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Corporate loans are on hold

The quality of bank loans to corporates will continue to deteriorate

The decline in oil prices and the coronavirus pandemic have led to a deterioration in the operating environment, which naturally has affected the profitability of banks and the quality of their assets. These trends have had the greatest impact on the increase in the volume of potentially problem loans in bank loan portfolios.

To assess the impact of the economic situation on corporate lending and the ability of banks to withstand the growth of possible losses from additional reserves on this group of assets, ACRA analyzed the statements of fifteen of the largest banks in Russia in terms of assets for H1 2020 under IFRS (with the exception of TRUST Bank). This sample accounts for 80% of all banking assets.

ACRA estimates that the real amount of corporate borrower problem debt on bank balance sheets will be clear by mid-2021. The potential amount of additional reserves for these loans created by banks in the sample should be at least RUB 650 bln. Banks can create additional reserves with profits and available capital without significantly reducing financial stability. Even when combined with additional reserves for retail loans, the average capital adequacy ratio of these banks should decrease by no more than 1.6 percentage points.

Problem loans will increase

For more information on retail lending, see ACRA's study titled "Retail lending has received a "vaccine" against the crisis" from September 2, 2020.

The volume and share of corporate loans that were actually recognized as problem loans (stage three[1]) did not change significantly in H1 2020, equaling about 8% of the corporate loan portfolio. However, their reserve coverage[2] has increased by only 3 percentage points since the beginning of the year, standing at 61% as of July 1, 2020.

At the same time, the volume of stage two[3] corporate loans has increased by more than 40% over this period and as of July 1, 2020, stood at 13% of the loan portfolio of the analyzed banks (about 10% as of January 1, 2020). Reserves on these loans increased by a third, with their share in the total amount of reserves on corporate loans increasing from 15% to 17%. Coverage on stage two loan reserves did not change significantly in H1 2020, falling to 9.2% as of July 1, 2020 (from 10% as of January 1, 2020).

ACRA notes that the share of stage two loans grew amid the overall growth of the portfolio, which outpaced last year's growth (the portfolio grew by 6% in H1 2020). The increase in the volume of corporate loans reflects the increase in lending to corporate borrowers in Q1 2020 before the economic crisis due to the need to replenish the working capital stock of companies that expected problems with liquidity, increased credit risk premiums, increased interest rates, and tighter risk policies for banks.

[1] IFRS reflects impaired loans that are expected to incur substantial credit losses due to significant financial difficulties, long delays in payments, the likelihood of bankruptcy, external conditions that have a critical impact on the company's business, etc.
[2] As part of this analytical commentary, ACRA considers loan reserves according to IFRS approaches that do not take into account current regulatory easing.
[3] Includes loans with a significant increase in credit risk manifested, for example, in the deterioration of the borrower's financial condition, its ability to service debt, late payments, a downgrade in the borrower's external or internal ratings, unfavorable external or internal business factors, etc.

ACRA also notes a significant increase in reserves on problem and potentially problem loans in Q1 before the negative trends in company activities were fully manifested. This growth was partly due to exchange rate dynamics, but also indicated that banks were preparing for the possible consequences of growing economic problems (amid falling oil prices and the increasing risks of a pandemic) and the potential depreciation of part of the corporate loan portfolio. This was reflected in increased reserves on expected credit losses.

The dynamics of loan transition by stage does not fully reflect changes in the quality of loan requirements

In Q2 2020, the real picture of portfolio quality may have been partly distorted due to large-scale loan restructuring measures taken by banks.

According to the Bank of Russia, corporate loans (excluding SMEs) restructured by 11 systemically important credit institutions from March 20 to July 10, 2020, equaled 11% of the total portfolio of such loans held by the analyzed banks (over RUB 3.5 tln). Based on the dynamics of the absolute volumes of restructuring carried out by these banks, only about 30% of these loans are evaluated by banks as assets with high credit risk and are recognized as stage two loans under IFRS.

Therefore, ACRA believes that the practice of Russian banks using IFRS 9 may not fully reflect loan portfolio quality.

According to ACRA, a significant number of corporate borrowers requested that banks change the terms of loans even before actual solvency problems arose. In the context of a prolonged economic crisis, this practice essentially delays the time needed for bank statements to reflect the problems that these borrowers have with debt repayment.

The deterioration of economic conditions in 2020 resulting in, among other things, a decrease in real GDP, falling energy prices, and a decrease in consumer demand, complicates any early improvement in the financial condition of the corporate borrowers most affected and their ability to regularly service and repay debt.

The scale of the problems in banks' corporate portfolios may fully manifest over time given different loan repayment periods (including after restructuring) and the heterogeneous dynamics of the financial condition of corporate borrowers. ACRA estimates that the amount of impaired debt may peak in mid-2021 barring any negative economic scenarios during this period.

The need for reserves is increasing, but banks will remain resilient

For more information on macroeconomic forecasting, see ACRA's study titled "Questions and lessons from the 2020 economic crisis" from April 21, 2020.

A significant part of new stage two debt arising in H1 2020 may be subsequently recognized as problem, according to ACRA. This will increase the volume of stage three loans in the corporate loan portfolios of the analyzed banks to at least 12%. Considering that the share of reserve coverage on stage two loans remains at pre-crisis levels, banks will most likely need to build up reserves to the current average level of stage three loans (no less than RUB 650 bln for the analyzed banks). Based on similarities in the dynamics of total reserves on corporate loans under IFRS and RAS in H1 2020 (an increase of approximately 11%), ACRA estimates that the required amount of additional reserves under Russian standards should be comparable to the amount indicated above.

However, the ability of banks to cover newly created reserves with operating income is declining. Almost all banks in the sample completed H1 2020 with positive financial results, which were still significantly lower (by 21%) than in the same period last year. Banks made most of their profits in Q1 2020, while they significantly decreased in Q2. When comparing Q2 2020 to Q2 2019, the drop reaches 43%, which is mainly due to the coronavirus pandemic and restrictive measures that affected the ability of banks to generate profits. Even without the impact of additional reserves for loan portfolios, profits in Q2 2020 would have been significantly lower than in the same period last year.

At the same time, the expected amount of additional reserves can be absorbed with profits and capital reserves created in previous periods, which ensures that the largest banks are ready for negative economic trends this year. The gradual recovery in economic activity that is currently being observed will provide additional support to the banks' revenue base and create opportunities to generate profits, which will increase the banking sector's resilience to credit risks.

ACRA does not expect potential losses from the deteriorated credit quality of loans (including the expected reserves on retail portfolios) to critically affect this group of banks. In addition, ACRA does not expect the decrease in average capital adequacy ratios to exceed 1.6 percentage points. For example, N1.2 could drop from 12.4% (as July 1, 2020) to 10.8%, with N1.0 falling from 14.4% to 12.8%.

Therefore, ACRA does not see the need for significant and direct state support, only in the instance of individual (least stable) financial institutions. However, ACRA believes that regulatory easing could be extended in terms of recognizing loans as problem and forming reserves.

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