

The Russian banking sector – heightened risks in a difficult environment

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The Russian banking sector has passed from excessive retail credit growth (up to early 2014) to a general contraction of credit (2015). This recent decrease is to a certain degree attributable to Western sanctions cutting off leading banks from cheap refinancing, but most notably to the steep fall of the oil price. The latter caused the ruble to plunge and pushed the Russian economy into recession. Temporary financial instability was reined in by the Bank of Russia's sharp increase of the key rate (largely reversed recently) and by expanding deposit insurance coverage. Liquidity injections, foreign currency repurchase agreements, and the recapitalization of a number of systemic banks also helped. Moreover, a degree of regulatory forbearance was introduced. As the economy shrinks, nonperforming loans are inevitably rising and profitability is declining. The banking sector is primarily exposed to credit risk, followed by liquidity and exchange rate risk. Connected lending is a structural problem now being finally tackled. Shock absorbers have eroded but still provide leeway: deposits are sizable and depositor confidence seems to have returned. Russian banks have a positive net external creditor position. Public debt is low and the country – notwithstanding terms-of-trade losses – continues to boast current account surpluses. Foreign currency reserves – after declining – have restabilized and remain substantial.

JEL classification: G21, G28, P34

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Faced with adverse developments, the Russian banking sector has become more crisis prone since the beginning of 2014. This study analyzes these developments, focusing in particular on the first three quarters of 2015.² Section 1 outlines the macroeconomic background, featuring the impacts of Western sanctions on Russia with respect to the geopolitical conflict in Ukraine, and of the sharp decline of the oil price. The authorities' salient policy reactions, including in the area of monetary policy, are also covered. Section 2 focuses on banking development in Russia from late 2013 to the fall of 2015, which essentially encompasses the movement from excessive retail credit growth to a general decline of lending. The particular measures taken

by the government and the Central Bank of the Russian Federation (Bank of Russia) to stabilize the banking sector are dealt with in Section 3. Section 4 gives an assessment of Russian banking risks and shock-absorbing factors as they are perceived in early December 2015. Section 5 concludes with an outlook.

1 Sharply deteriorating macroeconomic background and the authorities' policy reactions

While Russia until recently had boasted impressive macroeconomic achievements (including low budget deficits or even budget surpluses, current account surpluses, modest external debt, high foreign currency reserves, and a positive net external creditor position), its

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² This article ties in with previous Russian banking sector-related contributions in the OeNB's Financial Stability Report (Barisitz, 2013a; Wittenberger et al., 2014), but the environment for Russian banking activities has changed substantially in the meantime.

economic growth was much less impressive – despite high oil prices – and declined to very modest single digits in 2013 (1.3%) and 2014 (0.6%). The likely reasons for this shortcoming are long-standing structural and institutional problems, such as a traditionally rough investment climate, a sprawling bureaucracy, pervasive corruption and stalled reforms. In this ambiguous situation, the country in 2014 experienced a double shock caused by (1) Western economic and financial sanctions imposed from March 2014 in connection with the outbreak of geopolitical tensions in Ukraine, and (2) the steep decline of the oil price from July 2014 (Urals grade crude: USD 105 per barrel) to January 2015 (around USD 45). The most severe restrictive measures were imposed in the summer of 2014 and have been prolonged since; these include tight limits on the access of Russian state-owned banks (SOBs) and state-owned enterprises (SOEs) to EU and U.S. capital markets and bank loans. As a consequence, many Russian credit institutions and firms were effectively cut off from financing themselves on Western markets.

The steep drop of the oil price triggered a sharp decline of the ruble (as illustrated in chart 1), which contributed to a spike in inflation. As a result of combating the slide of the ruble, the Bank of Russia's foreign exchange reserves (including gold) shrank by more than one-quarter in the twelve months until March 2015 (to about EUR 320 billion). After some erratic exchange rate movements and heightened deposit

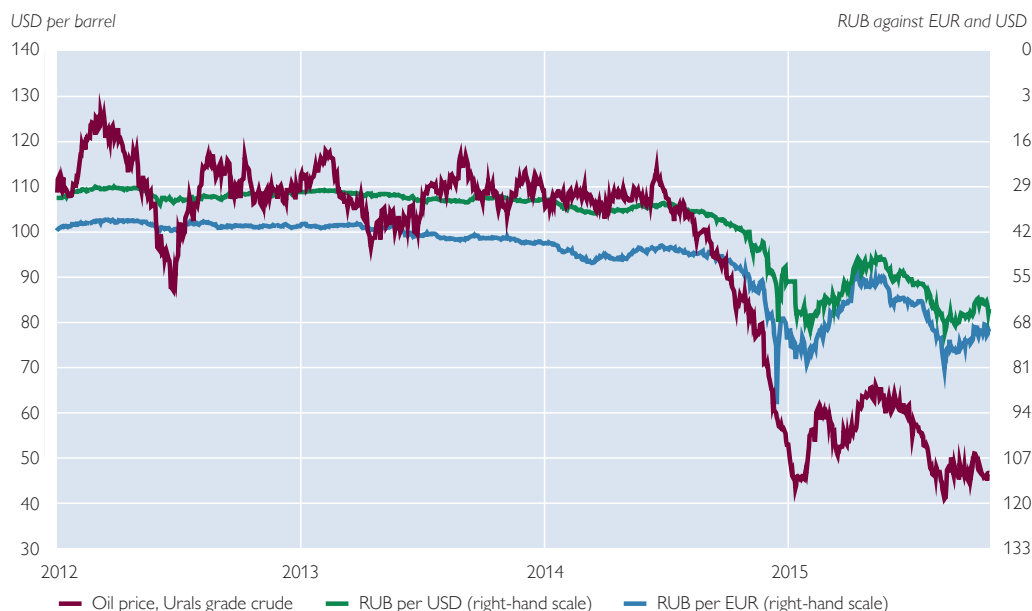
withdrawals (see section 2) in December 2014, the situation in the Russian foreign exchange market restabilized. This was partly due to the Bank of Russia's significant tightening of monetary policy, particularly its hefty increase of the key interest rate (the repo auction rate) by 6.5 percentage points to 17% in mid-December 2014. Restabilization was partly also attributable to the temporary recovery of the oil price (back to about USD 60–65 per barrel in May and June 2015), which helped the ruble regain some lost territory as well. However, practically all of this territory was lost again in July and August, when the oil price slid back to below USD 50 per barrel (chart 1).

The worsening of Russia's terms of trade and the uncertainty triggered by the sanctions weakened investment activity and pushed the country into recession: GDP shrank by 3.7% in January–September 2015 (year on year). Given this adverse environment, a possible further destabilization of the economy was prevented by the authorities' multifold crisis-response policies, which include the move to a fully flexible exchange rate regime, which was brought forward to mid-November 2014 (instead of January 2015 as originally planned);³ the Bank Capital Support Program (see below); and the partial anti-cyclical loosening of the traditionally rather tight fiscal stance.

Helped by the calming of financial markets and by the partial recovery of the ruble (from February 2015), the Bank of Russia decided to gradually reduce the key interest rate again (so far

³ *The Bank of Russia declared that from November 10, 2014, it would no longer intervene to support the currency unless financial stability was in danger. Interventions to support the ruble did follow, namely in December 2014 and January 2015. Amid lower hydrocarbon prices, a more flexible exchange rate served as a partly-offsetting buffer for extractive enterprises' profits and for the state budget's revenues (expressed in rubles).*

Chart 1

Russia: oil price and ruble exchange rates

Source: Thomson Reuters.

in five steps by 6 percentage points to 11.0%) in order to combat the deepening recession. Climaxing in March at 16.9%, CPI inflation (year on year) subsequently eased, but remained relatively high through November (at around to 15%). From May to July, the Bank of Russia carried out foreign currency purchases to shore up foreign exchange reserves. Yet the renewed decline of the oil price and the weakening of the ruble caused the Bank of Russia to suspend these purchases. Since April, foreign currency reserves (including gold) have stabilized and slightly recovered, running to EUR 344 billion at end-November 2015. Largely depending on oil price developments, the Russian recession has probably reached its trough in the second half of 2015, before it might ease in 2016.

2 Banking development: from excessive retail credit growth (late 2013) to general credit contraction (2014–15)

In late 2013 and early 2014, dynamic Russian banking activity, largely driven by excessive retail credit growth, was slowing down. The annual growth rate of total lending (to resident sectors, excluding interbank loans) eased from 14% in 2012 to 10% in 2013 (in real terms, exchange rate-adjusted, see chart 2). The expansion of retail lending declined from 31% to 21%; at the same time, the share of household credits in total credits increased slightly to about one-third, as table 1 shows. The reasons for the slowdown of (retail) credit growth included the weakening of GDP growth (from 3.4% in 2012 to 1.3% in 2013) as well as some prudential measures taken by the Bank of

Russia in 2013 that focused on reining in unsecured consumer lending, which had expanded to more than half of total retail loans.⁴

While credit growth (in real terms and exchange rate-adjusted) continued to slacken, albeit modestly, in the first half of 2014, deceleration gained momentum in the second half and turned into contraction in 2015. This was caused by a number of factors (some of them already mentioned above):

- Western financial sanctions imposed in the summer of 2014 cut off leading banks and enterprises from cheap refinancing and further weakened the investment climate and growth prospects in Russia.⁵
- The precipitous fall of the oil price and major deterioration of the terms of trade (particularly in late 2014), whose effect cascaded throughout the economy (on incomes, consumption as well as investment), was the most important factor leading from anemic GDP growth in 2014 (0.6%) into recession in 2015 (January–September: –3.7% year on year).
- The plunge of the ruble and the jump of inflation in December 2014 prompted the Bank of Russia to raise the key rate sharply (from 10.5% to 17%), which in turn also pushed up lending rates in the real economy, even if by less than originally expected or with a delay.⁶

Now spearheaded again, but in the opposite sense, by decelerating and then shrinking retail lending (+12% by end-June 2014, +1% by end-2014, –18% by end-October 2015, year on year), overall credit activity went into contraction (+7%, +2%, and –11% in the analogous periods; see chart 2).⁷ The depreciation of the ruble had a considerable impact on the share of foreign currency-denominated loans in total loans (mid-2014: 12%, end-October 2015: 21%; see table 1). In Russia, foreign currency loans are strongly concentrated in loans to enterprises (where the share of foreign currency loans expanded from 18% to 30% in the above time span).⁸ As far as they are exporters, corporations can be expected to possess hedges for an important part of their foreign exchange risk. However, regarding industries such as construction, trading and transportation, experts estimate that 30%–50% of these sectors' loans go to borrowers without stable foreign exchange revenues (Ulyanova et al., 2015, p. 6). Households, which are also often unhedged in this respect, have only taken up 2%–3% of their loans in foreign currencies. Thus, the problem of unhedged retail foreign currency credit borrowers running into trouble after a strong devaluation – repeatedly encountered in other CESEE countries – does not apply to Russia.

⁴ For more details on these measures, see Barisitz (2013a, p. 94).

⁵ Yet sanctions indirectly also supported domestic lending in that Russian companies that had lost access to Western financial markets redirected some credit demand to the (more expensive) home market (Fitzgeorge-Parker, 2015, p. 82).

⁶ In any case, in Russia banks on average only finance about 10%–15% of total investment; more than 50% comes from retained earnings, which however, have also suffered from the recession (Sapir, 2015).

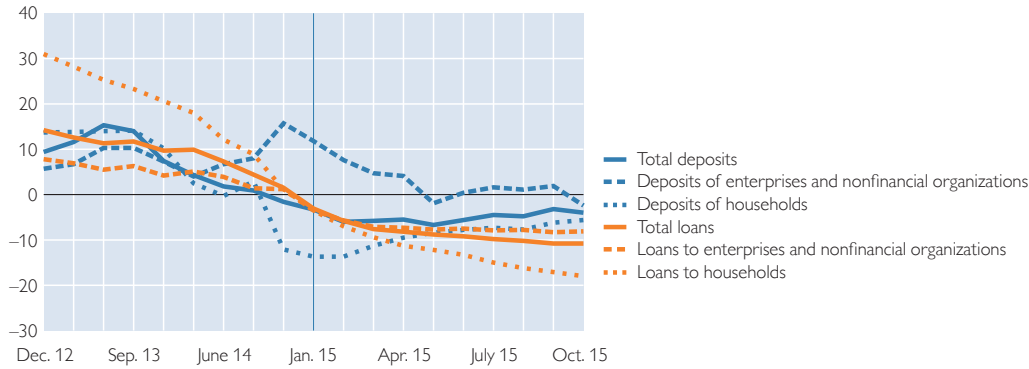
⁷ Only measured in exchange rate-adjusted, but not deflated, terms, total lending still increased 3% in the year to end-October 2015.

⁸ Foreign currency-denominated loans even made up about 45% of the loan stock of the top ten Russian corporate borrowers as at end-September 2015 (BOFIT, 2015).

Chart 2

Growth of bank deposits and loans

Real, year on year, exchange rate-adjusted, %, resident sectors excl. interbank



Source: Bank of Russia.

However, given the continuing recession, the lack of new lending, the plunge of the ruble, and aggravating problems for existing unhedged borrowers, Russia is grappling with swelling nonperforming loans (NPLs): The NPL ratio according to the narrow definition rose from 6.0% of total loans at end-2013 to 8.3% at end-September 2015. The NPL ratio according to the broader definition increased from 12.9% to 16.2% (table 1).⁹ Thus, credit quality has declined to levels last witnessed in the 2008–9 crisis. The buildup of loan loss provisions has been somewhat lagging behind NPLs of the narrow definition; at end-September 2015, the former attained 7.6% of the value of total loans.¹⁰

The slowdown, and shrinkage, of credit in the second half of 2014 and in early 2015 is well visible in the decline of the loan-to-deposit ratio from about 130% in early 2014 to 112% at end-October 2015. While the shock of the ruble's accelerated drop in early December 2014 had triggered short-lived bank runs and retail deposit withdrawals,¹¹ the Bank of Russia's sizable key rate adjustment in the middle of the month followed by commercial banks' strong hikes of deposit interest rates, as well as the State Duma's swift passage of legislation that raised the maximum deposit insurance coverage from RUB 700,000 (about EUR 10,000 at the time) to RUB 1.4 million, contributed to calming the situation again.

⁹ For details about the respective narrow and broader NPL definitions, see explanations in footnotes 2 and 3 of table 1. For a more elaborate discussion of these matters, see Barisitz (2013b).

¹⁰ This merits a note of caution: given recent Bank of Russia regulatory forbearance measures, the reported risk-weighted assets may not (fully) correspond to their market value. See also table 1.

¹¹ During the month of December 2014, household deposits shrank by more than 3% (in real terms and exchange rate-adjusted). These outflows partly financed a buying spree targeting consumer durables, cars and even apartments, in which Russian households effectively replaced some pecuniary savings with in-kind savings, which, it was rightly hoped, would provide a hedge against a burst of inflation anticipated at the time.

Table 1

Russia: selected banking sector stability indicators

	End-2012	End-2013	End-June 14	End-2014	End-March 15	End-June 15	End-Sep. 15
Credit risk							
Total loans (to resident sectors excl. interbank, ratio to GDP, %) ¹	42.3	47.0	47.5	53.6	53.2	51.8	54.6
Total loans, annual real growth, exchange rate-adjusted, %	+14.2	+9.7	+7.3	+1.5	-7.6	-9.2	-10.8
Loans to households (share in total loans, %)	29.3	32.0	32.2	29.7	28.9	28.6	27.3
Nonperforming loans (% of total loans incl. interbank, narrow definition) ^{2,10}	6.1	6.0	6.5	6.8	7.5	8.2	8.3
Nonperforming loans (% of total loans incl. interbank, broader definition) ^{3,10}	13.4	12.9	13.6	13.6	15.5	16.2	16.2
Ratio of large credit risks to total banking sector assets, % ^{4,10}	25.8	25.1	26.2	25.1	25.5	25.2	26.1
Market and exchange rate risk							
Loan-deposit spread (short-term retail deposits – medium- and long-term corporate loans)	5.0	5.5	6.3	0.7	5.5	5.5	5.4
Loan-deposit spread (short-term retail deposits – medium- and long-term retail loans)	13.6	12.2	12.2	5.1	10.9	9.9	9.7
Foreign currency loans (share in total loans, %)	12.3	12.9	12.3	18.3	19.8	19.5	22.2
Foreign currency loans to enterprises (share in loans to enterprises, %)	16.5	18.6	17.8	26.0	27.8	27.3	30.5
Foreign currency loans to households (share in loans to households, %)	3.1	2.3	1.9	2.6	2.6	2.3	2.6
Foreign currency deposits (share in total deposits, %)	17.9	19.1	21.2	29.6	30.5	29.1	32.4
Liquidity risk							
Total deposits (from resident sectors excl. interbank, ratio to GDP, %) ⁵	34.1	37.1	36.8	43.3	43.3	43.5	48.4
Total deposits, annual real growth, exchange rate-adjusted, %	+9.4	+7.4	+1.8	-1.6	-5.8	-5.6	-3.2
Loan-to-deposit ratio, %	124.2	126.5	129.1	123.8	122.9	119.1	112.8
Ratio of highly liquid assets to total assets, %	11.1	9.9	11.1	10.4	11.2	11.1	11.3
Banks' external assets (share in total assets, %) ⁶	13.0	13.2	13.8	13.7	15.0	15.4	16.4
Banks' external liabilities (share in total liabilities, %) ⁷	10.8	10.3	9.7	10.5	9.8	9.1	9.4
Liabilities to the Bank of Russia (share in banks' total liabilities, %) ⁸	5.4	7.7	8.7	12.0	10.2	9.4	7.3
Profitability							
Return on assets, % ¹⁰	2.3	1.9	1.7	0.9	0.5	0.3	0.0
Return on equity, % ¹⁰	18.2	15.2	13.6	7.9	4.8	2.4	0.4
Shock-absorbing factors							
Capital adequacy ratio (capital to risk-weighted assets, %) ¹⁰	13.7	13.5	12.8	12.5	12.9	12.9	13.0
Tier 1 capital ratio N 1. 2 (Basel III) ¹⁰	8.5	9.1	9.2	9.0	9.1	9.1	9.1
Loan loss provisions (ratio to total loans, %) ¹⁰	6.1	5.9	6.2	6.5	7.1	7.5	7.6
Claims on the Bank of Russia (share in banks' total assets, %) ⁹	4.4	3.9	3.3	4.2	3.2	2.9	2.7
Memorandum items							
Total banking sector assets (ratio to GDP, %)	79.6	86.7	88.5	109.4	105.2	101.9	109.9
RUB/USD (end of period)	30.37	32.73	33.63	56.26	58.46	55.52	66.24
RUB/EUR (end of period)	40.23	44.97	45.83	68.34	63.37	61.52	74.58
CPI inflation (year on year, end of period)	6.6	6.5	7.8	11.4	16.9	15.3	15.7

Source: Bank of Russia, OeNB calculations.

¹ Loans and other placements with nonfinancial organizations, government agencies and individuals.² Share of problem loans (category IV) and loss loans (category V) according to the Bank of Russia Regulation no. 254-P (Bank of Russia, 2004).³ Share of doubtful (category III), problem (category IV) and loss loans (category V) according to the Bank of Russia Regulation no. 254-P (Bank of Russia, 2004).⁴ Large borrowers are those with loans exceeding 5% of their regulatory capital.⁵ Deposits and other funds of nonfinancial organizations, government agencies and individuals.⁶ Funds placed with nonresidents including loans and deposits, correspondent accounts with banks and securities acquired.⁷ Funds raised from nonresidents including loans from foreign banks as well as deposits of legal entities and individuals.⁸ Loans, deposits and other funds received by credit institutions from the Bank of Russia.⁹ Accounts with the Bank of Russia and authorized agencies of other countries.¹⁰ Data for 2015 are subject to regulatory forbearance measures and therefore may not be fully comparable with previous data.

While household deposits had still expanded 10% at end-2013 (in real terms and exchange rate-adjusted, year on year), they were flat in mid-2014, shrank 12% by end-2014, and recorded a smaller decline, namely of 6%, at end-October 2015.

Growth of enterprise deposits, particularly in the second half of 2014, offset part of the decrease of retail deposits: As depicted in chart 2, total deposits still grew 2% by mid-2014, decreased 2% by end-2014, and were 4% below the year-earlier figure at end-October 2015. The referred-to expansion of enterprise deposits could mean that large SOEs followed the government's recommendation to increase their accounts; but this essentially appears to have been a one-off measure in late 2014. Largely due to revaluation effects, the share of foreign exchange deposits in total deposits rose from 19% at end-2013 to 32% at end-October 2015.

3 What have the Bank of Russia and the government done so far to stabilize the banking sector?

Apart from the above-mentioned adjustment of deposit insurance coverage, the authorities' efforts to stabilize the banking sector comprised liquidity injections, capital support and regulatory forbearance:

- The Bank of Russia temporarily stepped up financing of banks, including the provision of foreign exchange through foreign exchange

repos.¹² Thus, banks' liabilities to the monetary authority grew from below 8% of their total liabilities in early 2014 to 12% at the end of the year, and thereby reached a level equaling the peak attained during the financial crisis of 2008/09, before declining again to 7% at end-September 2015 (table 1).

- Another important step was the State Duma's approval in late December 2014 of a law on recapitalizing banks with a total sum of RUB 1 trillion, later reduced to RUB 840 billion (or about EUR 12.5 billion), which corresponds to around 13% of the sector's aggregate capital, via the Deposit Insurance Agency (DIA). Within the framework of this Bank Capital Support Program, 27 large credit institutions (each possessing at least RUB 25 billion in capital, excluding Sberbank) were assigned the highest funding priority, followed by other banks directly or indirectly affected by sanctions, and top regional lenders. The capital support has been delivered through the budget and financed through the sale of federal bonds (Obligatsii federal'nogo zaima – OFZs).¹³
- The State Duma also passed a bill allowing the government to invest up to 10% of the National Welfare Fund (NWF, i.e. about EUR 6.5 billion) in subordinate deposits and bonds of banks in order to support financing of large infrastructure projects.¹⁴ Moreover, the Bank of

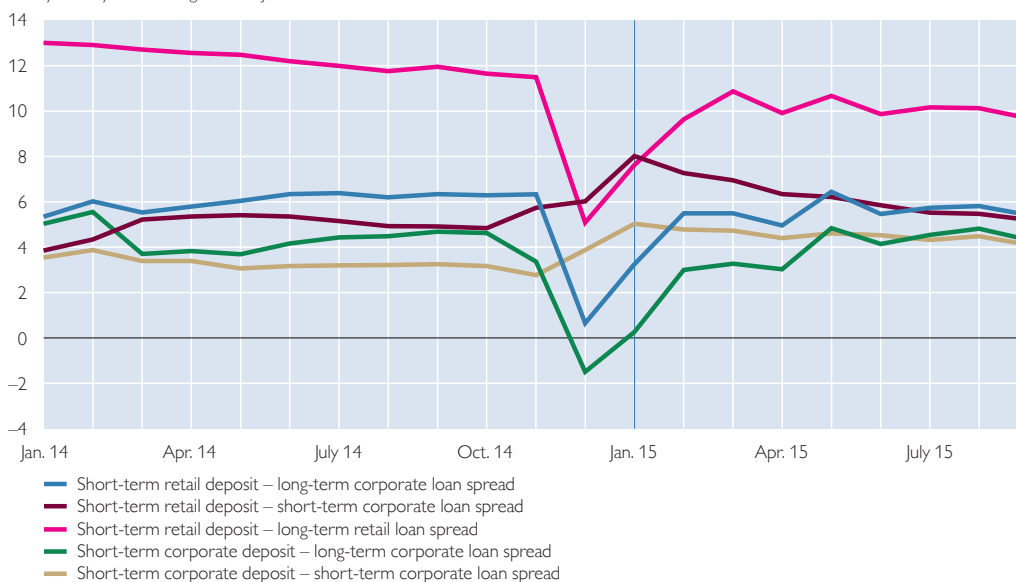
¹² The monetary authority created, and commercial banks intensively used, instruments for foreign currency liquidity supply, such as foreign currency repurchase credit and swap arrangements. This was, of course, greatly facilitated by the Bank of Russia's decision to float the ruble.

¹³ As of September 2015, eleven credit institutions had reportedly been recapitalized at a total cost of RUB 599 billion (about EUR 8 billion) (World Bank Group, 2015, p. 18).

¹⁴ As of September 2015, RUB 64 billion (about EUR 900 million) in NWF assets had actually been deposited in banks (World Bank Group, 2015, p. 19). Altogether, the authorities are reported to have earmarked up to 15% of GDP in budgetary and nonbudgetary funds to maintain liquidity and support capitalization in the major banks. This is comparable to the support provided in the crisis of 2008/09 (Standard&Poor's RatingsDirect, 2015a, p. 6).

Growth of bank deposits and loans

Real, year on year, exchange rate-adjusted, %, resident sectors excl. interbank



Source: Bank of Russia.

Note: The spreads are based on ruble-denominated loans and deposits.

Russia is authorized to support Sberbank with subordinate deposits, loans or bonds amounting to up to 100% of its capital, if necessary (IMF, 2015a, p. 16). Budget and NWF means are also used to support systemically important companies and strategic SOEs, which of course may facilitate their repayment of bank loans.

- Finally, the Bank of Russia has allowed banks some flexibility in classifying overdue loans and in provisioning (inter alia by applying October 1, 2014, exchange rates to foreign currency-denominated assets and liabilities, subsequently adjusted to more devalued, more realistic levels).¹⁵ This is based on the expectation that difficult times and losses will be temporary. But it implies that in reality NPLs are

likely to be higher than reported, and that the health of the banking sector as measured by prudential indicators may be overstated.

The crisis has left its mark on the sector's profitability. At least initially, the most important factor squeezing profits has been tightened net interest margins caused by three factors: (1) increased refinancing costs as a (direct and indirect) consequence of the Western financial sanctions, (2) increased deposit rates following the ruble slump-triggered hoisting of the key rate (in December 2014), and (3) limited room for lending rate hikes because of the economy's slide into recession. While the step-by-step reduction of the key rate from early 2015 has contributed to loosening the margin again, the situation remains delicate because of the deepening economic downturn

¹⁵ In September 2015, such allowable exchange rates were moved from 45 to 55 RUB/USD and from 52 to 64 RUB/EUR.

(Bank of Russia, 2015a, p. 44; Triebe, 2015a, p. 17; Triebe, 2015b, p. 10). Chart 3 shows sharply declining, and then only partly recovering, loan-deposit spreads (as based on ruble-denominated figures). Rising loan loss provisions are also increasingly weighing on profitability. This is also true for Austrian banks (see below).

While return on equity was still satisfactory in mid-2014 (13.6%), it fell sharply in the following months (end-2014: 7.9%, end-September 2015: 0.4%). After the banking sector's capital adequacy had declined from 13.5% at end-2013 to 12.5% a year later¹⁶, it recovered somewhat to 13.0% at end-September 2015 (table 1). This recovery was certainly due to the above-mentioned recapitalization steps, but to some degree the consequences of regulatory relaxations have to be factored in too.¹⁷ The authorities plan to eliminate forbearance rules from January 2016. Russian credit institutions continue to boast a net investor posi-

tion. Against the backdrop of the sanctions and with forced deleveraging, Russian banks' net external assets most recently rose to 7% of their total assets.

Due to particularly cautious credit stances and to selective divestment in the crisis environment, the share of majority foreign-owned banks in total sector assets gradually declined from 15.3% at end-2013 to 12.6% at end-September 2015. Foreign-owned banks have boasted above-average profitability. Some have reportedly profited from the downturn of the ruble, others from the relatively high interest rates (Karwacki 2015). SOBs, in contrast, have maintained and even further increased their predominance in the sector. The share of majority state-owned banks rose slightly to about 55% of total banking assets at end-2014. This can be explained inter alia by SOBs' preferential access to public assistance and by some crisis-triggered takeovers of weaker institutions.¹⁸

¹⁶ This decline was inter alia influenced by the Bank of Russia's introduction of the stricter Basel III capital requirements (see Barisitz, 2013a, p. 97).

¹⁷ According to expert estimates, the contribution of the government's crisis-response measures to the recovery of the capital adequacy ratio came to 1.2 percentage points (Vasileva, 2015, p. 3). At the same time, in the view of the Bank of Russia, forbearance measures have helped save up to 2 percentage points on capital adequacy levels (IMF, 2015b, p. 8).

¹⁸ For a comparison of the efficiency of public, private and foreign-owned banks in Russia, see Mamonov and Vernikov (2015).

Austrian banks' activities in Russia

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Russia is an important market for Austrian banks (in foreign and domestic ownership). They operate three subsidiaries there, whose aggregate total assets came to EUR 33 billion in the first half of 2015. This amount corresponds to 11% of the total assets held by Austrian banks' subsidiaries in CESEE. Thus, in terms of total assets, the exposure toward Russia is the third largest after the Czech Republic (EUR 67 billion) and Croatia (EUR 35 billion). The claims of Austrian banks on Russia (relative to home country GDP) have remained among the highest in Europe. Also, at about 3%, they hold a significant market share given that the market share of all fully foreign-owned banks in Russian banking sector assets amounted to around 7% at end-August 2015 (FitchRatings, 2015, p. 6).

The loan book of Austrian subsidiaries in Russia is dominated by corporate loans (75%). In recent years, lending to households has grown at a higher pace, however. As of end-June 2015, total loan growth stagnated (year on year). Credit quality measured by the nonperforming loans ratio worsened by nearly 2 percentage points (year on year) to 6.3% in the second quarter of 2015.

The net profit of Austrian banks' subsidiaries in Russia weakened markedly from high levels, namely by almost 30% year on year, in the first half of 2015. The main drivers of this deterioration were the weak operating environment (a slowdown in credit growth, the need for substantially higher loan loss provisions, higher funding costs, and compression in interest margins) and the ruble depreciation. Despite the strong reduction, profits from Russia remained the second-largest contribution (after profits from the Czech Republic) to the aggregated net result of Austrian banks' subsidiaries in CESEE and they are still above the respective average.

Overall, the outlook for banks in Russia remains weak, given the pressure arising from the economic downswing and the turn in the credit cycle.

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In early 2015, the Bank of Russia carried out banking sector stability stress tests, proceeding from end-2014 banking data and assuming as a scenario a serious worsening of external economic conditions, including a decline of the oil price to USD 40 per barrel and a GDP contraction of 7%. The stress tests factor in the above-mentioned recapitalization measures. As a result of the sharp economic deterioration, the ratio of "bad" loans is assumed to more than double to 18% of total loans. The overall capital adequacy ratio would decline from 12.5% (end-2014) to 10.9%, which is still above the minimum ratio of 10%; yet about 190 banks (comprising 43% of total assets)

would not be able to meet the minimum ratio and would feature a total capital shortage of around EUR 10 billion. The retail deposit volume could shrink 4% (in real terms). The sector would probably dip into the red (featuring losses of up to EUR 5 billion) (Bank of Russia, 2015b, pp. 53–56). Given the most recent (July–August 2015) decline of the oil price below USD 50 per barrel, the described downside scenario does not seem that far removed from reality.

Not necessarily directly related to the above crisis, the Bank of Russia – equipped with enhanced supervision authority since mid-2013 – has tightened supervisory activities and has been

quite active in attacking practices of “connected” or “related-party lending”¹⁹. Thus, licenses of many small, and some medium-sized, banks that were found to adhere to extremely risky business models or to engage in fraudulent practices, e.g. money laundering, were withdrawn. In a number of cases, the reasons cited included financial issues such as undercapitalization or insolvency.²⁰ This “cleaning up campaign” as well as bank mergers contributed to the decline of the number of banks from end-2013 to end-October 2015 by 166 or 18% to 757.

4 Assessment of current Russian banking risks and shock-absorbing factors

Salient risks affecting the banking sector currently include credit risk, liquidity and refinancing risk, exchange rate risk, and connected lending risk (structural risk).

4.1 Credit risk

Nonperforming loan ratios have grown markedly until end-September 2015 – to 8.3% according to the narrow definition, or 16.2% according to the broader definition. These ratios are,

respectively, one-quarter or one-fifth higher than they were a year ago – which may understate the actual expansion – due to forbearance. With the continuing recession in the second half of 2015 and the lackluster economic recovery to be expected later, NPL ratios are likely to swell further, before they eventually stabilize or decline.²¹ Perhaps a trace of a silver lining can be perceived in the fact that Sberbank in October 2015 announced a reduction of its interest rates on new consumer loans.

4.2 Liquidity and refinancing risk

With the likelihood that Western sanctions remain in place at least until 2016 or for the foreseeable future, pressure on large banks’ and enterprises’ refinancing channels and liquidity supply may become a long-term component of the Russian banking environment.²² No more large disruptive foreign debt payment deadlines (like in December 2014) can be expected in the coming years (except perhaps in December 2015, when total scheduled debt service payments come to about two-thirds of their amount of December 2014)²³. While overall debt service

¹⁹ As explained in Barisitz and Lahnsteiner (2010, p. 84), “connected lending” or “related-party lending” is typically conducted through “pocket banks” that function as extended financial departments or treasury accounts of owner firms or businessmen. Possibly to conceal this, beneficiary ownership relationships tend to be arranged in an opaque manner.

²⁰ As a result of these stepped-up activities, in the summer of 2015, the DIA was reported to have almost exhausted its funds in compensating depositors of failed banks. But, if needed, the DIA can claim public financial support.

²¹ In the specific case of a further substantial deterioration of the economic situation in Ukraine, the direct impact on Russian banks would be limited, since the most important Russian banking groups feature an aggregate exposure to Ukraine of less than 3% of their total assets (Standard&Poor’s RatingsDirect, 2015b, p. 2).

²² While enterprises’ refinancing problems do not directly affect banks, roll-over risk of enterprises can turn into credit risk for banks, and firms’ increased demand for foreign currency can push up exchange rate risk.

²³ According to information of the Bank of Russia, Russian commercial banks are due to make about EUR 4.4 billion of principal and accrued interest payments in December 2015, and EUR 22.2 billion in the entire year 2016. Russian corporations are slated to make payments, respectively, of EUR 15.8 billion and EUR 58.8 billion. Not all of these payables are denominated in foreign exchange. About one-tenth of banks’ external debt and one-fifth of corporations’ external debt constitute ruble liabilities. Moreover, at least one-third of corporations’ debt service payments are estimated to pertain to “intra-group operations,” which (according to experience) feature a higher likelihood of being rolled over. Finally, stable indebtedness data for the second quarter of 2015 suggest that Russian corporations actually managed to get at least part of their other external debt refinanced in international markets too.

appears bearable, restricted access to EU and U.S. capital markets will continue to dampen banks' earnings and profitability and render them financially more fragile.

4.3 Exchange rate risk

The Russian economy and the ruble remain extremely sensitive and vulnerable to oil price movements. After plunging in December 2014/January 2015 and partially recovering in the spring of 2015, the oil price and the ruble dropped again substantially and highly synchronically in July and August 2015 (almost reaching their low points of late January). However, a panic reaction of depositors like in December 2014 did not happen. The authorities' above-mentioned crisis-response measures certainly contributed to this outcome. Still, the situation remains fragile and a further slump of the oil price to a new low, which cannot be excluded, could rattle confidence anew.

4.4 Connected or related-party lending risk

While, as mentioned above, in recent years, connected lending activities of many smaller and some medium-sized banks have been reined in or eliminated by Bank of Russia intervention, such practices can also exist in larger credit institutions. It cannot be excluded that underlying structural financial problems unexpectedly "erupt" in a systemically important institution, which cannot be simply wound up. As already documented by painful experience,²⁴ bailouts or recapitalizations in such cases can be very costly.

4.5 Shock-absorbing factors

Shock-absorbing factors have eroded in recent years, but still provide leeway. Depending on the NPL definition, loan loss provisions are at best partly adequate to cover loans that have turned bad. While capital adequacy – following bank recapitalization measures in early 2015 – appears sufficient at present, the continuing economic downturn and lackluster prospects thereafter imply that in all likelihood further capital injections will become necessary soon. However, raising state liabilities for this purpose should not be a problem because Russian state debt (domestic and foreign) continues to be modest (as of mid-2015: about 15% of GDP).

Given the credit contraction and the boost of enterprise deposits in late 2014, the loan-to-deposit ratio has declined again from previous levels and is currently not excessive (end-October 2015: 112%). While depositors are still sensitive to exchange rate and inflation movements, a degree of confidence seems to have returned to household depositors recently: retail savings have somewhat recovered since early 2015 (+4% in real terms and exchange rate-adjusted from end-January to end-October 2015).²⁵ Another factor providing a cushion are credit institutions' net external assets, which were built up in the post-2008/09-crisis years and at end-September 2015 amounted to 7% of total assets (table 1). Moreover, the fact that SOBs account for the majority of Russian banking assets (with Sberbank comprising more than a quarter) implies that the authorities are directly responsible for the

²⁴ As a case in point, in 2011, Bank Moskv (Bank of Moscow), Russia's fifth-largest credit institution at the time, had become insolvent. The insolvency was reportedly linked to dubious real estate investments and credit fraud. The bailout package of EUR 9.8 billion was the largest for any bank in CESEE history.

²⁵ Over the summer of 2015, inflows of savings into long-term deposits grew again (after they had sharply declined at the beginning of the year), while growth of short-term deposits slowed down (Bank of Russia, 2015c, p. 22).

survival of most of the largest players, which may generate some confidence in crisis times.

Enhanced ruble exchange rate flexibility appears to have on balance strengthened the Bank of Russia's hand in crisis times in that the monetary authority should no longer risk losing substantial amounts of foreign exchange reserves (as it did in 2008/09 and again in 2014) in defending an exchange rate that has become unsustainable. In any case, Russia's foreign currency reserves (including gold), while having declined substantially (at end-2013 they had still stood at EUR 372 billion), remain sizable and have somewhat recovered recently (end-November 2015: EUR 344 billion or about 25% of GDP or 13 import months). Notwithstanding the deteriorated terms of trade, Russia's current account surpluses continue to be high (3.2% of GDP in 2014, about 5.5% of GDP in January–September 2015). Finally, the country registers a positive and large net investor position (about 18% of GDP).

5 Outlook

Save any surprising major negative event, like a severe escalation of the geopolitical tensions in Ukraine triggering further Western sanctions on Russia (unlikely, at least at the moment), a systemic crisis of the Russian

banking sector is not to be expected in the near future. Admittedly, the Russian recession in 2015 is pushing up nonperforming loans and loan loss provisions, which will put a drag on any revival of credit activity. The volatility and overall weakness of oil and other commodity price developments can create additional instability and also retard the recovery. In the full year 2015, the sector may be barely profitable. Some further recapitalization measures of stressed credit institutions are likely to be needed in the future. Confidence in the sector is fragile, but existent. While a number of shock-absorbing factors, as mentioned above, have weakened, and the government's capacity to provide financial support has become more restrained, the authorities still have important means at their disposal to support banks: public debt is low, and foreign currency reserves remain sizable. Banks' recovery will probably follow the recovery of the real sector. While the recession is expected to ease in 2016, economic growth is only expected to return in 2017. In an environment of widespread uncertainties, Russian economic expansion will probably be subdued in the coming years, which implies that banks may take an extended period to fully recover.

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