

December 16, 2019

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Key rating assessment factors

ACRA affirms BBB-(RU) to PJSCB «DERZHAVA» and changes outlook to Negative

The change of the outlook on the credit rating of [PJSCB «DERZHAVA»](#) (hereinafter, the Bank) from Stable to Negative reflects ACRA's opinion on the growing credit risks stemming from the Bank's guarantee portfolio and relatively aggressive risk management of the loan portfolio, which may have a negative impact on the Bank's capitalization if they materialize.

The credit rating of the Bank is based on the Bank's satisfactory business profile, adequate capital adequacy, satisfactory risk profile, and adequate liquidity and funding assessment.

The Bank is a small Moscow-based bank that focuses on bank guarantees, transactions in securities and, to a lesser extent, lending to individuals and small and medium-sized businesses. As of November 1, 2019, the Bank ranked 103rd in terms of capital and 133rd in terms of assets among Russian banks.

The controlling beneficiary shareholder of the Bank is S. Ents (about 83% of shares); the remaining shares belong to V. Polyakov.

The satisfactory business profile assessment (bb+) is a reflection of the Bank's diversified income structure. Commission income accounts for around 40% of operating income. The remaining part is made up of interest income relatively evenly distributed between the loan portfolio and the securities portfolio. In ACRA's view, this relatively diversified business structure contributes to operational stability.

Commission income is mainly generated by issuing bank guarantees for government contracts, a segment in which the Bank has occupied a relatively stable position for a number of years. However, we note that the Bank is a relatively small financial institution, which makes it sensitive to increasing competition on the part of larger players amid a decline in lending activity in the banking sector.

Although the loan portfolio is only a small portion of the Bank's business (approximately a quarter of all balance sheet assets and eight times smaller than the guarantee portfolio), in our opinion, risk management for this asset category is sufficiently aggressive and may lead to unforeseen losses in the future. In particular, these risky assets include around 60% of the credit portfolio, which has been provided to individuals and secured by real estate.

The Bank also acts as a market maker for the Moscow Exchange and thereby inflates the size of its balance sheet through back-to-back direct and reverse repo transactions. These transactions account for around 20% of the balance sheet, bear low credit risk (as they are conducted via the National Clearing Center, which acts as a central counterparty), have a neutral impact on net interest income, and generate additional commission income for the Bank.

The Bank's ownership structure is transparent, including its ultimate beneficiaries. ACRA does not possess any negative information about these beneficiaries.

Adequate capital adequacy buffer. Taking into account the Bank's modest business development plans (7–10% growth of the guarantee portfolio in 2020), we expect the N1.2 ratio to be no lower than 9% in the 12 to 18-month horizon (as of November 1, 2019 it stood at 9.7%). The RUB 425 mln of perpetual subordinated debt recently issued by the Bank and acquired by its shareholders supports its capitalization (this debt is part of the regulatory capital and accounted for 7% of equity as of November 1, 2019). Consequently, the current capital adequacy allows the Bank to absorb an increase in the

cost of risk relative to ACRA's base case scenario (growth of around 100 bps per year in 2019–2020) by around 300–400 bps without breaching the N1.2 ratio.

Capitalization is also supported by moderately high profitability indicators. From 2015 to the end of September 2019, return on equity averaged around 20%, while the average capital generation ratio stood at 212 bps. The Bank's relatively low administrative expenses have a noticeable positive effect on financial results, with the cost-to-income ratio at approximately 40% on average from 2017 to the end of September 2019.

Satisfactory risk profile assessment. ACRA sees risks of a deterioration of the credit quality of issued guarantees, which is reflected in the Negative outlook. Our estimates show that the share of potential problem guarantees could form up to 3% of the portfolio or around 23% of equity. This might limit the Bank's ability to absorb losses in the event of the negative scenario. Although the loan portfolio is several times smaller than the guarantee portfolio, it still places significant additional pressure on capital because the share of potential problem loans amounts to around 20–25% of the total portfolio and around 25% of the Bank's common equity. The bulk of potential problem loans is concentrated on loans provided to individuals under pledge of real estate.

The Bank's portfolio of securities primarily consists of bonds issued by high credit quality issuers. ACRA views the market risk accepted by the Bank as moderate.

Adequate funding and liquidity assessment. As of October 1, 2019, the short-term liquidity shortage indicator was positive both in ACRA's base case and stress scenarios. The long-term liquidity shortage indicator was 90%. At the same time, there is a relatively high single-name concentration in the funding (as of October 1, 2019, the shares of the largest lender and top 10 largest lenders were 12% and 33% of liabilities, respectively).

Key assumptions

- Maintaining the current business model and diversification of income within the 12 to 18-month horizon;
- Maintaining the N1.2 CAR at higher than 9% within the 12 to 18-month horizon.

Potential outlook or rating change factors

The **Negative outlook** assumes the possibility of a negative rating action over the next 12 to 18-months.

A positive rating action may be prompted by:

- Significant improvement of the quality of the guarantee and loan portfolios;
- Sustainable growth of N1.2 above 12%.

A negative rating action may be prompted by:

- Significant decrease in the stability and diversification of income;
- N1.2 falling below 8%;
- Further deterioration of asset quality and off-balance sheet claims.

Rating components

Standalone creditworthiness assessment (SCA): bbb-.

Adjustments: none.

Support: none.

Issue ratings

No outstanding issues have been rated.

Regulatory disclosure

The credit rating has been 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 the Analytical Credit Rating Agency Within the Scope of Its Rating Activities](#).

The credit rating assigned to PJSCB «DERZHAVA» was published by ACRA for the first time on December 29, 2017. The credit rating and its outlook are expected to be revised within one year following the publication date of this press release.

As the Bank's off-balance sheet obligations form the bulk of RWAs (about 75%), ACRA does not consider the loan portfolio to be the main class of its assets. In connection with this, ACRA carried out an expert analysis of the Bank's risk portfolio.

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

No material discrepancies between the provided information and the data officially disclosed by PJSCB «DERZHAVA» in its financial statements have been discovered.

ACRA provided no additional services to PJSCB «DERZHAVA». No conflicts of interest were discovered in the course of credit rating assignment.

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