liquidity reserves under the conditions of high uncertainty in the financial markets in late 2014.



Source: the Bank of Russia, IEP estimates.

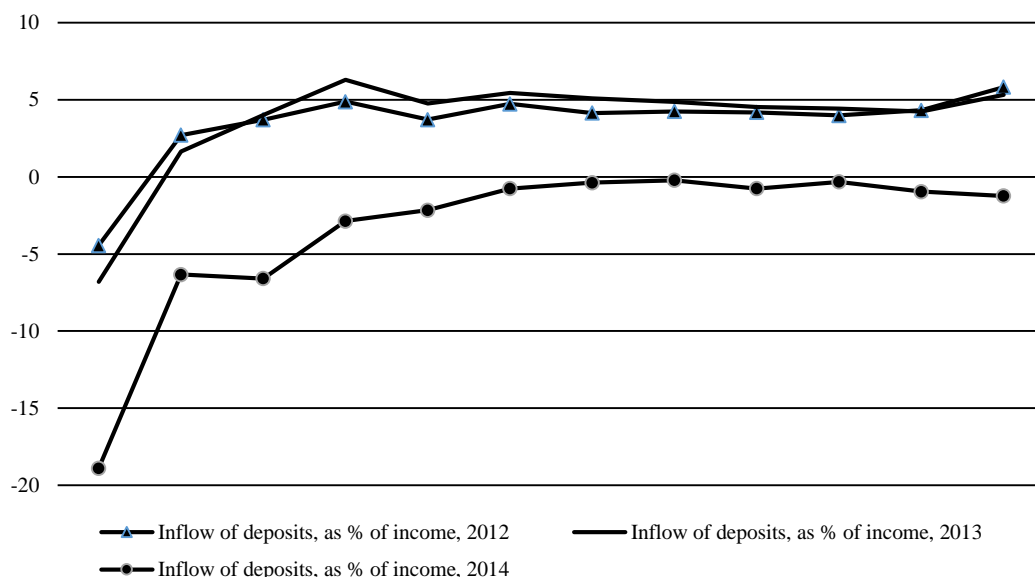
Fig. 53. The structure of allocation of resources within the banking sector (increase in assets and decrease in liabilities) in 2014, as % of the total

Next, let us consider in detail each of the above groups of risks to banking activity that were relevant as of the end of 2014.

### 3.9.2. The slowdown of the resource base growth

#### *The slowdown of private deposits*

The slowdown of private deposits was evident as early as the end of 2013, as the banks' clients responded to the increased rate of revocation of the licences of credit institutions. From early 2014, devaluation also came into play, worsening the negative attitude of individual depositors towards saving in bank accounts and deposits. The inflow of new private deposits to the banks dried up in 2014. Throughout the whole year, the accumulated inflow of deposits failed to climb above zero. Whilst, in previous years individuals had saved about 5% of their income in bank accounts, in 2014, by contrast, the volume of deposits decreased by more than 1% of the population's income in monetary terms (*Fig. 54*).

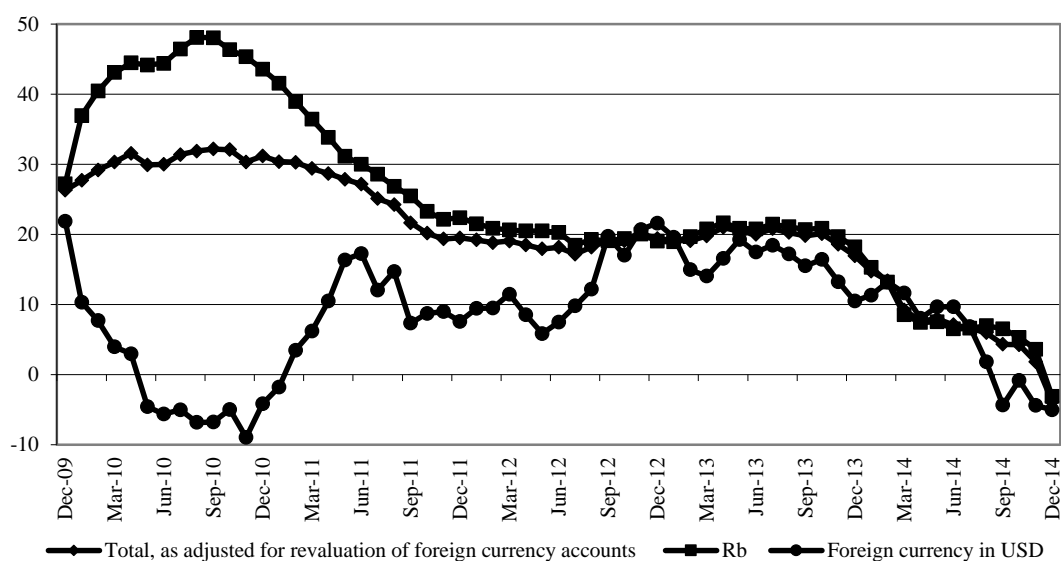


Source: the Bank of Russia, Rosstat, IEP estimates.

*Fig. 54.* Inflow of deposits of individuals to the banks for the period from the beginning of each year, as % of the population's monetary income, 2012–2014

Judged by the year-end results, the annual growth of deposits was negative: when adjusted for the revaluation of currency deposits, the volume of deposits decreased in 2014 by 4.0% (by Rb 684bn). Taking into account interest payments, which were about 5% per annum (Rb 863bn), individuals withdrew over Rb 1.5 trillion from the banking sector during last year.

Traditionally, the growth in individuals' demand for foreign currency has been an alternative to bank deposit savings. According to preliminary estimates of the Bank of Russia, in 2014 the foreign currency cash reserve in the territory of the Russian Federation increased by \$34bn. In ruble equivalent, this corresponds to Rb 1.4 trillion, which is very close to our estimate of the withdrawal of deposits and interest.



Source: the Bank of Russia, IEP estimates.

Fig. 55. Growth rates of individual deposits in 2010-2014 (as % to the corresponding month of the previous year)

### Foreign debt

Even before the introduction of limitations on foreign loans for Russian state-owned banks, the dynamics of the total debt of the banks to non-residents had become negative. In the payment balance methodology the reduction of the foreign liabilities of the banks had started from Q2 2014, amounting to \$7.5bn, \$12.1bn and \$18.4bn, respectively, in Q2, Q3 and Q4. According to the balance sheet reports of the credit institutions, the volume of foreign liabilities had also been decreasing from April 2014. From its maximum as of 1 April 2014 (\$176bn) until 1 January 2015 the banks' foreign debt has decreased by \$36bn, or 20%. Out of this \$36bn, \$27bn, or 75%, was attributed to Sberbank and other large state-owned banks. This is considerably higher than the share of the state-owned banks in the total debt of the banking sector to non-residents - about 60%. Such a faster reduction in the foreign debt of the banks is, obviously, a consequence of the foreign sanctions aimed directly against the largest Russian banks.

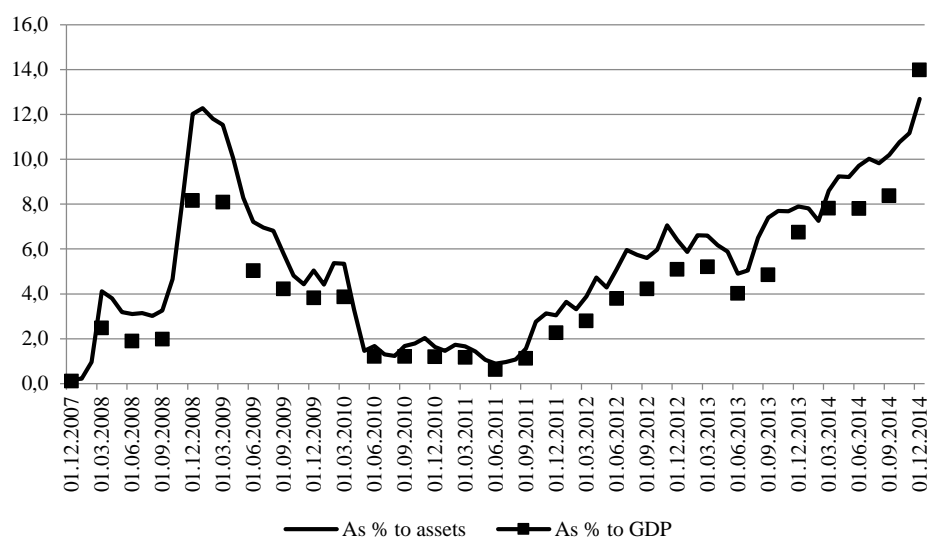
The problem of external funding was softened by the fact that the banking sector used foreign assets to repay foreign debts, which, over the same period (from 1 April 2014 to 1 January 2015), decreased by \$50bn, out of which \$34bn represents the reduction in the assets of state-owned banks. This means that the total investment in foreign assets decreased even more than did the volume of external debt. The latter can be explained, perhaps, by certain intent on the part of the banks to secure themselves against any possible strengthening of the pressure of sanctions that might forcibly restrict foreign transactions by Russian banks.

### Debt to regulators

The negative dynamics of the key segments of the borrowed funds of banks naturally resulted in the dependence of the banking sector on refinancing by the Bank of Russia and the Ministry of Finance. Such funding compensated the banking sector for the lack of other raised funds, supporting credit growth and avoiding increased problems with bank liquidity. In 2014,



the banks' debts to the monetary authorities more than doubled, growing by Rb 5.3 trillion, to reach Rb 9.9 trillion. This represents 12% of the total assets of the banks, having almost reached the maximum observed during the 2009 crisis (12.3%). In relation to the size of the economy, the dependence of the banks on state support has already exceeded 12% of GDP, whilst in 2009 it reached only 8%. This is related to the aforementioned growth of the banking sector relative to the size of the Russian economy.



Source: the Bank of Russia, the Ministry of Finance of Russia, Rosstat and authors' estimates.

Fig. 56. State support of the banking sector relative to bank assets and the size of the Russian economy

In late 2014 the problem of the worsened currency deficit in the internal market, which had resulted in an increased volatility of the ruble exchange rate, made the money market regulators step up their provision of currency to the banks on a return basis. On the one hand, this satisfied the demand for currency on the part of the banks and their clients whilst, on the other hand, not putting any pressure on the exchange rate.

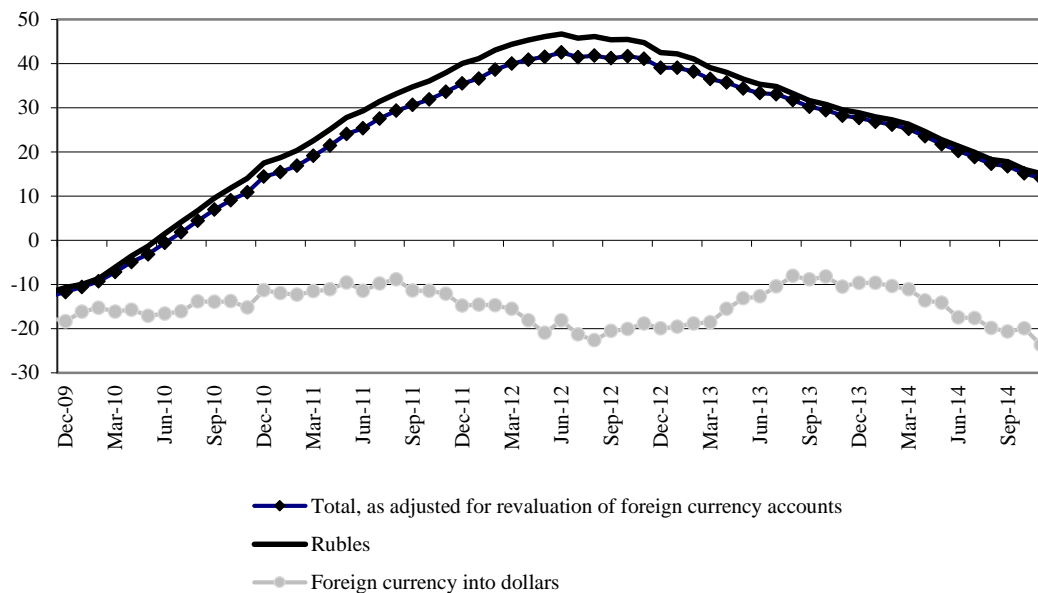
The first auctions for repo transactions in foreign currency were held in November 2014, but the main volume of currency funds was provided to banks in December (\$21.6bn versus \$0.6bn in November). As of 1 January 2015 the banks' total debt to the Bank of Russia on currency repo transactions was \$20.2bn (a portion of the funds provided for periods of 1 and 4 weeks have already been repaid). Moreover, the Ministry of Finance has also started to place foreign currency deposits into the banks. As of 1 January 2015 the foreign exchange debt of the banks to the Ministry of Finance was \$3bn.

Of the total volume of bank debt to the regulators as of the beginning of 2015, over 13% was in foreign currency (\$23bn, or Rb 1.3 trillion).

### 3.9.3. Deterioration of the quality of assets

2014 was marked by a slowdown in the growth of the aggregated loan portfolio of the banks - an obvious consequence of the problems with the resource base. The annual growth rate of the total loan debt of individuals and legal entities decreased from 16.6% in 2013 to 12.3% based on the results of November 2014.

The most dramatic slowdown of growth in 2014 was observed in the retail segment of the loan portfolio. Here, the annual growth rate dropped from 27.7% in 2013 to 11.6% in 2014. Although foreign currency loans to individuals in USD had decreased by almost 25% for the year, it is this segment that is the most problematic for the banks because of the almost halved ruble to USD exchange rate.

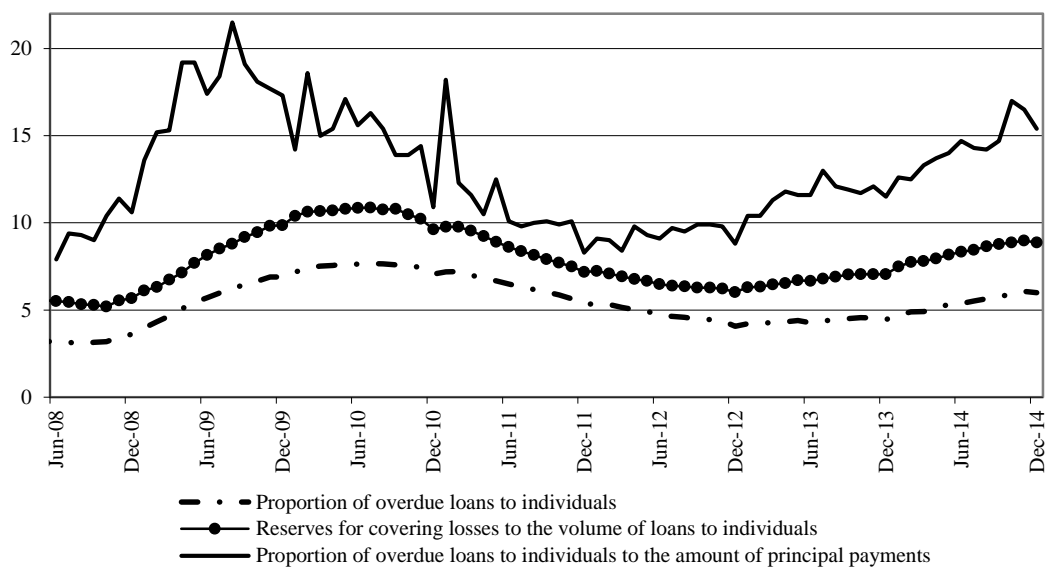


Source: the Bank of Russia, IEP estimates.

Fig. 57. The dynamics of the overall debt of individuals on bank loans in 2010–2014 (as % of that for the corresponding month of the previous year)

The slowdown of growth of the loan portfolio was accompanied by deterioration in its quality. In 2014, reserves for possible loan loss increased by Rb 977bn (42%), with almost 40% of this increase coming from an increase in the provisions for overdue loans (Rb 389bn). Overdue debt increased by Rb 547bn (39%). As a result, the proportion of overdue debt on all loans in the total debt increased from 4.0% to 4.5% during 2014, meaning that the ratio of reserves for possible loan loss to the volume of the loan portfolio changed from 6.8 to 7.7%.

The deteriorating loan portfolio quality affected its retail segment in a most vivid manner. By 1 January 2015, the proportion of overdue loans provided to individuals (relative to the total debt on individual loans) had grown to 6.0%, while the reserves for losses on loans to individuals moved to 8.9% of the total debt of individuals to the banks. Moreover, by late 2014 the volume of payments that had not been made in due time (as required by the loan agreements) had increased sharply - to 15-17% on average for all loans to individuals, including to 17-19% for consumer loans (Fig. 58).



Source: the Bank of Russia, IEP estimates.

Fig. 58. Quality indicators of the retail loan portfolio, 2008-2014, %

In late 2014 retail loan quality indicators corresponded fairly closely to those of summer 2009. However, the distinctive feature of the current situation is that, until the end of 2014, the growth of the loan debts of individuals had remained positive, whilst in summer 2009 it had dropped below zero. This means that, at the moment, the growth potential of “bad debt” is even higher in relative terms, let alone in absolute terms.

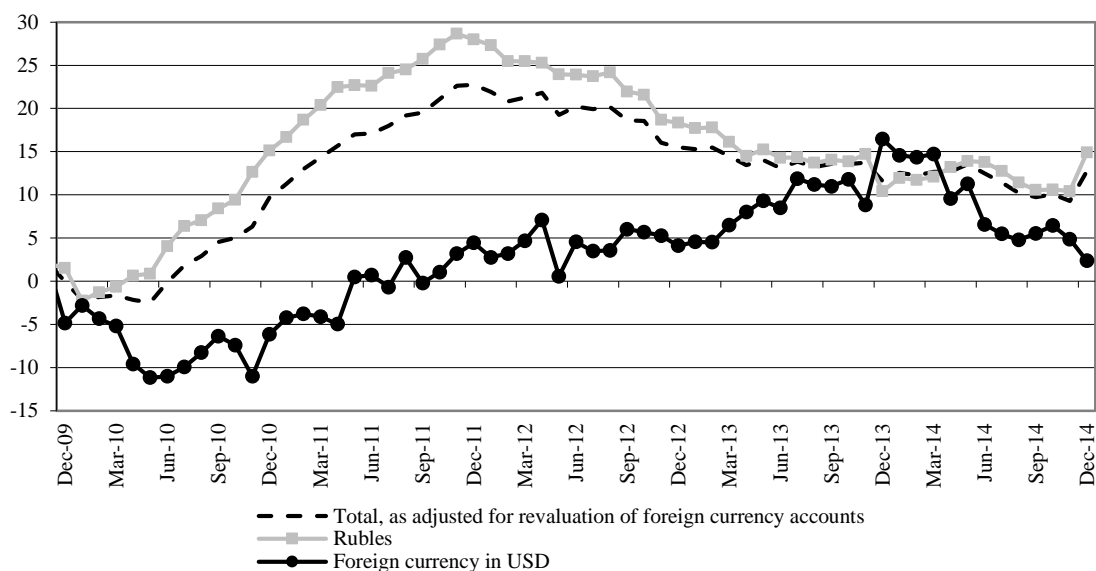
Lending to corporate borrowers in 2014 grew fairly slowly. One should not be misled by the nominal dynamics of the debt of corporate customers to banks that, based on the results of 2014, had increased to 26%, because this increase was largely due to effect of the revaluation of foreign currency loans as a result of ruble devaluation. When adjusted for the revaluation of foreign currency loans the corporate loan portfolio increased by 12.7% in 2014, which is, however, still slightly higher than in 2013 (11.6%).

This small acceleration of the growth in corporate loan debt to banks in 2014 was due to the increasing growth rates of ruble debt from 10.4% in 2013 to 14.9% in 2014. In contrast, the growth rates of foreign currency debt in USD terms have slowed down sharply, from 16.4% in 2013 to 2.4% in 2014. Obviously, this was due to the considerable ruble devaluation in 2014, as a result of which the servicing of foreign currency loans has become too expensive for borrowers, and the growth in demand for such loans has slowed dramatically.

We should note, separately, that during almost the entire year, the growth of both the ruble and foreign currency loan debts of companies were slowing down. Overall, the growth of ruble loans increased as a consequence of the December results, but this is partly related to the base effect - in December 2013 a shrinking of the volume of bank lending in the real sector had been observed.

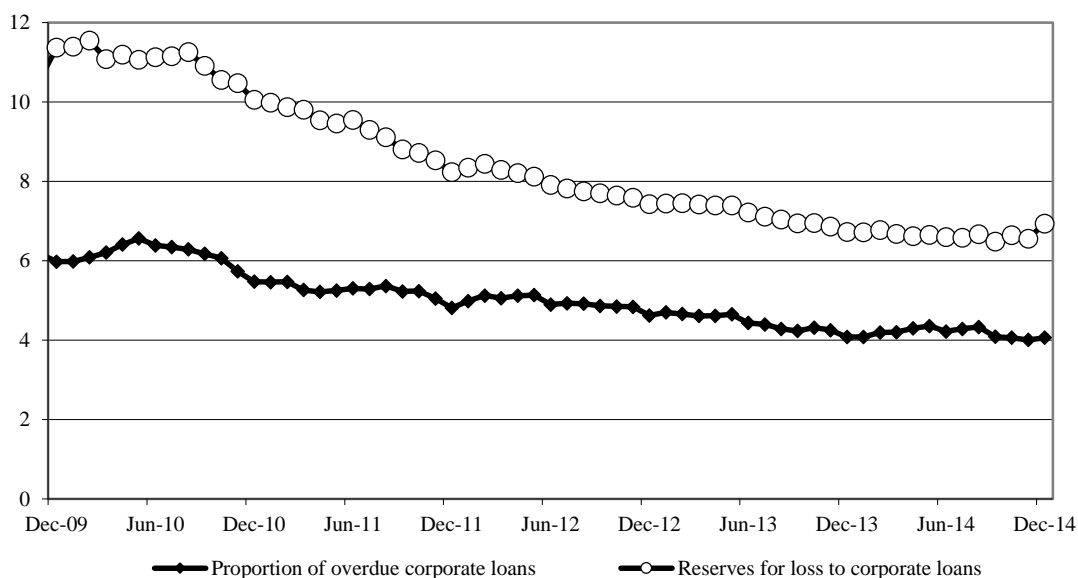
Curiously enough, the slowdown in the growth of the loan portfolio has not yet affected its quality. Normally, a decrease in the growth of loan debt is caused by accumulated problems, resulting in a faster growth of overdue loans and loan-provisioning. Nevertheless, up until November 2014 the proportion of overdue debts of corporate clients (out of the total debt of corporate borrowers) did not increase, and the value of this indicator as of 1 December 2014 (4.0%) was actually the lowest since the crisis of 2008-2009. The ratio of possible loan loss

provision to the volume of loan debt of corporate borrowers in 2014 also reached its post-crisis minimum (6.5%), but a little earlier - on 1 October 2014.



Source: the Bank of Russia, IEP estimates.

Fig. 59. The dynamics of debt of corporate clients on bank loans in 2010-2014 as % of the amount on the corresponding month of the previous year)



Source: the Bank of Russia, IEP estimates.

Fig. 60. Quality indicators of the corporate loan portfolio of banks, %, 2010-2014

However, in the last months of the year, and mainly in December, the quality of the corporate loan portfolio also started to demonstrate a tendency to deteriorate. Whilst, for the first three quarters of 2014, the volume of reserves had increased by Rb 119bn, in Q4 the increase was already Rb 306bn. The growth in overdue debt at the end of the year also accelerated. Its

increase in Q4 (Rb 112bn) being comparable to the increase for the first three quarters combined (Rb 109bn).

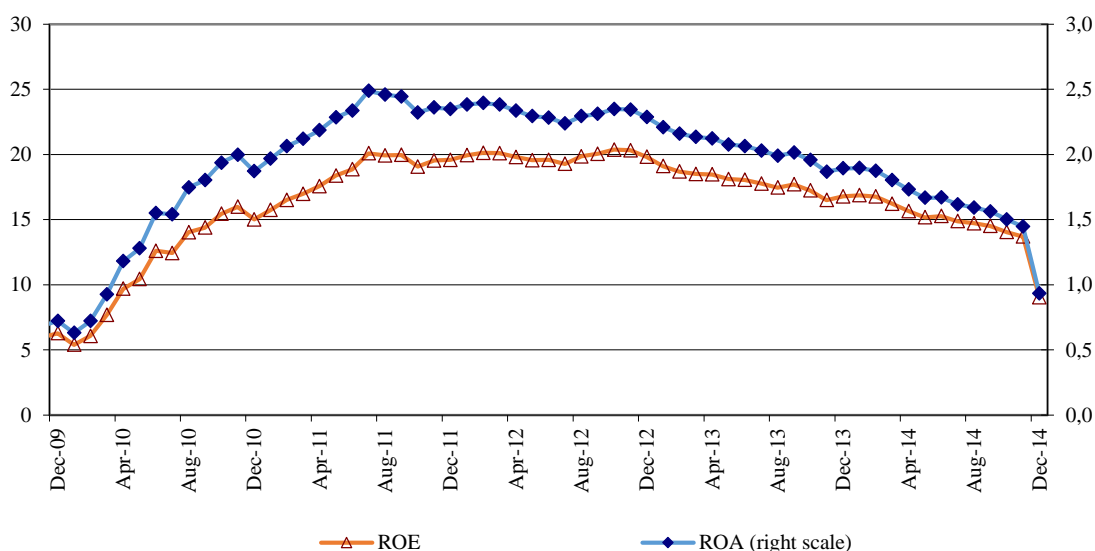
### 3.9.4. Decrease in profitability of the banks

The profitability of the banking sector has been gradually decreasing for several years now. In the last months of 2014 this process accelerated under the influence of the deterioration of the quality of the loan portfolio, requiring increased allocations for reserves and a rise in the key interest rate of the Bank of Russia. This has led to an increase in the cost of servicing the funds received from the monetary authorities and a corresponding growth in the cost of other borrowed funds. However, up until December 2014 loan interest rates had not fully responded to the increase in the key interest rate.

From January to November 2014 the key interest rate had grown by 4 p.p., while the average interest rate on ruble loans to non-financial organizations grew by less than 3 p.p. In December 2014 the key interest rate was raised to 17% per annum, however, on average, its value was 13.5%, which was 4 p.p. higher than in November. The average weighted rates on ruble corporate loans in December 2014 increased by more than by 6 p.p. however, the growth in the net interest income of the banking sector in 2014 had slowed sharply. Whilst, in Q1 of 2014 it was 25% higher than in the corresponding period of 2013, in Q4 it was only 2% higher.

Furthermore, in late 2014, as has been noted above, the banks increased their provisioning for possible losses, and in December 2014, for the first time in a long while, the banking sector suffered losses.

Based on the results of 2014, the return on assets of the banking sector dropped to 0.9%, and the return on equity to 9%, which was close to the financial results of the banking sector in 2009 (0.7% and 6%, respectively).



Source: the Bank of Russia.

Fig. 61. Return on assets (ROA) and return on equity (ROE) of the banking sector for the 12 months preceding the reporting date, %, 2009-2014