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TRENDS AND OUTLOOKS

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R95 **RUSSIAN ECONOMY IN 2017. TRENDS AND OUTLOOKS** / [Alexander Abramov etc.; Doctor of sciences (economics) Sergey Sinelnikov-Murylev (editor-in-chief), Doctor of sciences (economics) Alexander Radygin]; Gaidar Institute for Economic Policy. – Moscow: Gaidar Institute Publishers, 2018. – 544 p. – ISBN 978-5-93255-530-9.

The review "Russian economy in 2017. Trends and outlooks" has been published by the Gaidar Institute since 1991. This publication provides a detailed analysis of main trends in Russian economy, global trends in social and economic development. The paper contains 6 big sections that highlight different aspects of Russia's economic development, which allow to monitor all angles of ongoing events over a prolonged period: the socio-political issues and challenges; the monetary and budget spheres; financial markets and institutions; the real sector; social services; institutional changes. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts confirming the conclusions.

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3.10. Russia's banking sector[1]

3.10.1. Banking sector's main development trends

In 2017, banking sector demonstrated moderate development trends across main indicators. Asset holdings went up by 6 percent during the year somewhat below nominal growth rate of Russia's GDP. The ratio of banks' asset holdings and annual GDP remained at 91–92 percent for the second year in a row (*Fig. 55*).

The number of lending institutions decreased by 56 from 623 to 567 during the year. The process whereby some of the credit institutions were forced out of the market on the grounds of failing to meet the regulator's requirements notably slowed down. Around fifty banking licenses were revoked in 2017 – half of what was seen in 2015 and 2016 when ninety banking licenses were revoked annually.

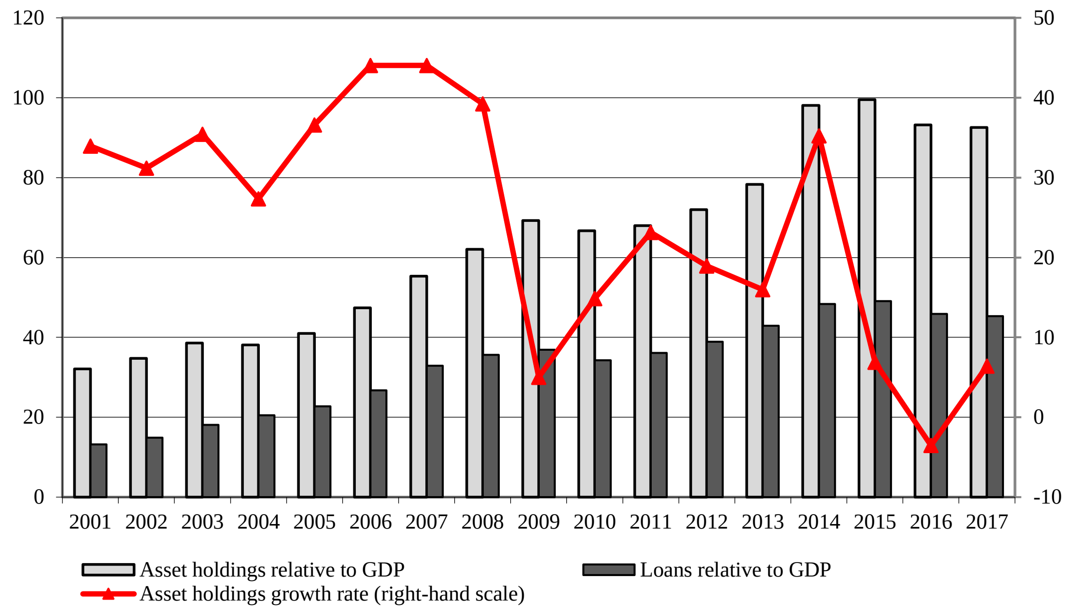

Fig. 55. Banks' asset holdings growth rate and banking sector size relative to Russian economy size, percent

Sources: Bank of Russia, Rosstat, own calculations.

3.10.2. Update of regulation procedure for bank resolution mechanism

The resolution of Bank Otkrytie FC will be the first case of applying a recently introduced new mechanism for the resolution of commercial banks. The mechanism enables the Bank of Russia to control more efficiently bank resolution costs and can tilt the balance between banking license revocation and solvency recovery in favour of the latter.

[1] This section is written by Mikhail Khromov, the Gaidar Institute, IAES-RANEPA.

For the entire H2 2017, bank resolution mechanisms were applied to five banks, three of which were major Russian private banks, namely Bank Otkrytie FC, Promsviazbank, and Binbank.

Amendments to the federal law were adopted in spring 2017, which regulate procedures for bank resolution mechanisms.

New regulations securing an alternative mechanism for the resolution (solvency recovery) of banks are in force since June 2017. For this purpose the Bank of Russia has established an entity, the Fund for Banking Sector Consolidation (FBSC), and set up a FBSC management company fully controlled by the Bank of Russia. The updated mechanism has been proclaimed to be designed primarily for curtailing bank resolution costs and for increasing control over spending of appropriated resources.

Until recently bank resolutions have been performed basically at the cost of the Bank of Russia, involving Deposit Insurance Agency (DIA) and investing banks that are interested in bailing out a given bank so that it can develop its business. Quite often, however, investing banks used the money allotted for bank resolution for the purpose of their own business development. The new bank resolution mechanism prevents using the money prior to selling the rescued bank. Thus two elements – the DIA and the investing bank – have been removed from the chain of financial aid for rescued banks and replaced with the management company controlled by the Bank of Russia

What are the DIA's provisional results concerning procedures for the recovery of Russian banks' solvency? As at 1 August 2017, the Deposit Insurance Agency was involved in recovering solvency of 26 banks using the old procedure. Bank resolution procedures had been completed by the same date for another 20 banks. As a result of such procedures, rescued banks generally affiliated with investing banks. As at 1 July 2017, the Deposit Insurance Agency allotted more than RUB 1.2 trillion in banks' solvency recovery procedures, most of which (RUB 1.14 trillion) were provided in the form of repayable loans from the Bank of Russia. Furthermore, actual maturity dates for such loans may be found to be long-term enough. DIA's repayments to the Bank of Russia within the bank resolution procedures in place have so far been less frequent than new loans. The DIA's debt in H1 2017 increased more than RUB 70 billion. Moreover, this happened under the circumstances when solvency recovery procedures had not yet started for new banks. There were only two such banks in 2016-H1 2017, one (Peresvet Bank) of which was already subject to a preliminary moratorium on the repayment of creditors' claims, that is, the insured event occurred from the perspective of the deposit insurance framework.

What should be kept in mind is that the financing of bank resolution procedures is just one of the channels available for crediting the DIA by the Bank of Russia. The DIA's core function – to provide insurance for retail bank deposits and to ensure that the depositors of shutdown banks are repaid on a continuous basis – is loss making. The *Mandatory Deposit Insurance Fund* ran out of its own money as early as summer 2015. Today, the deficit of the deposit insurance framework is covered by Bank of Russia's loans, with a credit limit being updated on a regular basis. At half-year (2017) end, the existing agreement between DIA and the Bank of Russia envisages to allocate RUB 820 billion, of which only RUB 657 billion were received. Over six months of 2017, the Ban k of Russian actually allocated around RUB 108 billion for assistance to the deposit insurance system.

The ratio of these two items of Bank of Russia's spending on the DIA – on bank resolution and on payments to depositors – can be a criterion for making a decision on banking license revocation or for making attempts to revive a bank. As long as the *Mandatory Deposit*

Insurance Fund is able to cover payments to depositors, the decision-making on resolution of a given bank, particularly a big enough bank, could be a way to continue running a deficit-free deposit insurance framework. These considerations have not been applied since summer 2015 until now because both processes – deposit insurance and bank resolution – have been financed in a similar manner, that is, through the Bank of Russia's loan to the Deposit Insurance Agency. Within the new bank resolution mechanism framework the Bank of Russia is supposed to increase its control over spending on solvency recovery of troubled banks, and therefore it may be assumed that bank resolution would be a more preferable regulatory tool than banking license revocation when it comes to controversial cases

The Bank of Russia decided 29 August to implement policies aimed at increasing the financial sustainability of *Bank Otkrytie FC*. Otkrytie thus became the first bank in which the new bank resolution mechanism was applied just two weeks after the Bank of Russia's new regulations came into effect. Although no exact amount of the required aid has to date been announced, such an amount may be much bigger than what the Bank of Russia allocated in H1 2017 for bank resolution procedures. The Bank of Moscow project is still the largest ever solvency recovery project worth almost RUB 300 billion in 2011. The Otkrytie rescue project has very good chances to hit a new all-time high.

It is safe to say, on the one hand, that as a result of this operation the Russian banking market would de facto miss a private player until the Otkrytie package is sold at a public auction. Until then the rescued bank will be managed by the regulator, with its development strategy being determined by regulator's actions. Indeed, this will have a strong effect on the market because Otkrytie has been a country's largest private bank over the past two years. However, an attempt to save a top private bank seems rather a step towards promoting competition in the banking market in the long term. Had the Otkrytie's banking license been revoked, top state-owned banks would have had a big share of retail deposits.

What in this case should be regarded as definitely negative signal is that this has secured the 'too big to fail' concept in the Russian banking market. Let us recall the liquidity crisis of 2004 at Alfa Bank, representing the then largest private bank in Russia, facing a drastic deposit outflow. No deposit insurance framework was in place at that time. To prevent panic among customers and to compensate the owners for liquidity loss, the bank owners had to use their own money to prop up the bank in short order. The owners of Otkrytie seemed to have neither money nor incentives to save the bank in 2017. The bank's customers however received a signal from the regulator suggesting that their money will be intact regardless of the quality of management and whether or not the owners want to keep the bank alive. This indeed was a positive fact for the Otkrytie's customers, whereas the same fact is quite negative in terms of management of risks that may affect the financial system in the long term.

3.10.3. Banking sector financial result

The deceleration in the banking profit was caused by large losses in banks that were placed under financial recovery. The biggest banks continue accumulating the major share of profits among operating banks. Moreover, the yield from regular banking operations remains rather volatile.

The Russian banking sector ran a book profit of RUB 790 billion as of the 217 year-end, which was 15 percent less than a year earlier. The annualized return on assets (ROA) down from 1.1 percent to 1.0 percent and return on equity (ROE) down from 13.2 percent to 10.4 percent.

As we noted a year earlier, the banking sector profitability remains lower than what it was during the pre-crisis period of 2011–2012 and especially with the period of 2005–2007 when Russia's banking sector boasted of the highest investment attractiveness.

The deceleration in the banking sector growth rates in 2017 was caused by losses in large banks that were placed under financial recovery in Q3 2017. As of the end of three quarters of 2017, there were top four loss-making banks, namely *Bank Otkritie FC* (-RUB 279.3 billion), Rost Bank (-RUB 82.8 billion), Trust Bank[1] (-RUB 72.9 billion) and Binbank (-RUB 31.9 billion), making a total of -RUB 466 billion. These banks were loss making at year-end as a whole. However, starting with bank resolution Bank of Russia stopped opening their books. Moreover, in December resolution was opened regarding another large private bank – Promslyazbank. Its financial result as of 2017 year-end also turned out to be negative

The losses emerged following the appointment of provisional administration to the banks – a compulsory procedure as part of the financial recovery (resolution) process – moving a great deal of assets to higher risk categories, which required immediate increase in provisions for losses on such assets. Therefore, the banks had to spend more on increasing their provisions, thus deteriorating their financial performance figures. The financial performance figures were satisfactory enough until financial recovery came into force

For instance, *Bank Otkritie FC*, which was placed under resolution on 29 August 2017, reported a profit of RUB 7.1 billion as of the end of July 2017, whereas RUB 31.8 billion in losses were recorded shortly after in August. The primary negative financial performance results of RUB 254.5 billion were posted in September.

Binbank and Rost Bank, which were placed under financial recovery on 20 September 2017, were officially considered as profit-makers (RUB 2.1 billion and RUB 1.3 billion, respectively) as early as late August 2017, whereas substantial losses were recorded in September.

Trust Bank has disclosed its financial reports on an irregular basis since its resolution in December 2014. Its financial performance figures were most likely negative throughout the entire period of financial recovery. For example, the bank posted RUB 9.6 billion in losses as of the end of the first three quarters of 2016.

The banking sector profitability was heavily affected by the performance figures of problem banks, showing considerable growth in costs on loan loss provisions that increased RUB 605 billion during the first three quarters of 2017, including an increase of RUB 370 billion in September alone. The banking sector posted an increase of RUB 361 billion in loan loss provisions as of the end of the first three quarters of 2016.

The banking sector profit related to the revaluation of foreign exchange accounts turned out to be zero over the first three quarters of 2017, whereas bank losses totalled RUB 42 billion as a result of exchange rate dynamics over the same period previous year (*Fig. 56*).

[1] Financial recovery procedure for Trust Bank commenced as early as 2014, with active involvement of *Bank Otkritie FC*. This affiliation enables us to include Trust Bank in the group of banks that were placed under resolution in Q3 2017

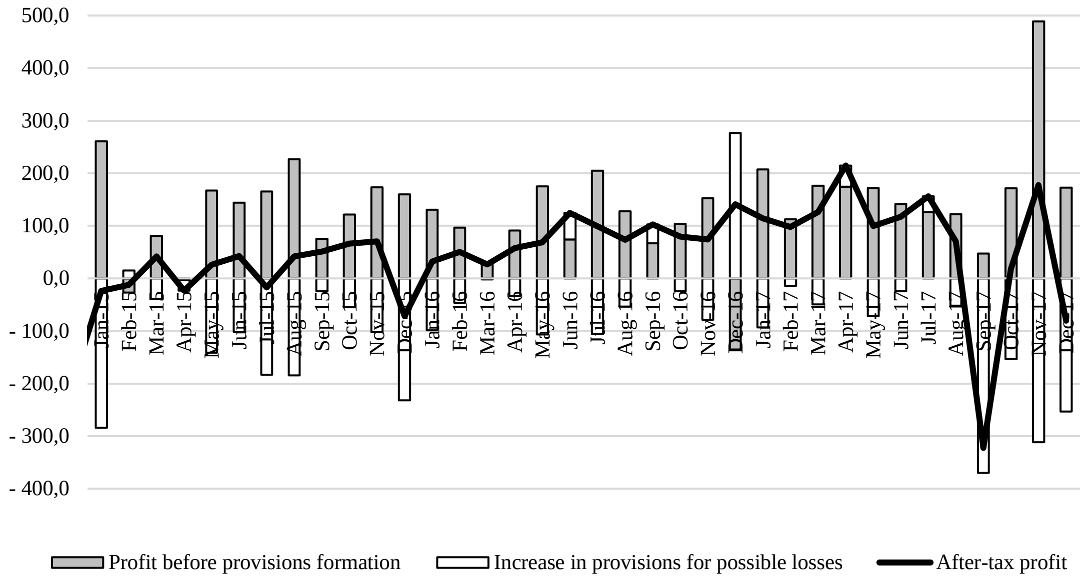

Fig. 56. Principal components of bank profit, billions of roubles

Source: Bank of Russia, own calculations.

Thus profit from regular banking operations in January-September 2017 amounted to RUB 1,279 billion, up by 28 percent from RUB 996 billion a year earlier. The result could have been regarded as a positive signal if it were not for the fact that profit from regular banking operations remains volatile enough. The profit from regular banking operations in January-September 2015 was higher than what it was over the first three quarters of 2016. The profit varied during the first nine months of 2017, from RUB 207 billion in January 2017 to RUB 47 billion in September.

The sharp decline in the performance figures of banks under resolution gives evidence of long-brewing problems facing the banks. This leads to a conclusion that the financial statements of these banks released shortly before the commencement of financial recovery contradicted the reality. This brings some scepticism towards the performance figures of other banks. The Bank of Russia, as a banking market regulator, de facto has turned out to have limited control over financial status of most banks.

Therefore, there is close relationship between Russian banking sector's financial performance figures and its high concentration, when financial performance figures of some banks, including also smaller banks, can have a strong effect on the entire banking sector. Excluding the top four loss-making banks, the rest of the banks reached a profit of RUB 1,141 billion in January-September 2017, up 80 percent from the same period of 2016.

Another aspect of such a concentration is a persistently big number of state-run banks. For instance, the four biggest state-run banks (Sberbank, VTB, VTB24 and Gazprombank) ran a profit of RUB 675 billion during the first three quarters of 2017, which means that the entire banking sector profit was generated by state-run banks. A significant contribution of state-run banks to the banking sector profit reflects their leading position in the market. Therefore, by accumulating a great deal of financial resources for equity build-up, these banks have a bigger development potential than private banks. A kind of vicious circle is therefore developing. Low profitability of private banks discourage their owners to increase equity, thus securing their subordinate position to the public segment of the banking sector.

3.10.4. Interaction between banks and households

Recovery of consumer lending has facilitated growth in final consumption expenditures and brought about stability of households' savings amid the ongoing decline in real income. However, in the long-term prospect this situation will put at risk both the financial stability of households and the resource base of the banking sector.

In 2017, households' budgets were formed amid the ongoing stagnation of real incomes. During 2017, households' cash incomes rose in nominal terms by 2.5 percent, however, in real terms they turned out to be 1.1 percent lower than a year earlier. In the same period, households' real disposable cash income fell even further by 1.7%.

Despite weak cash income growth in nominal terms, final consumption expenditures increased both in nominal and real terms. The volume of consumption in nominal terms rose by 5.3 percent notably outstripping income growth rates. Final consumption expenditure growth rates came to 1.1 percent in 2017. The share of expenditures on final consumption in the total volume of households' cash incomes amounted to 72.3 percent, which is 2.0 percentage points higher against 2016.

In 2017, households' savings saw mixed dynamics as regards various components thereof. In 2017, households' bank deposits increased by RUB 1.9 trillion, down 18.2 percent compared to the previous year. In 2016 savings on individuals' bank accounts and deposits rose by RUB 2.3 trillion. In addition, the share of households' incomes used for replenishment of bank accounts fell from 4.3 percent in 2016 to 3.4 percent 2017.

The fall in the households' cash inflow into banks affected both ruble deposits and, to a greater extent, accounts and deposits denominated in foreign currency. In 2017, the cash inflow to retail ruble accounts and deposits with Russian banks amounted to RUB 2.3 trillion unchanged compared to 2016. Dynamics of deposits denominated in foreign currency (with adjustment to the exchange rate revaluation) were already close to zero in 2016. In 2016, growth of foreign currency deposits constituted in ruble equivalent 52 trillion. In 2017, the decrease of bank deposits denominated in foreign currency constituted RUB 388 billion, constituting mora than 7 percent of the total households' accounts and deposits denominated in foreign currency in Russian banks.

Against the background of deceleration of personal cash inflow into banks, cash turnover has picked up both in rubles and in foreign currency. Monetary aggregate M0 (physical paper and coin) increased over 2017 by RUB 731 billion up 54 percent against 2016.

The volume of foreign currency in cash notably increased in 2017. Over the year, the volume of foreign currency in cash went up by USD 11.8 billion. A year earlier, purchases of foreign currency were less by 60 percent–around USD 7.5 billion. However, in our view it would be premature to speak about substantial growth in foreign currency predominance. A larger portion of growth in foreign cash can be explained by the abovementioned reduction of foreign currency deposits with banks. In 2017, the aggregate deposits denominated in foreign currency (both cash and non-cash) turned out to be lower than a year before.

A greater appeal of cash as compared to bank deposits can be explained by a sustained decrease in interest on bank deposits. Therefore, as regards annual ruble deposits the average interest rate fell from 7.1 percent per annum in 2016 to 6.0 percent per annum in 2017. As regards annual ruble deposits, the reduction was even more dramatic (from 8.6% to 7.0% per annum).

The interest on foreign currency deposits fell notably. If in 2016 USD deposits could yield 1.2–2.1 percent per annum, in 2017 they earned only 0.7–1.4 percent. The interest on annual euro deposits constituted solely 0.3 percent compared to 0.7 percent in 2016.

Against the background of low interest on bank deposits households do not see any difference between keeping cash or have a bank deposit. By choosing the cash mode of savings in foreign currency, the depositor avoids risks related to the Russian banking sector, primarily, the risk of a bank license being revoked and the need to purchase foreign currency again and loose on the exchange rate transaction. It is noteworthy that deposits are compensated in rubles only.

As regards ruble deposits, the effect of the interest rate decrease happened to be less significant, but even in this segment households in general were less motivated to keep money on bank accounts.

Nevertheless, total amount of households' bank deposits and cash at 2017 year-end moved up by 9.2 percent from RUB 34.4 to 37.7 trillion.

Recovery of bank lending has become the main factor both behind growth in households' consumption expenditure and maintaining behavior of savings in 2017.

Personal debt on bank loans over 2017 up RUB 1.4 trillion, nearly 8-fold more than a year earlier (RUB 177 billion). Outstanding debt growth vis-à-vis households' cash income up from 0.3 percent seen in 2016 to 2.5 percent in 2017.

Consumer landing was the main contributor to the expansion of the loan portfolio. In this money market segment, the sustained decline of the debt gave way to its growth in March 2017. As a result, over 2017, households' consumer lending debt to banks rose by RUB 0.68 trillion following a drop of RUB 0.34 trillion in 2016.

Mortgages also demonstrate positive dynamics. Over the year, households' mortgage debt up RUB 0.68 trillion against RUB 0.52 trillion seen in 2016.

It appears that in the near future the existing situation with households' finances and relations between banks and households will stay highly unstable.

Firstly, as was stated above, consumption growth and even stability of households' savings are underpinned by growth in borrowed funds, rather than higher incomes. This source of households' well-being can be regarded only as a temporary one. In the long-term, any loan reduces the nominal value of households' disposable income by the value of interest payments. It means that amid a lack of sustainable cash income growth active refinancing of loan debts is inevitable. Probably, such a process is already underway driven by falling loan interest rates. However, reduction of interest rates has its own limits and both for borrowers and lenders it is crucially important that by the time when interest rates cease to go down the Russian economy could embark on the trajectory of sustainable growth ensuring a substantial increase in households' real incomes.

Secondly, in 2017 households ceased to be net creditor of the banking sector: growth in accounts payable turned out to be higher than that in deposits growth. The situation is likely to change for the better in December when bank deposits demonstrate notable growth by virtue of seasonal factors. However, generally, for banks such a trend means a loss of one of the most stable sources of their liabilities. Amid reduction of external borrowing volumes, corporate lending which is less profitable as compared to the retail one will continue to stagnate.

3.10.5. Bank lending as the main source of financing Russian economy

Corporate lending in Russia exhibited sings of buoyancy in 2017. New corporate bank loans have reached higher nominal volumes than prior to the crisis. Most importantly, the ratio of lending to economic activity volumes has also increased, albeit not higher than pre-crisis values.

The quality of credit portfolios owing to large banks resolution does not provide visible improvements.

During 2017, banks issued new corporate loans worth RUB 38.4 trillion, up 8.1 percent from the previous year. At the same time, 2017 so far has not become a record one in new corporate loans issued – 2014 results were a little bit higher in nominal terms – RUB 38.53 trillion.

The rise in the lending market in 2017 was generally triggered by the increase in both ruble and foreign currency loans. Over the year, banks issued ruble loans worth RUB 34.8 trillion, up 7.5 percent from the previous year. The increase in foreign currency loans was more impressive. During 2017, banks increased foreign currency corporate loans by 29.4 percent in ruble terms and 8.1 percent in dollar terms.

However, the share of foreign currency loans remains small. In 2017, banks issued loans to the tune of USD 62 billion or RUB 3.6 trillion in ruble equivalent that constituted less than 10 percent of total new loans.

The loan market recovery has been seen not only in nominal terms but, most importantly, also in the size of economic activity. Over 2017, the volume of corporate bank loans reached 25.1 percent of companies' turnover against 24.2 percent a year earlier. However, the today's ratio of lending to economic activity in the lending market is far behind the ratios seen in previous periods. At 2013 year-end, the ratio reached 30.4 percent (*Fig. 57*).

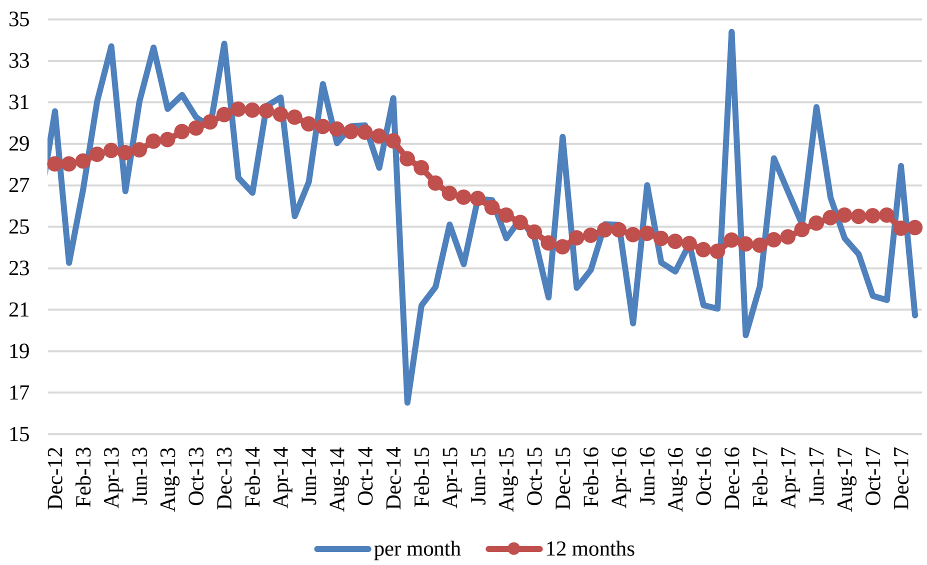

Fig. 57. Ratio of corporate bank loans to companies' turnover, %

Sources: Bank of Russia, Federal State Statistics Service, own calculations.

The upsurge in new loans has naturally led to a recovery in outstanding corporate bank loans. During 2017, total outstanding bank loans up 4.9 percent with adjustment to loans issued in foreign currency, meanwhile in 2016, outstanding debt shrank by 0.1 percent (*Fig. 58*).

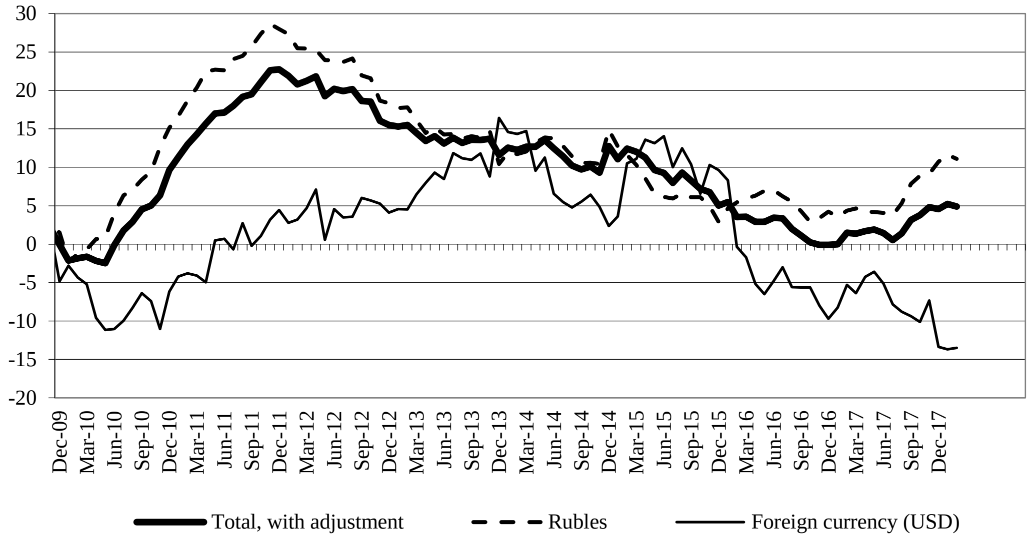

Fig. 58. Dynamics of corporate bank loans growth for 12 months

Sources: Bank of Russia, own calculations.

Current state of the corporate loan portfolio quality so far does not allow to speak about notable improvements. Over 2017, the share of outstanding loans in the total volume of outstanding corporate bank loans contracted merely by 0.2 percentage point from 6.1 percent as of January 1, 2017 to 5.9 percent as of January 1, 2018.

Moreover, foreign-currency components of overdue loans exhibited mixed dynamics. The share of overdue ruble loans in total outstanding ruble loans dropped by 0.5 percentage point during 2017, whereas the share of overdue foreign currency loans shrank by merely 0.1 percentage point. This is due to the overall decline in outstanding foreign currency loans, in front of which the proportion of "bad" foreign currency loans becomes bigger.

A negative factor is the recovered growth in the ratio of loan loss provisions to total credit outstanding was due to large banks resolution, additionally quality of the credit portfolio deteriorates. Most likely, this issue can solely be resolved surgically – by keeping bad loans off the resolution banks' banker books, for example, through setting up of toxic debt funds and dumping bad assets of resolution banks onto the funds balance sheets.

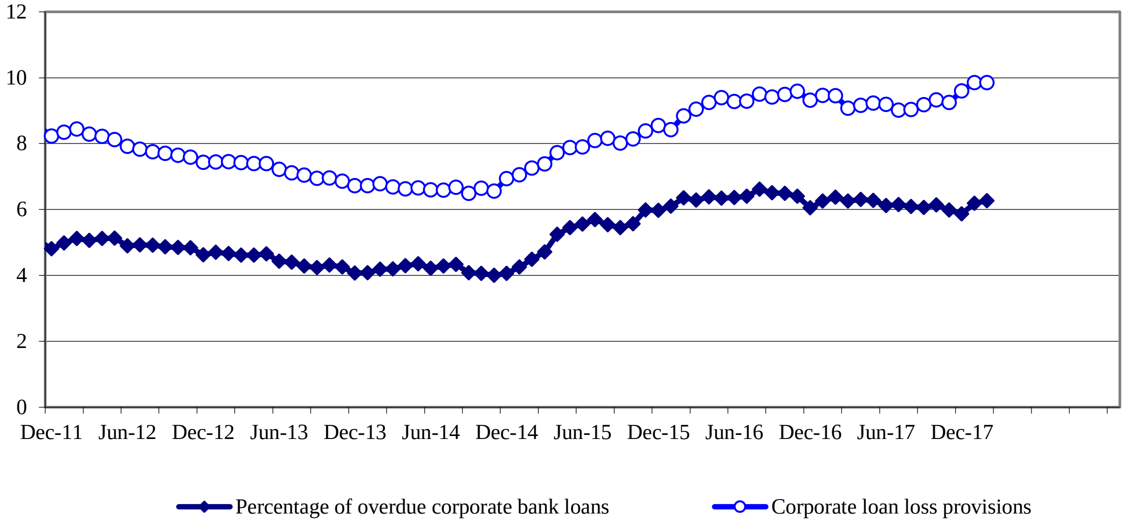

Fig. 59. Values of quality of bank corporate credit portfolio, percent

Sources: Bank of Russia, own calculations.