

September 2, 2020

Retail lending has received a “vaccine” against the crisis

Impact of state support on the retail banking sector

Retail lending could become a special risk zone during the 2020 crisis 2

State support measures did not meet requests from borrowers..... 3

Creation of additional reserves for retail loans will have a moderate impact on banks’ capital..... 4

Banks are hoping for an extension of relief measures 6

- **Retail lending, which showed aggressive growth rates in 2018–2019, could become a special risk zone during the 2020 crisis due to the specifics of measures taken to combat COVID-19.** Restrictive measures have led to an increase in unemployment and a decrease in income.
- **Timely support from the government and the Bank of Russia have helped mitigate the impact of the pandemic on the retail banking sector.** However, public support measures were limited to a maximum loan size that was set at a low level. This freed banks from restructuring large loans in accordance with the law and allowed them to do so using their own judgment.
- **ACRA’s survey, which included 22 Russian banks (25% of the total retail portfolio), showed that restructuring under banks programs was 7–8x higher than under Federal Law No. 106-FZ.** Unsecured consumer lending accounted for most of the restructuring.
- **A significant portion of restructured retail loans may remain problematic after the relief period and require additional reserves.** ACRA estimates that the impact on capital could be around 5–6%. In general, this level is not critical for the banking system, but it makes getting through the crisis more difficult given the need to create additional reserves for other credit products.
- **According to ACRA’s survey, regulatory easing in general did not significantly improve bank compliance with ratio regulations.** Among the surveyed credit institutions, easing on N1.0 and N1.2 ratios averaged only 21 bps and 14 bps, respectively. Certain banks improved their compliance by 100-150 bps, which indicates significant but not critical (non-financial) assistance from the regulator in terms of banks maintaining mandatory ratios at an acceptable level.
- **ACRA has not ruled out an extension on relief due to the risk of a second wave of COVID-19 and weak economic recovery.** According to ACRA, the majority of Russian banks assess the impact of the regulatory measures as positive, and according to the results of the survey, a number of credit institutions are interested in having them extended.

Irina Nosova
 Director, Financial Institutions
 Ratings Group
 +7 (495) 139-0481
 irina.nosova@acra-ratings.ru

Valeriy Piven
 Director, Financial Institutions
 Ratings Group
 +7 (495) 139-0493
 valeriy.piven@acra-ratings.ru

Contacts for Media

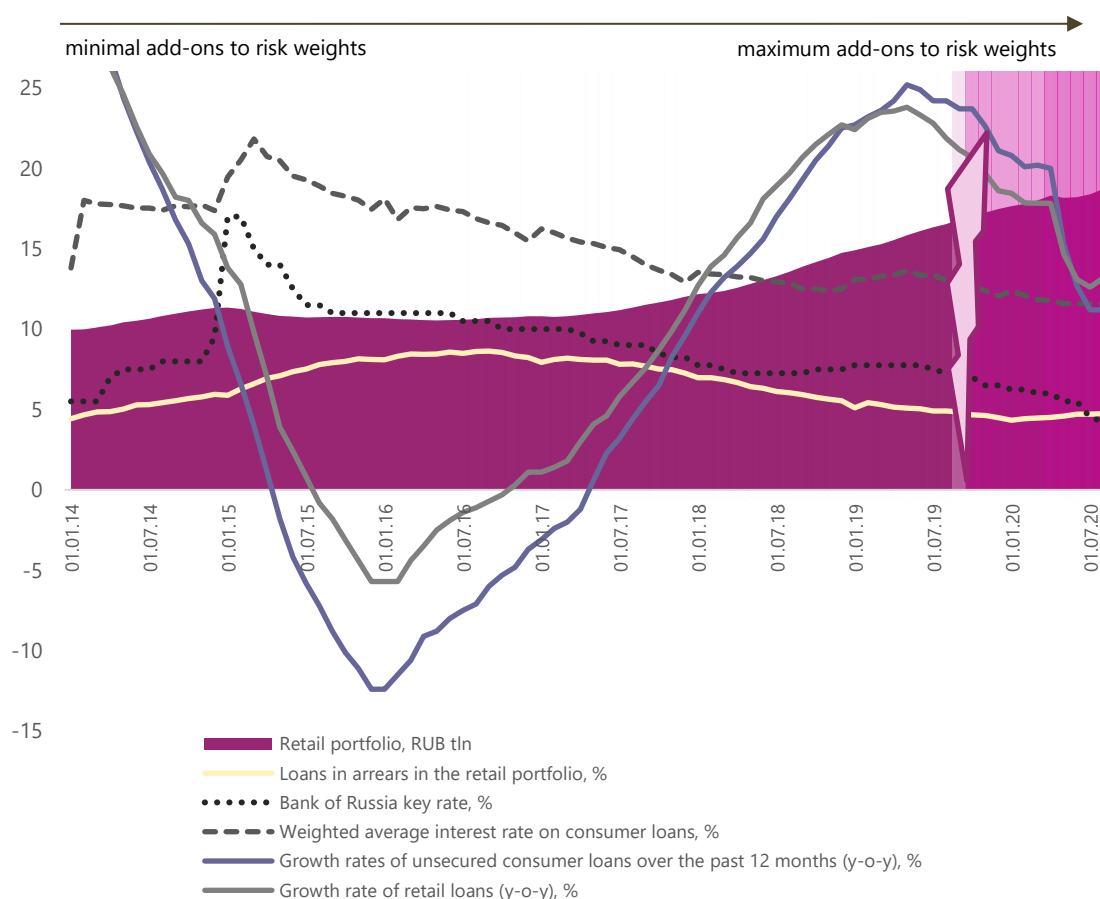
Alexey Churilov
 Manager, External
 Communications
 +7 (495) 139-0480 ext. 169
 media@acra-ratings.ru

Retail lending could become a special risk zone during the 2020 crisis

In 2018–2019, the growth rate of retail lending (mainly unsecured) was significantly affected by the extremely low growth rates of real disposable household income as well as a significant increase in consumer loan refinancing due to the debt load of the public. According to the Bank of Russia, the total number of borrowers reached 39.5 million, or 54% of the employed population, as of September 1, 2019. In addition, negative interest rate dynamics after the Bank of Russia reduced the key rate amid sluggish economic growth, as well as state support for mortgage lending, contributed to the high demand for consumer loans.

In turn, weak business growth and profit opportunities in the context of low economic development have predetermined the increased interest of Russian banks in allocating capital mainly to the dynamically growing retail sector, which also has a relatively higher interest margin (especially in terms of unsecured lending). At the near-zero growth rates of the corporate loan portfolio in 2018–2019, the dynamics of the retail loan portfolio (including unsecured loans) exceeded 20%.

Figure 1. Main indicators of the retail loan portfolio and interest rates



Sources: Bank of Russia, ACRA

In order to slow down the dynamics of consumer and mortgage lending, the Bank of Russia introduced restrictions in October 2018 under the [new macroprudential regulation mechanism](#), which were subsequently tightened several times. Regulatory measures have significantly contributed to the retail loan portfolio's lower growth rates as a whole (maximum growth of 23.8% y-o-y was recorded on May 1, 2019, but fell to 17.8% y-o-y by March 1, 2020).

However, according to ACRA, retail lending (primarily unsecured loans) remained the most vulnerable segment of the banking industry. Restrictive measures related to the spread of COVID-19 led to a significant increase in unemployment (6.3% in July 2020 according to Rosstat) and a drop in household income (according to Rosstat, real household income in Q2 2020 was 8% lower than in the same period last year). It struck first and foremost the credit institutions that specialize in these market segments or were rapidly increasing their volumes in order to make a profit. Without immediate support from the Russian Government and the Bank of Russia, the country’s population and banking sector could face significant financial losses.

State support measures did not meet requests from borrowers

Thanks to timely support from the government and the Bank of Russia, the adverse impact of COVID-19 on the retail banking sector has been reduced. Enacting Federal Law No. 106-FZ¹, dated April 3, 2020 (hereinafter, 106-FZ), as well as regulatory easing and other macroprudential measures from the Bank of Russia, provided the population with loan deferments without any penalties from creditors. This also gave banks the chance to reduce the amount of reserves required to maintain capital adequacy.

At the same time, loan deferments under 106-FZ had a number of restrictions that reduced effectiveness in terms of large-scale assistance to the public. In particular, the maximum loan size² contributed to narrow borrower coverage and the criteria for classifying citizens as victims of COVID-19 were not clearly laid out. In addition, consumers faced the risk of receiving penalties from banks if documents did not confirm the validity of the request for loan deferments within the time limits established by law. Also, according to banks, high regulatory risks that could arise if the opportunities provided were misinterpreted made it difficult and slow for banks to use these tools.

At the same time, restrictions on granting loan deferments, including maximum loan amount, contributed to the expansion of bank programs on restructuring loan agreements. In fact, banks were given the opportunity to independently decide whether to make changes to existing loan agreements in the event of a consumer request. In order to avoid credit risks, lenders preferred to allow borrowers to get through the crisis less painfully and return to normal debt service after some time (usually no more than six months).

To determine the effectiveness of state support measures for the public and banks, ACRA surveyed twenty-two credit institutions (which form 25% of the total retail portfolio) with ACRA ratings and leading positions in retail lending. According to the survey, 86% of banks actively used the proposed support measures during the pandemic. However, the volume of restructured loans in bank programs exceeds 106-FZ by about 7–8x (Bank of Russia statistics show comparable figures) and the total volume equals about 4% of the retail portfolio.

¹ Federal law No. 106-FZ, dated April 3, 2020, “On amendments to the Federal law ‘On the Central Bank of the Russian Federation (Bank of Russia)’ and certain legislative acts of the Russian Federation regarding the specifics of changing the terms of loan agreements.”

² According to RF Government Decree No. 435, dated April 3, 2020 “On establishing the maximum size of loans for which borrowers have the right to apply to lenders for with a request to change the terms of the loan agreement that suspends the borrower's obligations.”

Table 1. Main parameters of restructuring consumer loans during the pandemic (from March 20, 2020, to the date specified)

| | June 30, 2020 | July 15, 2020 | July 29, 2020 | August 12, 2020 | August 26, 2020 |
|--|---------------|---------------|---------------|-----------------|-----------------|
| Volume of retail loan restructuring, RUB bln. | 625 | 665 | 697 | 715 | 734 |
| <i>Including under 106-FZ</i> | 88 | 92 | 95 | 97 | 81 |
| Consumer loans* | 56% | 54.3% | 52.9% | >50% | n/a |
| Mortgage* | 20% | 22.7% | 24.8% | n/a | n/a |
| Credit cards* | 20% | 18.5% | 18.6% | n/a | n/a |
| Auto loans* | 3% | 3% | 2.3% | n/a | n/a |

*Data on applications pending in banks.

Source: Bank of Russia (based on a survey of 75 banks)

More than half of borrowers' requests to make changes to loan agreements apply to consumer loans, which are unsecured and bear the highest credit risk among retail loans. Around a quarter of requests are made by mortgage borrowers, which is mainly due to the size of the loan check and, as a result, the monthly payment. At the same time, credit cards also have a high cost of credit risk due to the unsecured and short-term nature of transactions and the less accurate analysis of the financial position of the borrower when the limit is being approved.

The results of ACRA's survey also showed that before the pandemic (data as of April 1, 2020), the leaders in terms of the share of restructuring (including due to reduced interest rates) in the retail portfolio were consumer (53%) and mortgage loans (42%). As of August 1, 2020, there was only one leader — consumer loans (62%) — which indicates that their quality has deteriorated. The share of restructuring for credit cards also grew, from 1% to 12% due to the possible replacement of consumer loans by credit cards and the poor debt servicing associated with this. The share of mortgages declined to 23%.

The right to not create reserves to cover problem debt granted to banks as part of restructuring encouraged them to offer their own programs that do not meet the conditions of 106-FZ, which was a key factor in the state's provision of support to borrowers. At the same time, the impact of the consequences of the actual worsening of the quality of the retail portfolio may have a significant negative impact on the financial stability of a number of banks after the support measures are cancelled. However, ACRA does not consider the current volume of restructuring to be critical for the banking system in general.

Creation of additional reserves for retail loans will have a moderate impact on banks' capital

The practice of restructuring loans, including the provision of loan deferments, is the root cause of the delayed realization of credit risks and inadvertently masking the existing quality problems of retail loans. The share of overdue debt in the total retail portfolio in the banking system in 2020 amounts to 4.6% (a low value) on average, compared to 4.9% in 2019 and 6.1% in 2018. This is achieved, on the one hand through active growth of the volume of lending, and on the other hand, by restructuring loans via deferred payment. A comparatively worse situation should be

visible as early as Q4 2020 after the period during which borrowers submit restructuring requests ends (on September 30), or in early 2021 if banks prolong their own programs until the end of this year.

The volume of restructured loans provided to the population amounts to RUB 734 bln (according to Bank of Russia data as of August 26, 2020), and ACRA expects this value to continue growing in the near future, despite slower growth (the peak in restructuring was recorded in April–May this year). According to ACRA’s base case [forecast](#) for 2020 with regard to unemployment (6.7% of the economically active population) and changes in real disposable income (-6.4% year-on-year), the possibility of a quick recovery of the population’s solvency is unlikely. If all restructured debt is assigned to quality categories IV–V, this may require additional creation of reserves to the sum of around 70% of total debt. In addition, it will be necessary to create additional reserves for a significant part of loans that are 90+ days overdue, the share of which, according to ACRA’s assessments, has grown by 10–15% and now exceeds 5% of the portfolio (on average for the banking system). The regulator’s deadline for additional creation of reserves is no later than the end of H1 2021.

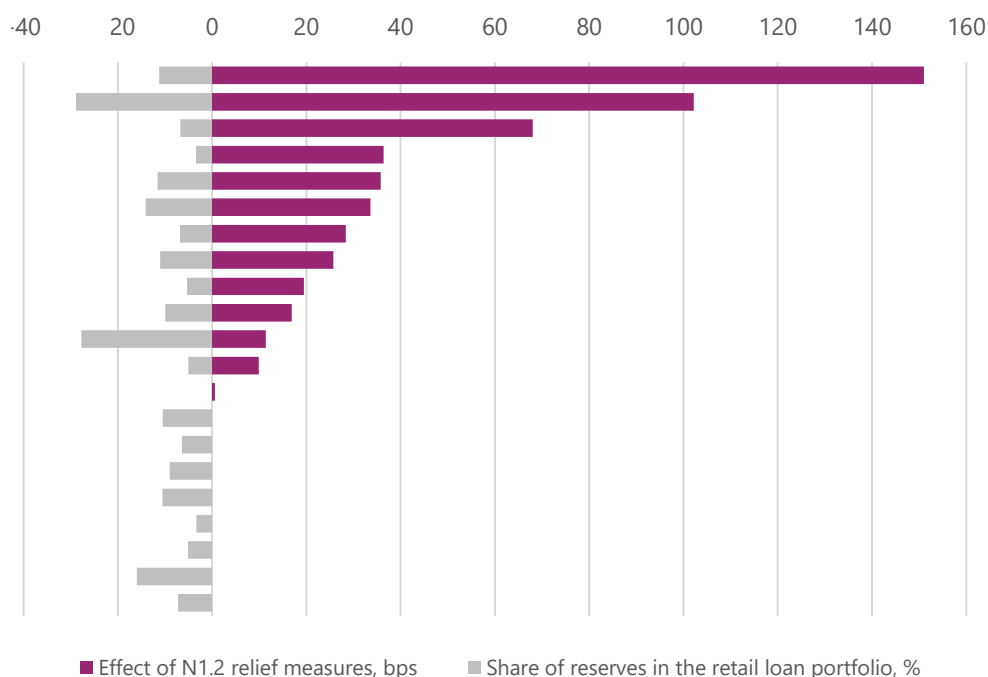
According to ACRA’s estimates, the need to create additional reserves for restructured debt may lead to losses of around RUB 600 bln (or around 5–6% of the total capital of the banking system as of August 1, 2020). This volume of reserves will not contribute to a significant decline in capital adequacy ratios, however, it will make it harder for banks to get through the crisis due to the need to create additional reserves for other credit products.

The regulator’s requirement that banks recognize loans with amended lending conditions (due to the pandemic) as restructured from January 1, 2021 will also put pressure on regulatory ratios. A macroprudential buffer may be used for these purposes in the conditions of an economic downturn (according to ACRA, Russia’s GDP will contract by 4–4.5% in 2020) and rather low profitability from operations (partially due to a low interest margin). A reserve has been accumulated by banks through the application of higher add-ons of risk weights for retail loans and the use of capital adequacy premiums and for systemic importance. According to the Bank of Russia, this buffer amounted to RUB 5.6 tln as of July 1, 2020, however it is unequally spread across the system and therefore does not guarantee that all banks will be able to create additional reserves without running into problems.

ACRA analyzed changes to the share of reserves in the retail portfolio of Russian banks since the start of 2020, taking into account the dynamics of the N1.2 capital adequacy ratio (the primary capital adequacy ratio according to ACRA’s methodology). To do this, banks with a share of the retail portfolio in assets above the average level (17.8%) for the banking system were selected from the 100 largest Russian banks in terms of assets and also banks with a lower share but among the top 30 in terms of assets (due to their fairly large retail portfolio system-wide). The analysis showed that 50 banks that were included in the sample had generally not added to reserves for the portfolio of loans to individuals over the first seven months of 2020 (their share only grew from 10% to 11% of the portfolio). At the same time, the level of capital adequacy (mainly due to profits received by the banks) increased from 10.6% to an acceptable 12.3% (weighted averages by retail portfolio volume). Therefore, banks have not yet begun to prepare for the realization of retail credit

risks by forming reserves. ACRA expects these risks may materialize as early as Q4 2020.

Figure 2. The impact of easing regulatory requirements for the N1.2 ratio is insignificant, reserves are maintained at a moderate level



Source: ACRA

We also cannot see any major differences between the level of mandatory capital adequacy ratios (N1.2 and N1.0) during the pandemic when they are calculated taking the relief measures into account and without them. According to a survey carried out by ACRA, as of August 1, 2020, N1.0 ratio would be only 21 bps lower than its actual level without regulatory easing, whilst N1.2 ratio would only be 14 bps lower. However, the impact would range from 100 to 150 bps for certain banks that account for 1.5% of the aggregate retail portfolio in Russia, which indicates significant although not critical (non-financial) support from the regulator in terms of maintaining banks' capital adequacy ratios at an acceptable level.

In addition, ACRA still does not rule out the possibility of the regulator prolonging its measures to support Russian banks, especially with regard to maintaining ratios at an acceptable level. Credit risks, which are the main risks in classic banking, are still heightened (mainly with regard to retail and SMEs) and may only fall in the event of sustained economic recovery and the absence of strict quarantine measures. In turn, these factors depend directly on the occurrence of a second wave of the pandemic in Russia and the state of the oil market.

Banks are hoping for an extension of relief measures

Besides the spread of COVID-19 and the introduction of the related quarantine measures, a significant factor in Russia's economic downturn was instability in oil markets, which led to volatility in the foreign exchange and securities markets. In ACRA's opinion, although the situation has now stabilized, the risks related to the need to create additional reserves for restructured loans amid a weak economic

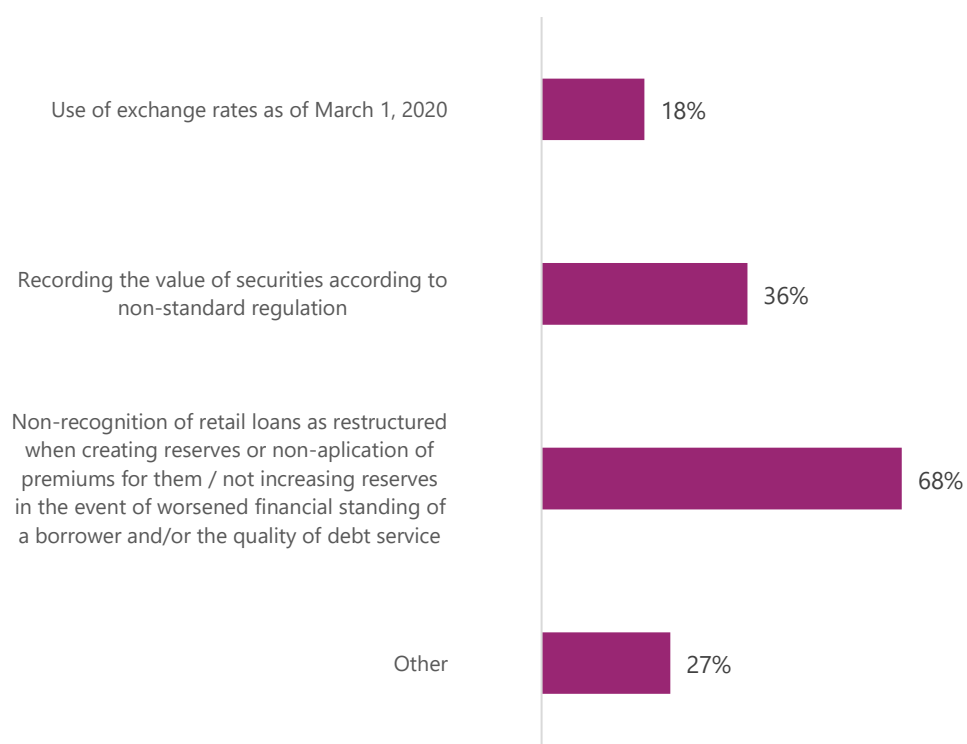
See ACRA's research "[Bank of Russia updates the playbook](#)" from August 20, 2020.

recovery may require the support measures for the sector to be prolonged. Above all, these measures will involve deferring the recognition of problematic loans and the need to properly create additional reserves.

Uncertainty with regard to a second wave of the pandemic does not fully exclude the possibility of the state prolonging or even expanding its measures to support borrowers.

The overall effectiveness of the support measures adopted at the start of the pandemic is rather high, with the majority of banks that participated in ACRA’s survey expressing a positive view of them. It is logical that the main measure used by the surveyed banks is the option to not recognize retail loans as restructured when creating reserves or apply premiums for them, as well as the option to not increase reserves in the event of a worsening financial situation of the borrower and/or the quality of debt service. The measures related to recording securities according to non-standard regulation and using exchange rates as of March 1, 2020 are applied much less often. This is due to the relatively lower acceptance of market risks by banks in contrast to credit risks, and also due to the gradual decline in the share of foreign currency in bank balance sheets in recent years (related to the materialization of currency risks during the 2014–2015 crisis).

Figure 3. Most popular regulatory relief measures among banks, % of those surveyed



Source: ACRA

Furthermore, some of the surveyed banks consider that it is necessary to prolong certain regulatory measures. We selected the most common proposals that are universal. In particular, banks are interested in: 1) extending the current relief measures until the end of 2020 or mid-2021 because it is not possible to fully assess the duration and extent of damage to the economy caused by the pandemic; 2) prolonging the reduction of the existing add-ons to risk weights for loans to

individuals; 3) extending relief measures for exchange rates of the main foreign currencies for the purposes of calculating capital adequacy ratios.

ACRA believes that on the whole, the Russian banking system was in good shape going into the 2020 crisis, which is mainly due to the implementation of prudential regulation. In connection with this, we do not see significant risks of a decline in the financial stability of the system in case of retail credit risks materialize in late 2020/early 2021. In addition, a number of banks (including the largest ones) are in a somewhat vulnerable position, and therefore they are interested in a continuation of the support measures. However, it is not worth ruling out the risk of a second wave of the pandemic, which could hit the already weakened banking system.

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Analytical Credit Rating Agency (Joint-Stock Company), ACRA (JSC)

75, Sadovnicheskaya embankment, Moscow, Russia

www.acra-ratings.com

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