THE BANKING SECTOR: ECONOMIES OF SCALE AFOOT[1]

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During ten months of 2015, the banking sector has demonstrated very low results. Operating income and profitability have declined and many credit institutions have obtained negative financial results. State owned banks and banks under resolution regime have been bearing losses. Obvious economies of scale is being observed: large banks are more profitable than the small ones even despite the more active provision of reserves against potential losses.

Dramatic decline of profit and, correspondingly, the fall of the banking operations profitability represent paramount indicator revealing serious problems existing in the banking sector. By the period-end results for ten months of 2015, the banking sector financial results have constituted barely Rb 193bn. Return on assets (ROA) for January–October 2015 has decreased to merely 0.3% year-on-year, and profitability of the capital base – to 3.4%. This year, all these indicators turned out to be 3.5–5-fold less than a year earlier. Over ten months of 2014, the banking sector profit constituted Rb 723 bn (in 2015 reduction by 3.8-fold), return on assets – 1.4% year-on-year (reduction by 4.7-fold), and profitability of the capital base – 13.5% year-on-year (reduction by 4-fold).

Significant number of the credit institutions boasted negative financial result. By the period-end for ten months of 2015, two hundred and fifteen credit institutions have shown losses totaling Rb 413bn. Meanwhile, profit of the remaining 538 institutions came to Rb 606bn. The magnitude of profitability of the profitable banks' assets (1.3% year-on-year) has turned out to noticeably below the absolute value of the negative profitability of the loss-making banks (-2.3% year-on-year). Thus, the losses have proved to be more significant than the profit. The share of the bank assets which accrue to the loss-making banks constitute 27% of the total volume of assets.

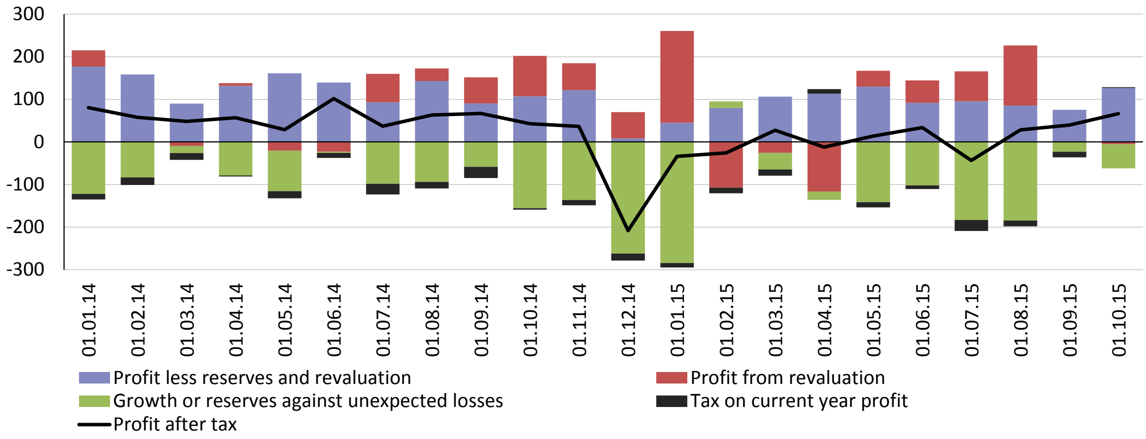
Main roots for the sharp drop of the banking profit, as we stated before[2], consisted in the decrease of the bank assets quality resulting in considerable increase of provision for reserves against potential losses as well as reduction of profitability generated by the main banking operation[3]. These causes have revealed themselves especially in relation to the loss-making credit institutions.

Overall, the banking sector's provisions for reserves came to more than Rb one trillion during tem months of 2015 and the ratio of reserves to potential losses to the total assets have moved up by 1.3 p.p. (from 5.2% to 6.5%). This indicator reflects estimate of the soft assets in the overall volume of the bank assets. The loss-making banks were marked both by lower assets quality and by higher rate of the soft assets growth. The ratio of reserves against poten-

1 This paper was originally published in *Online Monitoring of Russia's Economic Outlook* No.17.

2 See, for example, «Income tax have resulted in losses for the banking sector", The Online Monitoring of Russia's Socio-economic Outlook, № 7 2015; "Banks: deterioration of assets quality and earnings reduction", The Online Monitoring of Russia's Socio-economic Outlook, № 13 2015.

3 Income less operation with reserves and adjustment to revaluation of accounts denominated in foreign currency.



Source: Bank of Russia.

Fig. 1. The main components of the banking sector's profits, Rb bn

tial losses to the total assets regarding the loss-making banks has moved up in 2015 from 7.2 to 9.2%, meanwhile for the profitable banks – from 4.4 to 5.3%. At the same time, the growth of reserves in both groups of banks in nominal terms has turned out to be comparable: Rb 546bn for the profitable and Rb 539bn for the loss-making banks, wherein the assets of the profitable banks 2.6-fold exceed assets of the loss-making banks.

Net operating income for the profitable banks also remains at a significantly higher level than for the loss-making ones. Over ten months of 2015, all credit institutions have gained Rb 929bn (1.5% year-on-year) less provision for reserves and revaluation of deposits in foreign currency of which Rb 889bn (2.0% year-on-year) accounts for profitable banks and merely Rb 106bn (0.6% year-on-year) for the loss-making banks.

A year earlier (over ten months of 2014), net operating income amounted to Rb 1.29 trillion or 2.4% of assets year-on-year. This speaks for a notable reduction of this component of the banking sector financial performance.

More detailed analysis of the financial performance structure with separating certain groups of banks reveals the following features of the banking profit pattern (*Table 1*).

Table 1

FINANCIAL PERFORMANCE PATTERN OF MAJOR GROUPS OF BANKS

	Share in assets as of 1 Nov 2015 %	Profit Rb bn	ROA %	Provision of reserves Rb bn	Profit from revaluation Rb bn	Profit less reserves and revaluation Rb bn	ROA (less reserves and revaluation) %
Banking system	100	193	0.3	1018	282	929	1.5
Sberbank	29	210	1.1	213	30	393	2.1
Major state banks*	27	-92	-0.5	242	17	133	0.8
Banks under resolution regime**	3	-61	-3.3	126	4	60	3.2
Major foreign banks	6	38	0.9	20	77	-19	-0.5
Major private banks	15	59	0.7	224	83	200	2.3
Other banks	21	40	0.3	193	71	162	1.2

*VTB group of banks (VTB, VTB24 and Bank of Moscow), GPB and Rosselkhozbank.
**Banks subject to resolution regime as of 1 November 2015, minus Bank of Moscow designated as state bank.
Sources: Bank of Russia, banks' books, IEP calculations.

Major state banks and banks under resolution regime make more than half of the losses bore by the loss-making banks. Among banks, comprising major state banks solely head bank of the VTB group received profit as of the period-end for ten months of the current year in the amount of Rb 65bn. Other banks comprising VTB group of banks (VTB24 and Bank of Moscow) have suffered losses totaling Rb 70bn as well as other two banks – GPB and Rosselkhozbank. Total loss of these four banks for ten months of 2015 has reached Rb 157bn.

In 2015, the state banks have boasted of the lowest profit margin obtained from the regular operations. ROA for this indicator constituted merely 0.8% year-on-year against 1.5% across the banking sector as a whole. This shows that these banks have a significant volume of transactions of non-market character. For example, aimed at the implementation of state support of certain sectors of the economy. In case of Rosselkhozbank this is most pronounced. Its main operations in 2015 were loss making in the amount of 1.0% of assets year-on-year.

Among banks affiliated with the state, Sberbank stays apart. Much better assets quality gave the largest bank an advantage to obtain a relatively high return of assets. Regarding net operating income, Sberbank is at the head of the pack.

Apart from the state banks, further Rb 70bn of losses accrue to the banks under resolution regime (part of these banks obtained profit). Banks under resolution regime have the worst assets quality: ratio of accumulated reserves to the total volume of assets for these banks reached 18%. Growth rate of provision for reserves against potential losses over ten months constituted 40% (Rb 126bn).

The level of profit less reserves and revaluation of the banks under resolution has proven to be higher than normal. In 2015, return of assets of this indictor constituted 3.2% year-on-year. Such high level comparable solely with the banking sector indicators in the course of 2008–2010 crisis when similar trends, reduction of the total profit amid notable growth on net operating income, were intrinsic to the banking sector as a whole. Then, it, clearly, signified wide use of certain accounting mechanisms leading to the losses offset in banker's books with proactive recording of soft assets.

At present, the regulator moves to exercise stringent control over the banks under resolution. The regulator helps to resolve issue linked to the actual assets quality preventing manipulations with accounting. However, in order to reduce bank resolution costs implementation of certain arrangements is feasible aimed at reduction of lump sum losses. For example, let us take the situation with the Bank of Moscow in 2011, when in order to compensate unexpected non-performing assets; the bank obtained a loan from the regulator at the preferential rate. Income of interest payments allowed the bank to offset the costs on provision of reserves in required volumes. To note, currently no additional measures are being taken regarding Bank of Moscow and its net operating income is on the average level for the banking system.

In 2015, it was typical for foreign banks to bear losses on the regular operations. The subsidiary banks' principal source of income was revaluation of deposits denominated in foreign currency. In other words, their financial situation totally depended on the exchange rate movement. Despite a relatively fair quality of assets, low profitability predetermines drastic reduction of the investment interest of nonresidents to the Russian banking sector especially taking into account external political risks. Gradual reduction of the non-residents' share in the capital of the Russian banks from 25–26% in 2014 to 20% in 2015 support this fact.

Economies of scale is being observed: large banks are more profitable than the small ones even despite a proactive provision of reserves against potential losses. This is the result of high net operating income of large private banks. Small and medium banks face serious competition from large banks and are forced to proactively increase profitability of borrowed assets which determines lower profitability of regular operation due to decreasing net interest income.

Over recent months, the situation in the banking sector as a whole, at first sight, was improving. In the course of three months (August–October), total financial performance of all credit institutions has come to Rb 159bn and October was the first month of 2015 when the volume of the total banking profit happened more than in the corresponding month of 2014. However, significant share of the profit was ensured by another upsurge of ruble devaluation and growth of net revenues generated by revaluation of deposits denominated in foreign currency which over these three months came to Rb 136bn or 85% of the profit. Net operating income during three months (Rb 288 bn) remained at the level comparable with the turn of the year: 1.5% of assets year-on-year.