RUSSIAN BANKS – A YEAR ON SINCE THE APPOINTMENT OF NEW CANTRAL BANK'S HEAD

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The Central Bank's new management have revoked the banking license of 7% of banks which were operating last year. Additionally, the following trends in the development of the banking sector developed most visibly during the elapsed 12 months: retail market segments – retail loans and retail bank deposits – saw slowdown in growth rates; the role of state-run banks increased, especially in retail markets; banking sector's profitability was diluted, and the scale of refinancing of banks increased to a level comparable with the crisis in 2009.

A year elapsed on June 24, 2014 since Elvira Nabiullina's appointment as Chairwoman of the Central Bank of Russia. In this review we will trace how the banking sector's key indicators changed over the past year under the banking sector regulator's newly appointed management. Indeed, many trends were intrinsically determined by the economic situation while some of them have a history longer than the Bank of Russia's new management's tenure in office. Nonetheless, the past-year period seems to be sufficient to make analysis of the interim results.

As of July 1, 2013, 956 credit institutions were operating in Russia. A year on 72 units ceased to exist and the said number of credit institutions was reduced down to 884, of which 67 units lost their banking license, while the other five units left the market as a result of merger with other banks or ceased to exist at the request of shareholders[1]. Intensity of banking license revocation has reached its highest over the last few years. "A total of" 53 banking licenses were revoked during the most acute phase of the crisis over the period of 12 months between November 2008 and October 2009. Furthermore, it took the former management of the Bank of Russia more than three years, since January 2010, to remove a comparable number of credit institutions from the market.

Growth in the banking sector 's assets decelerated over the past year, annual growth rate in banks' assets was 19–23%[2] in the period of 2012 to H1 2013, while it slowed down to 14–17% for the last year, and annual growth in the said assets stood at 15.6% at the end of June 2014, including 0.9% in June 2014. The banking sector lost 1.1% of its total assets through banking license revocations over the past few years. Therefore, the trend towards deceleration of growth in banking assets would have remained unchanged, even if all the license-revoked banks had retained their position in the market.

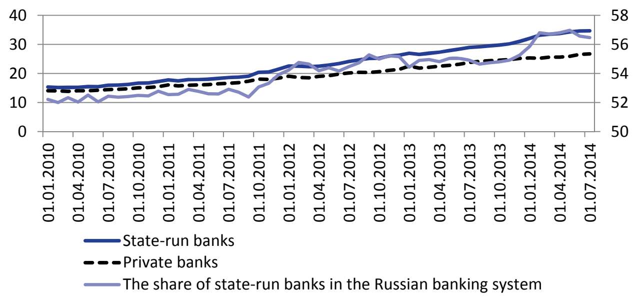

Fig. 1. Dynamics of assets in state-run banks and other banks (trillions of rubles), and the share of state-run banks in the assets (%, right-hand scale)

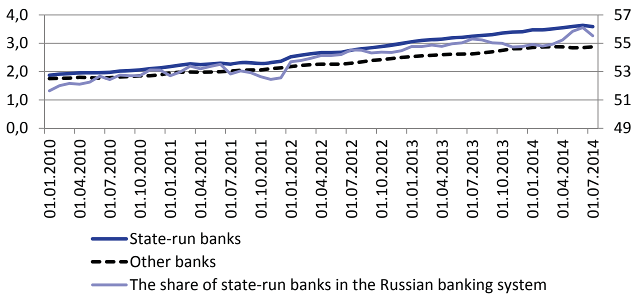

Fig. 2. Dynamics of equity[3] in state-run banks and other banks (trillions of rubles), and the share of state-run banks in the capital (%, right-hand scale)

The banking sector began to lose profit over the past year. In 2012, banks generated Rb 1012bn of profit before tax, which corresponds to a return of equity at 19.8% p.a. In 2013, profit amounted to Rb 994bn, being indicative of declining return on equity to 16.8% p.a. During a period of 12 months, between July 2013 and June 2014, banks' total profit decreased to Rb 954bn while banks' profitability went down to 15.3% p.a.

1 In August 2013, Swedish Swedbank decided to shut down its Russian "subsidiary", and the banking license of the Russian unit of Swedbank was revoked on October 1, 2013.

2 Hereinafter growth rates in balance-sheet indicators are presented with allowance for revaluation in foreign currency, but without taking account of banks whose banking license was revoked, unless otherwise stated.

3 Calculated according to balance-sheet accounts (form No. 101).

It is the deterioration of the credit portfolio quality and the need to build up provisions for losses that became the key factor of dilution of banks' profitability. For instance, banks allocated Rb 260bn to provisions for losses in H1 2013 and Rb 399bn in H1 2014, which is comparable with the amount (Rb 411bn) of provisions for losses built up throughout the entire period of 2013.

Raised funds

The principal outcome of the "mop-up" policy in the banking sector was erosion of retail depositors' confidence in banks. Fifty four of the 67 banking licenses revoked over the past year were held by banks eligible to provide services for retail customers. At the moment of revocation of the banking license[1] these banks had Rb 296bn accumulated on retail accounts and deposits. In addition, The State Agency for Deposit Insurance covered a total of Rb 243bn, and more than 15,000 bank depositors actually lost more than Rb 50bn of their money.

The foregoing, along with the marked depreciation of the ruble exchange rate during the first few months of 2014, drastically slowed down retail money inflow to banks. For instance, as of July 1, 2013, ruble-denominated bank deposits saw an annual growth rate of 20.8% while foreign-currency bank deposits expressed in U.S. dollars increased 17.5%. During the year (as of July 1, 2014), growth rate in ruble-denominated retail money in banks dropped to 6.5% while that of the retail money expressed in a foreign currency fell to 9.7%. Furthermore, bank deports outflow in Q1 2014 was so strong (Rb 683bn) that the inflow (Rb 492bn) recovered in the second quarter couldn't cover the outflow. In June 2014, bank deposits increased timidly 1.4%, but retail deposits inflow saw a higher increase only twice during the elapsed year, in December 2013 (4.6%) and in April 2014 (1.5%).

State-run banks increased their share in market of retail bank deposits as retail deposit inflow slowed down. Over less than a year state-run banks recovered the market position which they occupied four years ago. On May 1, 2014, the share of state-run banks in the retail bank deposits market was 61%, the same as that observed early in 2010, whilst it was no more than 58% as early as the fall of 2013. It is with good reason that retail depositors have more confidence in large state-run banks than small banks. The Bank of Moscow case is a good illustration of this. After Bank of Moscow, Moscow Mayor's Office's former bank, was acquired in 2011 by other state-run bank, VTB, the Russian Government had to allocate about Rb 300bn to support the latter, twice as much as the total retail deposits accumulated in Bank of Moscow at that period. To date , no private bank could have expected such a generosity from the shareholders.

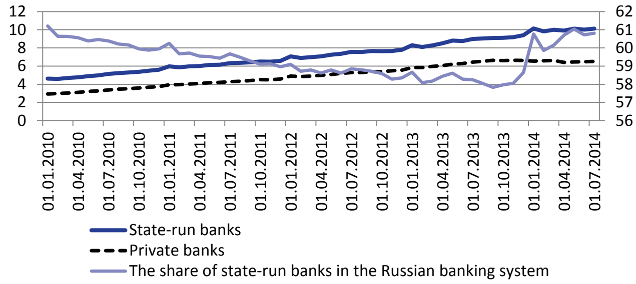

Fig. 3. Dynamics of retail deposits in state-run banks and other banks (trillions of rubles), and the share of state-run banks in the retail deposit market (%, right-hand scale)

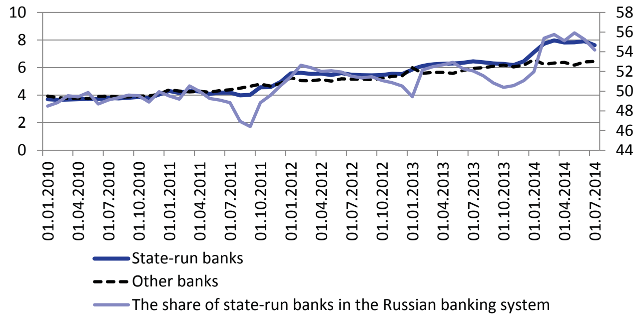

Fig. 4. Dynamics of corporate accounts with state-run banks and other banks (trillions of rubles), and the share of state-run banks in the corporate account market (%, right-hand scale)

Gorwth rates in the corporate loan market remain slow since 2012 when they droppred to 10.5%. In 2013 this indicator increased to 13.9%, but contracted again to 12.7% in H1 2014. Additionally, June 2014 saw a decline of 1.1% in corporate customers' accoutns and deposits in banks.

Corporate customers' resources were exposed to stronger "dollarization" than retail deposits. The share of non-bank institutions' bank accounts denominated in foreign currency was up 2.8 p.p. during the elapsed 12 months, reaching 25.7% of their total volume as of 1.07.2014, whereas retail accounnts denominated in foreing currnecy accounted for only 19% of the total retail deposits, a growth of 1.0 p.p. over the said period.

Fixed-term deposits have been prevailing in the corporate total resources for more than two years (since January 2012), and the share of current accounts and settlement accoutns has been 50% or less. As of 1.07.2014, the share of fixed-term deposits stood at 54.5%. During the period of 12 months, between July 2013 and June 2014, the volume of current accounts of non-bank institutions increased 9.3% while the amount of fixed-term deposits grew up 15.7%.

1 As of the latest reporting date prior to the license revocation.

Table 1

RUSSIAN BANKING SYSTEM'S STRUCTURE OF LIABILITIES (AT MONTH END), AS PERCENTAGE OF TOTAL

	12.08	12.09	12.10	12.11	12.12	06.13	09.13	12.13	3.14	04.14	05.14	06.14
Liabilities, billions of rubles	28022	29430	33805	41628	49510	52744	54348	57423	59377	60208	61196	61385
Equity	14.1	19.3	18.7	16.9	16.2	16.3	16.5	16.0	16.0	15.9	15.9	15.8
Loans from the Bank of Russia	12.0	4.8	1.0	2.9	5.4	4.4	5.8	7.7	7.9	8.4	8.2	8.7
Interbank operations	4.4	4.8	5.5	5.7	5.6	5.2	5.1	5.1	4.7	4.8	5.6	5.9
Foreign liabilities	16.4	12.1	11.8	11.1	10.8	10.8	10.1	9.9	10.6	10.3	9.8	9.4
Retail accounts and deposits	21.5	25.9	29.6	29.1	28.9	29.6	29.3	29.4	27.8	27.9	27.3	27.4
Corporate accounts and deposits	23.6	25.9	25.7	26.0	24	23.5	22.9	23.8	23.9	23.3	23.4	22.9
Accounts and deposits of government agencies and local government authorities	1.0	1.0	1.5	2.3	1.6	2.4	2.9	0.9	1.8	2.2	2.5	2.3
Outstanding securities	4.1	4.1	4.0	3.7	4.9	5.1	4.7	4.5	4.2	4.1	4.0	3.9

Source: Central Bank of Russia, Gaidar Institute's estimates.

According to the evaluation of Russia's foreign balance, the banking sector's obligations to non-residents contracted by $10bn in H1 2014 . Given the aforementioned contraction of retail bank deposits, the banking sector in H1 2014 encountered two of the three principal segments of its resource base – it is only the resources borrowed from Russian internal corporate customers that saw growth. This couldn't but affect the banks' need in extra liquidity which they used to obtain from the monetary authorities – the Bank of Russia and the Ministry of Finance of Russia.

During six months banks' debt to the money market regulators increased Rb 1,4 trillion, which includes Rb 929bn of the resources provided by the Bank of Russia and Rb 475bn of Minfin deposits. As of 1.07.2014, banks' total debt to the monetary authorities reached Rb 5,944 trillion, including Rb 5,369 trillion of Bank of Russia's loans and other resources and Rb 575bn of Minfin deposits. Relative to the economy's size, state support to the banking sector already exceeded the level observed in 2009, when the highest banks' debt to the regulators accounted fro 8.2% of GDP, it is now 8.5% of GDP. Nonetheless, the highest level in the banking sector's total liabilities during the crisis (12.3% as of 1.02.2009) hasn't yet been reached. As of 1.07.2014, banks' total debt to the Bank of Russia and the Ministry of Finance of Russia accounted for 9.7% of the banking sector's total liabilities.

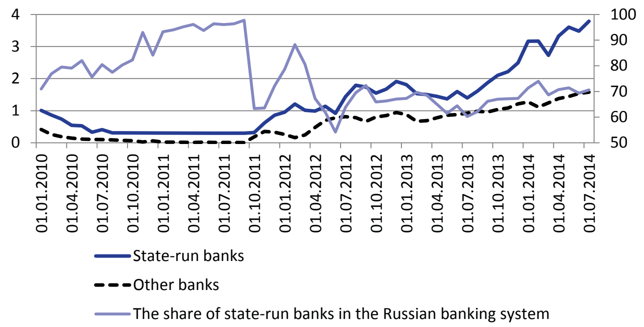

Fig. 5. Dynamics of Bank of Russia's loans extended to state-run banks and other banks (trillions of rubles), and the share of state-run banks in Bank of Russia's loans. (%, right-hand scale)

Loans issued

Three trends were prevailing in the retail lending market over the past year: slowdown in the credit portfolio's growth rates, deterioration of the credit portfolio's quality, and increase in the market share of state-run banks.

The first and the second trends developed at the time when the Bank of Russia former management were in the office. Annual growth in debts on retail loan reached its highest as early as the summer of 2012 (42.5%). It has gradually been declining since then. As of 1.07.2014, it dropped to 20.2%. Inter alia, household debts to banks increased 1.2% in June 2014.

The quality of banks' retail credit portfolio has been deteriorating since the beginning of 2013. Post-crisis lows of overdue repayment of debts (4.1%) and the ratio of provisions for losses to total loans (6.0%) were recorded on January 1, 2013. Both indicators have been deteriorating monthly since then. In H1 2014, the share of overdue repayment of retail loans increased from 4.5 to 5.4%, and the ratio of provisions to loan debts went up from 7.1 to 8.3%. Nonetheless, the highest values during the crisis (7.7% on overdue repayment of debts and 10.9% on provisions) have not been reached yet. Furthermore, the share of repayments of overdue loans has increased substantially, which varied within 10–12% in 2013, but in 2014 it was already 13–14%, including 14.7% in June 2014.

The two of the aforementioned trends have been steady because of high debt ratio in Russian households. Households' loan debt servicing costs exceed

12% of all households' disposable income, and this share is definitely bigger when it comes to active borrowers from banks.

The third trend – growth in the share of state-run banks in the retail lending market – developed late in 2013 and may well be considered an effect of the "mop-up" policy in the banking sector which has been in progress since the summer of 2013. In the period of October 1, 2013 thru July 1, 2014 the share of state-run banks in retail loan delinquencies increased more than 3 p.p., from 51.2% to 54.3%. There is a strong possibility that retail customers have become less interested in dealing with small private banks with regard to not only money saving services, but also the whole package of banking services.

Annual growth rates in corporate loan debts to banks have been stable, within 12–15%, for six months so far. In June 2014, the corporate credit portfolio increased 0.4%, while annual growth rate stood at 12.5% at the end of June 2014.

The quality of corporate loans also remains stable. The share of overdue repayment of debts in H1 2014 increased 0.1 p.p. to 4.2% as of 1.07.2014, and the ratio of provisions for losses to loan debts contracted by 0.1 p.p. to 6.6% during the same period.

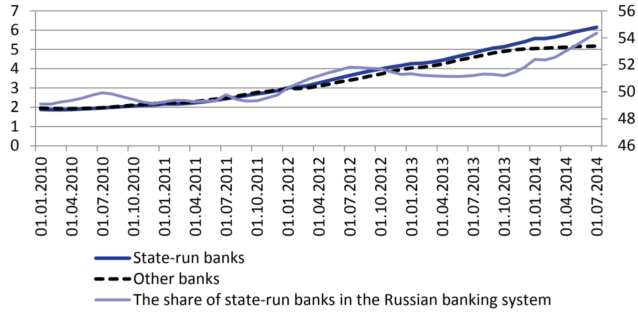

Fig. 6. Dynamics of retail loans issued by state-run banks and other banks (trillions of rubles), and the share of state-run banks in the retail loan market (%, right-hand scale)

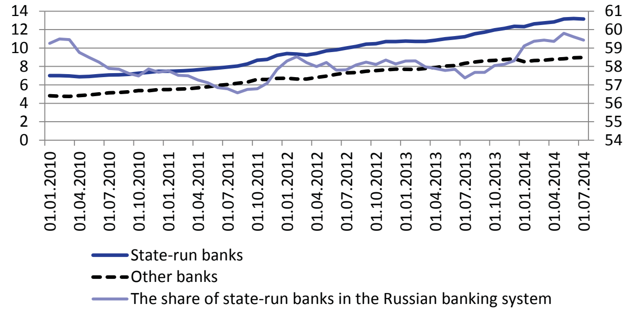

Fig. 7. Dynamics of corporate loans issued by state-run banks and other banks (trillions of rubles), and the share of state-run banks in the corporate loan market (%, right-hand scale)

Table 2

RUSSIAN BANKING SYSTEM'S STRUCTURE OF ASSETS (AT MONTH END), AS PERCENTAGE OF TOTAL

	12.08	12.09	12.10	12.11	12.12	06.13	09.13	12.13	3.14	04.14	05.14	06.14
Assets, billions of rubles	28022	29430	33805	41628	49510	52744	54348	57423	59377	60208	61196	61385
Cash and precious metals	3.0	2.7	2.7	2.9	3.1	2.4	2.3	2.8	2.8	2.7	2.4	2.4
Deposits with the Bank of Russia	7.5	6.9	7.1	4.2	4.4	3.3	3.5	3.9	3.5	3.4	2.9	3.3
Interbank operations	5.2	5.4	6.5	6.4	6.8	6.0	5.8	5.7	5.3	5.7	6.5	6.9
Foreign assets	13.8	14.1	13.4	14.3	13.0	15.1	13.6	13.3	14.4	15.1	14.6	14.1
Retail sector	15.5	13.1	13.0	14.4	16.8	17.9	18.5	18.5	18.4	18.4	18.3	18.5
Corporate sector	44.5	44.5	43.6	44.0	41.3	40.8	41.2	39.3	39.6	39.0	38.8	38.8
State	2.0	4.2	5.1	5.0	3.2	3.2	2.9	3.1	3.0	2.7	3.2	3.4
Property	1.9	2.7	2.6	2.3	2.2	2.2	2.1	2.0	1.9	1.9	1.9	1.9

Source: Central Bank of Russia, Gaidar Institute's estimates.