November 30, 2017

Stagnant net interest margin to hold back creditworthiness of Russian banks

Analysis of NIM dynamics in the Russian banking sector

- **After recovering post 2014-2015 crisis, net interest margin of Russian banks is sluggish.** According to ACRA estimates, net interest margin (NIM) of the Russian banking system calculated on the basis of IFRS reporting recovered to 4.5% in 2016 after falling to 3.8% in 2015 (versus a five-year record of 5.6% registered in 2013). The growth continued in 2017, but NIM failed to get back to pre-crisis level, which, in ACRA's opinion, is an element of a long-term trend for stagnation of banking business returns at the current low level.

- **NIM may start a gradual decline in 2018.** We expect NIM to decline to 4.5% in 2018, i.e. returning to the 2016 level. Weak post-crisis recovery of NIM in 2016-2017 and its expected decline in 2018 are indicative of a quite rapid transition of the banking system to a "new normal". Such state of the economy exhibits low inflation (versus historic figures), interest rate cuts by the Bank of Russia as well as comparatively low lending and deposit interest rates.

- **With NIM tightening and net income growth ending, creditworthiness of some Russian banks will come under pressure.** Further gradual decline of NIM and a higher probability of a long-term net income stagnation in the banking system at the current low level would affect the sector's capital generation capacity in the next 12-18 months. A substantial number of banks would still operate at a marginal level of the regulatory capital adequacy. Considering higher regulatory pressure as to problem loans provisioning, ACRA will consider declining operational performance and low capital generation capacity as triggers for a potential downgrade of credit ratings or change of outlook with respect to specific banks most affected by these developments.

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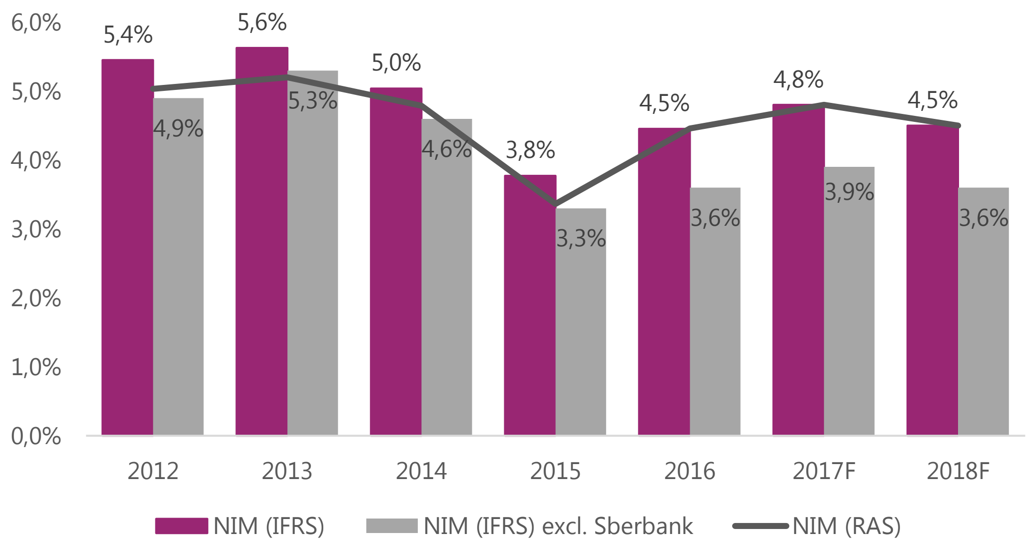
Net interest margin is recovering but remains below 2013 figures

NIM represents net interest income to average interest-earning assets ratio. Interest-earning assets include total loan portfolio, debt securities portfolio, and interbank loans.

Broad economic recovery and stabilization of the Russian financial system after the 2014-2015 crisis drove higher net income in the banking system in 2016 and in the first six months of 2017; and this effect was largely driven by improved net interest margin figures. According to ACRA estimates, net interest margin of the Russian banking system calculated on the basis of IFRS reporting[1] after a drop to 3.8% in 2015 (versus 5.6% - the maximum figure for the last five years since 2013) grew to 4.5% in 2016. The data for the entire banking system (including Sberbank) calculated on the basis of RAS reporting figures show a similar NIM dynamics: it declined to 3.4% in 2015 versus the peak of 5.2% seen in 2013 and 4.8% in 2014, and then recovering to 4.5% in 2016.

Sberbank has a significant effect on NIM figures of the entire system as it has a higher interest margin as compared to the majority of large and medium-size Russian banks. NIM excluding Sberbank grew from 3.3% in 2015 to 3.6% in 2016 remaining well below 5.3% registered in 2013. At the same time, net interest margin of the top ten systemically important banks (excluding Sberbank) is below the average level for the total sample of banks analyzed: 4.0% in 2014, 3.0% in 2015 and 3.2% in 2016. This specific is typical of few systemically important banks with developed operational networks and quite substantial amounts of non-core or problem assets on their books that generate no interest income.

Figure 1. NIM dynamics



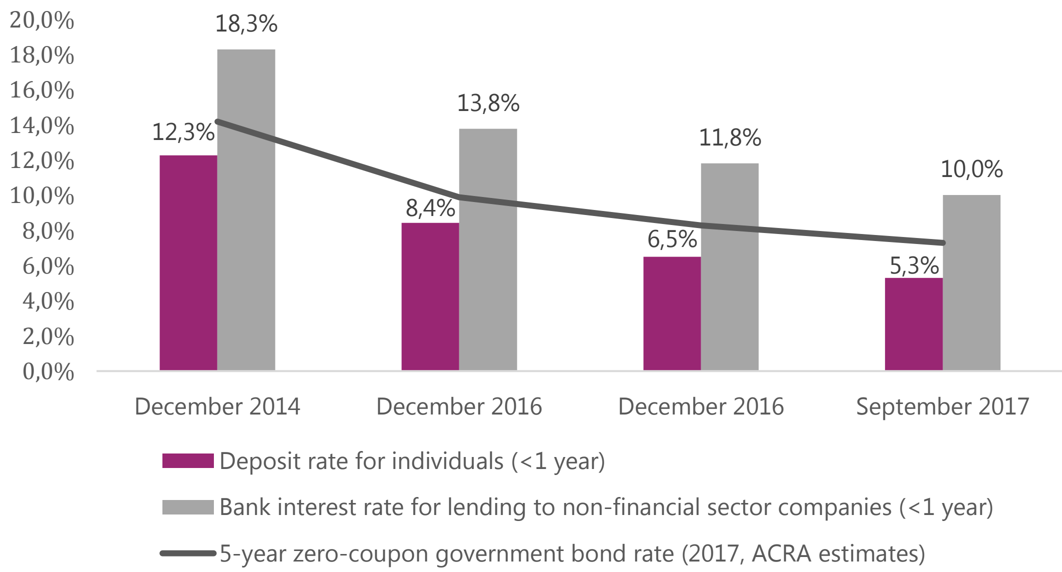
Note: NIM under RAS was calculated for the entire banking system.
Source: CBR, IFRS reporting of Russian banks, ACRA estimates

[1] ACRA calculated this figure based on audited IFRS financial statements of 90 large, medium and small banks (including subsidiaries of foreign banks) that account for over 80% of the total assets in the Russian banking system. The sample includes only banks existing as at year-end 2016.

A significant shrinkage of NIM in 2014-2015 was caused by a high volatility in the financial market accompanied amid the crisis. It was accompanied by a spike in interest rates in late 2014 and early 2015 followed by lending interest rate cuts outpacing the decline in funding costs. In addition, interest income of banks was negatively affected by a sharp decline in yields of fixed income portfolios after it climbed in late 2014 (see Figure 2).

According to ACRA estimates, slight increase in NIM in 2016 outlines both the emerging stabilization of lending and deposit rates and rebalancing of fixed income assets of the Russian banks favoring instruments with higher yields. Nevertheless, NIM failed to recover to the pre-crisis level in 2017, which, in ACRA's opinion, is part of a long-term trend to stagnant earning capacity of the banking business at the current low level.

Figure 2. Interest rate dynamics



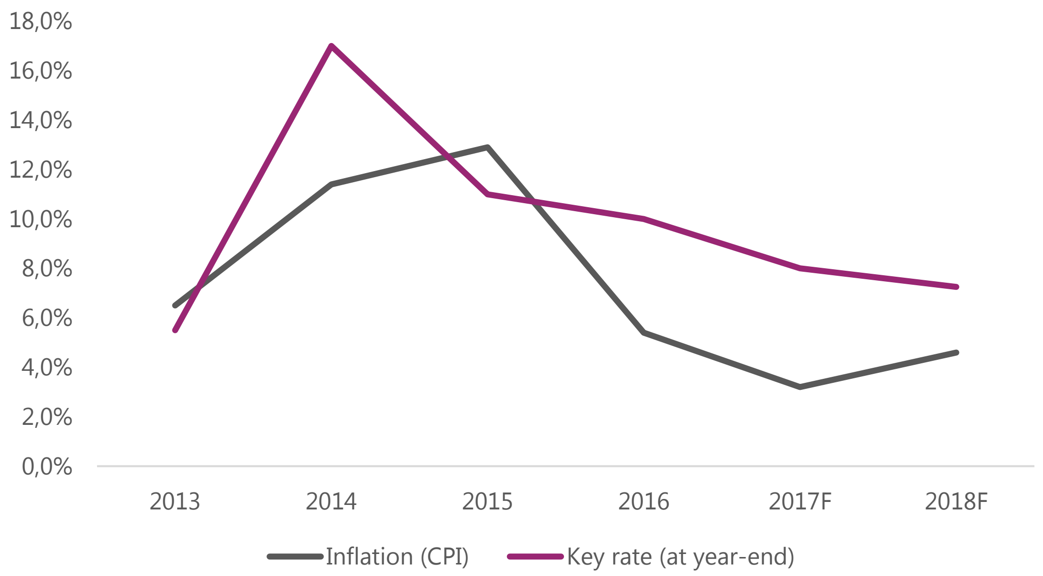
Source: Bank of Russia, Russian Ministry of Finance, ACRA estimates

NIM recovery to end as early as in 2018

ACRA expects NIM (under IFRS) to increase just slightly in 2017 to 4.8% in the sample of analyzed banks and to 3.9% excluding Sberbank (see Figure 1). At the same time, we expect NIM to decline to 4.5% and 3.6%, respectively, in 2018, which means a retreat of this indicator to the 2016 figures. We expect a similar decline of NIM for the entire banking sector to 4.5% according to RAS data as well.

In ACRA's opinion, weak post-crisis recovery of NIM in 2016-2017 followed by a decline expected in 2018 means a rapid transition for the banking system to a new normal, typical of which are low inflation (as compared to the historic data), interest rate cuts by the Central Bank of the Russian Federation as well as comparably low lending and deposits interest rates. ACRA expects that inflation (consumer price index) would increase to 4% in 2018 after a decline to about 3% seen in 2017, while the key interest rate of the Bank of Russia will continue going lower, which would further narrow the spread between lending and deposit interest rates in the next 2-3 years.

Figure 3. Inflation and key rate of the Central Bank of the Russian Federation



Source: ACRA estimates

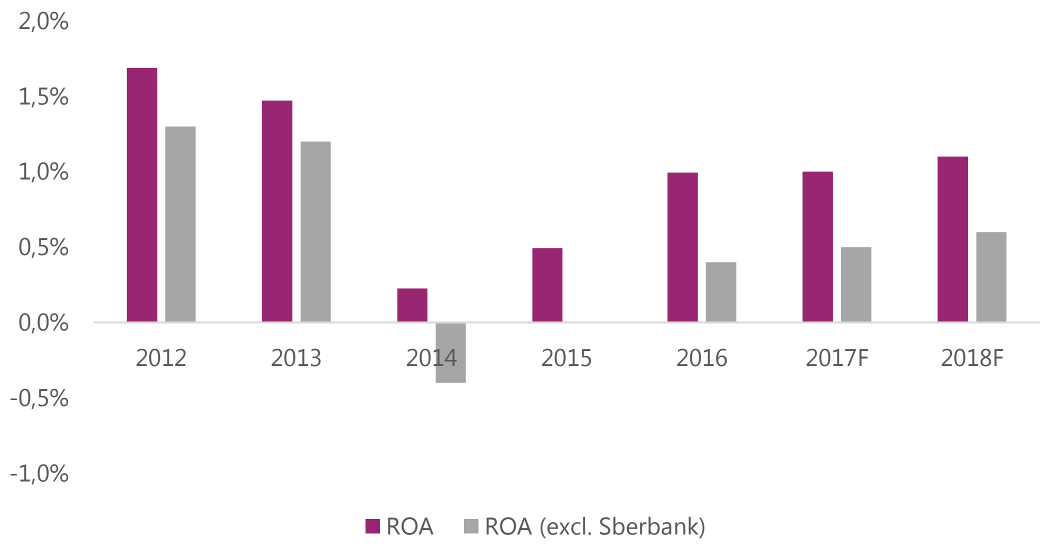
Transitioning to a new normal for the Russian banks would mean fewer opportunities to maximize interest margin by arbitraging between various types of interest-bearing assets and liabilities, and, consequently, further increase in competition.

Creditworthiness of those banks unable to increase their operating efficiency may worsen

According to our assessment made on the basis of IFRS reporting, return on assets (ROA) stood at 1.0% in 2016 – a significant improvement from 0.5% seen in 2015 and 0.2% in 2014. It is worth noting that Sberbank's contribution to the aggregate income of the banking sector remains quite substantial: excluding Sberbank performance, ROA was 0.4% vs 0% in 2015 and -0.4% in 2014.

Nevertheless, we expect no improvement of ROA for the entire banking in 2017 as the expected loss of the largest banks taken over by the Banking Sector Consolidation Fund of the Central Bank of the Russian Federation (FC Otkritie and B&N Bank) affects the aggregate financial result. In 2018, this factor would expectedly have a significantly smaller effect on the profitability of the banking sector; however, the financial results would come under pressure from the estimated shrinkage of NIM, and, therefore, net income of the entire system would not be substantially higher.

Figure 4. ROA dynamics (IFRS)



Source: ACRA estimates

See ACRA's research titled "Weak economic growth to boost capital adequacy of Russian banks" published on June 22, 2017

ACRA notes that stagnation and decline of NIM would affect not only small and medium-sized banks unable to compete in terms of interest rates due to the economies of scale, but also those from among the largest and large universal banks that hold substantial portfolios of problem loans generating no interest income and/or maintain significant non-core banking assets on their books. Amid tightening of interest rate spreads, the banking sector's capacity to generate profits would depend on by how much the banks are able to increase their commission income and strengthen their control over operating expenses that have been growing by 9% on average over the last four years as seen in the sample analyzed.

See ACRA's publication titled "Poor asset quality to remain the key risk of Russian banks' creditworthiness decline" as of September 14, 2017

In our opinion, further gradual decline of NIM and the increasingly probable long-term stagnation of the banking system's net income at the current low level would have a direct effect on the sector's profit-generation ability in the next 12-18 months. As a result, capital adequacy in the banking sector taken as a whole would not recover; instead, some banks would continue operating at marginal levels of regulatory capital adequacy. We note that following substantial losses recorded by banks that are under financial rehabilitation procedure within the Consolidation Fund, a stagnating capital adequacy scenario is materializing, which has been previously considered by ACRA as less probable.

According to ACRA methodology, both net income and NIM indicators are taken into account in the capital adequacy factor through averaged capital generation ratio (ACGR) and assessment of operating efficiency, respectively. As regulatory pressure intensifies as to provisioning of problem loans, ACRA will regard declining operating efficiency and low capital generation capacity as a trigger to potential downgrade of credit ratings or change of outlook with respect to specific banks most affected by the above trends.

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