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ACRA affirms B(RU) to JSC Bank VENETS, outlook Developing

Lead analysts:

Suren Asaturov, Associate Director
+7 (495) 139-0480, ext. 130
suren.asaturov@acra-ratings.ru

Batchuluun Lkhagvaa, Director
+7 (495) 139-0480, ext. 135
batchuluun.lkhagvaa@acra-ratings.ru

The credit rating of JSC Bank VENETS (hereinafter, the Bank) has been affirmed at B(RU) in view of the Bank's low business profile assessment, satisfactory capital position, weak risk profile, and adequate funding and liquidity position.

The Developing outlook (previously, the credit rating status was “Rating under revision: developing”) reflects ACRA's view on the significant uncertainty regarding the Bank's capital level and corporate lending prospects in the medium term. In July 2019, when the Bank posted a loan loss, its total regulatory capital went below RUB 1 bln (a minimum threshold required for any bank to hold the universal banking license). However, according to the Bank, it has managed to increase its total regulatory capital above RUB 1 bln by November 1, 2019. Nevertheless, it is still close to the threshold, and therefore in our view the Bank is vulnerable to a repeated decrease in capital below RUB 1 bln, which may cast doubt on the Bank's ability to retain its universal banking license. Therefore, ACRA is of the opinion that the risks of business model transformation that may be induced by a transition to the basic banking license will remain in the medium term. In particular, the Bank's business profile may impair in the next 12–24 months, since the basic banking license implies stricter regulation of large corporate loans.

The most significant regulatory change that may affect the Bank refers to N6 ratio (limits maximum exposure per a group of affiliated borrowers), which is set to 25% for banks with universal banking license and to 20% for banks with basic banking license. Moreover, banks with basic banking license are required to apply a multiplier of 2.0 to loans granted to large businesses. In view of the above, in case the Bank migrates to the basic license, the Agency does not exclude a drop in its lending volumes since, according to ACRA's estimates, approximately a quarter of the Bank's loan portfolio is sensitive to the above regulatory changes.

It should be noted that the recent amendments introduced to the Bank of Russia Instructive Order No. 183-I dated December 6, 2017 “On Mandatory Ratios for Banks with Basic License” partially mitigate the above risks and allow delaying possible negative consequences for banks stepping down to the basic license. According to the amendments, multiplier 2.0 will not apply to borrowers whose liabilities belong to quality category I or II at the time a bank is downgraded to a basic license. Such relief is granted for five years after the transition from the universal license to the basic license and, in ACRA's opinion, it will make such transition smoother.

ACRA notes that, in case the Bank minimizes the risk of losing the universal license or successfully adapts its operations to the basic license (in a more negative scenario), a positive rating action is possible within the next 12–18 months. More stable and predictable quality of the Bank’s assets coupled with the high coverage of problem loans by reserves may result in a stable improvement in the Bank’s ability to absorb losses.

The Bank is a small credit institution engaged in corporate and retail lending and focused on the Ulyanovsk Region. As of October 1, 2019, the Bank ranked 275th in capital and 228th in assets. Despite its moderate positions in the banking sector, the Agency notes that the Bank benefits from its relatively well-known regional brand.

Key rating assessment factors

Low business profile assessment (b). In ACRA's opinion, the Bank is susceptible to the certain business risks. As total regulatory capital is still low (slightly above RUB 1 bln), ACRA does not exclude possibility that the Bank may be required to transfer to the basic license from the current universal in the medium term, which may hamper the Bank's corporate lending business.

The Bank’s business diversification is assessed as relatively low. Operating income includes mainly interest income from loans to customers. According to ACRA's calculations, Herfindahl-Hirschman Index was 0.39 as of July 1, 2019.

The ownership structure is transparent and disclosed in full.

Satisfactory capital position. The Bank has a relatively comfortable reserve of N1.2 ratio, 9.5% as of October 1, 2019. The capital adequacy assessment is limited by the Bank’s unproved ability to generate capital from profits (the average capital generation ratio (ACGR) is -32 bps over the past five years).

The Agency believes that, despite the negative ACGR, the Bank has a potential to improve its ability to absorb unexpected losses as the coverage of current problem loans is high. As part of the ACRA stress test, which involves a partial impairment of potentially problem loans in the next 24 months, the Bank is able to withstand an increase in the cost of risk in the range of 400–500 bps without violating N1.2 ratio.

The Bank's moderate performance indicators have a neutral effect on the assessment of capital positions: the average net interest margin under IFRS is 5.7% for the past three years. At the same time, we see opportunities for the Bank to optimize the cost to income (CTI) ratio, which amounted to 71% for the same specified period.

Weak risk profile. According to ACRA's estimates, the share of potentially problem loans account for about 14% of the total loan portfolio (which corresponds to the fourth and fifth quality category under the Russian prudential standards). Although almost 100% of potentially problem loans are covered with reserves, the relatively volatile quality of assets and the high concentration of the Bank's loan portfolio (the share of the top 10 borrowers was 36% as of July 1, 2019) are the key factors that restrict the risk profile assessment. ACRA also notes that the volume of loans issued to borrowers from high-risk industries is significant (134% of Tier 1 capital as of July 1, 2019).

Adequate funding and liquidity position. The Bank is able to withstand a significant outflow of client funds in both the base case scenario (about RUB 1 bln) and the stress scenario (liquidity shortage is minimal). There are no imbalances for longer periods (as of July 1, 2019, the long-term liquidity shortage indicator exceeded 100%).

The Bank’s main funding source is deposits held by individuals (73% of total liabilities as of October 1, 2019), therefore, the concentration on depositors is relatively low (the share of top 10 groups of depositors does not exceed 15% of the total deposits).

Key assumptions

- N1.2 ratio at least 9% in the next 12–18 months.

Potential outlook or rating change factors

The **Developing outlook** assumes with equal probability either an upgrade or a downgrade of the rating within the 12–18-months horizon.

A positive rating action may be prompted by:

- More stable asset quality amid maintenance of the the currently high coverage of problem loans by reserves;
- Higher loss absorption ability allowing the Bank to withstand an increase in the cost of risk above 500 bps without violation of N1.2 ratio.

A negative rating action may be prompted by:

- Destabilization of the business following transition to a basic banking license, which may result in a loss of key customers and inability to attract new customers;
- Growth in problem loans above 15% of the total loan portfolio and significant decrease in the coverage of problem loans by reserves;
- Signs of a decline in N1.2 capital adequacy ratio below 9%;

- CTI growing above 75%.

Rating components

SCA: b.
Adjustments: none.
Support: none.

Issue ratings

No outstanding issues have been rated.

Regulatory disclosure

The credit rating was assigned under the national scale for the Russian Federation based on the Methodology for Credit Ratings Assignment to Banks and Bank Groups under the National Scale for the Russian Federation and the Key Concepts Used by Analytical Credit Rating Agency within the Scope of Its Rating Activities.

The credit rating of JSC Bank VENETS was first published by ACRA on November 6, 2018. The credit rating and the credit rating outlook are expected to be revised within one year from the publication date of this press release.

The credit rating is based on the data provided by JSC Bank VENETS, information from publicly available sources, as well as ACRA's own databases. The rating analysis was performed using the IFRS financial statements of JSC Bank VENETS and the financial statements of JSC Bank VENETS composed in compliance with the Bank of Russia Ordinance No. 4927-U dated October 8, 2018. The credit rating is solicited, and JSC Bank VENETS participated in its assignment.

No material discrepancies between the provided data and the data officially disclosed by JSC Bank VENETS in its financial statements have been discovered.

ACRA provided no additional services to JSC Bank VENETS. No conflicts of interest were discovered in the course of credit rating assignment.

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