European banks in Russia: developments and perspectives from 2017 through the COVID-19 pandemic (2020/2021)

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Russia's recent economic growth has been supported by the country's banking sector, including the European banks operating in the market. While Russia's pre-pandemic GDP growth had suffered from a weak investment climate, oil price volatility and sanctions, the strong financial buffers built up in recent years were an asset for the country and its banking system during the pandemic-triggered recession. The European banks that qualify as significant institutions (Raiffeisenbank Russia, Rosbank/Société Générale and UniCredit Bank Russia), while pursuing different strategies, have remained committed to the Russian market. During the crisis, banking and economic activity were supported by temporary regulatory forbearance with respect to asset (loan) valuation and provisioning as well as the central bank's key rate cuts and targeted government subsidies. European banks in Russia nevertheless keep facing exogenous risks, such as sustained compliance with sanctions regimes in a situation that remains volatile and sensitive to adverse geopolitical developments. Foreign currency fluctuations and the depreciation of the ruble require adequate risk management, and climate risk represents an emerging challenge. There is also strong competition driven by the digital transformation of banking. In March and April 2021, Russia's central bank raised its key policy rate again amid rising inflationary pressures and signs of incipient economic recovery. Once regulatory lenience and lending subsidies expire, the banking sector would in general appear sufficiently capitalized to cover a potential increase of loan losses and provisioning needs. This goes especially for the European banks in Russia, which tend to have better-than-average asset quality and a sound capital base, although their market environment is expected to remain challenging. Besides, generous reserves remain at the disposal of the authorities should financial problems emerge, a scenario whose implications remain untested in the case of European banks due to their resilient performance.

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How have the European banks that qualify as significant institutions in the Russian banking market[2] been performing in the past five years, including the first year of the COVID-19 pandemic? This article discusses the top trends observed in the period between 2017 and early 2021 and updates the review of recent developments in the Russian banking sector provided by Barisitz (2018). Trends which occurred before and during the crisis triggered by the COVID-19 pandemic are highlighted separately, in light of the magnitude of this crisis. Its wide-ranging

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[2] *These banks are referred to as "the European banks" in the article to facilitate reading.*

impacts on the Russian and global economy represent a major challenge for European banks in Russia. Section 1 presents the macroeconomic background and discusses the overall development of Russia's banking sector ahead of the COVID-19 crisis from 2017 to March 2020. Section 2 explores how European banks in Russia fared in this period. Section 3 analyzes the main COVID-19 pandemic impacts on the economy and the banking sector since March 2020, with section 4 focusing on the effects on the European banks operating in Russia. Section 5 gives an assessment of current Russian banking risks and shock-absorbing factors, particularly as far as the European banks are concerned, as the crisis has put their market presence and strategy into question. Finally, section 6 wraps up with an outlook.

1 Pre-pandemic macroeconomic conditions and banking sector developments (2017 to March 2020)

1.1 Macroeconomic developments: modest growth amid sanctions, accompanied by the build-up of sizable financial buffers

For an emerging market, the Russian economy was growing at a modest rate of about 2% year on year on average (see table 1) from 2017 to the first quarter of 2020. This modest growth performance can be explained by a combination of factors: well-known long-standing structural weaknesses (difficult business climate, weak rule of law, vulnerabilities to corruption, large economic footprint of government) on top of Western sanctions and persistently tight fiscal and monetary policies. The government pursued prudent macroeconomic policies aimed at building up financial buffers to better protect the oil export-dependent economy from external shocks, including oil price gyrations and sanctions. Russia's fiscal rule[3] was instrumental in decoupling the exchange rate of the ruble from oil price changes. While Western economic sanctions imposed in 2014[4] increased uncertainty, weighed on the ruble and affected FDI inflows into Russia, the accumulation of substantial buffers over the years also bolstered the economy's shock resilience.

In recent years, Russian GDP growth was driven by domestic demand, mostly by private consumption and to a lesser degree by gross fixed capital formation. On the production side of GDP, growth continued to be fueled by resource extraction, manufacturing (notably automobile production), agriculture, and to a lesser degree by retail trade. Russia's unemployment rate (ILO definition) steadily declined to a post-Soviet historical low of 4.5% in early 2020. Monetary policy (inflation targeting since late 2014) remained cautious, also against the backdrop of high inflation expectations. The key policy rate of the Central Bank of Russia (CBR) – the one-week repo rate – was reduced from 7¾% in late 2017 to 6% in March 2020 – with a temporary upward correction by half a percentage point in late 2018 and early 2019 against the backdrop of intermittent ruble depreciation pressures. CPI inflation fell

[3] *Introduced in 2017, the fiscal rule applies a baseline Urals oil price assumption. When prices are above this assumption (e.g. USD 40/barrel in 2017 and USD 42/barrel in 2020), excess oil and gas revenue is transferred to the National Wealth Fund (NWF), which is primarily used to support the pension system. If oil prices are below the assumption, NWF drawdowns may be used to replace the government's revenue shortfall (subject to a drawdown cap of 5% of GDP below which the NWF's liquid assets must not fall).*

[4] *The strongest restrictive measures imposed include tight limits on access to EU and US capital markets and bank loans for large Russian state-owned banks and firms. As a consequence, many Russian banks and firms have been effectively cut off from financing on Western markets.*

from a peak of above 5% in early 2019 (due also to housing and communal tariff adjustments and a VAT increase) to 2.5% at end-March 2020 – substantially below the CBR's 4% target. Greater confidence in the Russian currency contributed to further de-dollarization.

Improved tax administration and pension reform (adjustment of retirement age) contributed to low budget deficits (2017) or budget surpluses (2018 and 2019). The latter held down government debt exposure and contributed to replenishing the National Wealth Fund, which expanded from about 4% of GDP at end-2017 to 11% of GDP at end-March 2020 (table 1). The Finance Ministry's forex purchase program carried out by the CBR in order to (further) strengthen the country's international reserve position helped keeping the ruble's exchange rate "competitive." This gave Russian oil and gas corporations, which operate on a ruble basis and whose revenues are (mostly) earned in US dollars, some advantages in terms of profitability over some of their competitors. Tight macroeconomic policies and the weak ruble caused the current account balance to remain in surplus, notwithstanding oil price volatility. The resulting twin surpluses – fiscal and current account, from 2018 to the first quarter of 2020 – as well as Western sanctions contributed to reining in gross external indebtedness, which declined from 31% of GDP in 2017 to 27% of GDP at end-March 2020. Meanwhile, gross international reserves (including gold) grew from 28% of GDP to 33%.

Table 1

Russia: selected macroeconomic indicators

	2017	2018	2019	End-March 2020	End-June 2020	2020	End-March 2021[3]
	%						
Real GDP growth (annual change)	1.8	2.8	2.0	1.4	–3.4	–3.0	–0.7
Inflation (CPI, end of period, year on year)	2.5	4.3	3.0	2.5	3.2	4.9	5.8
Unemployment rate (ILO definition, average)	5.2	4.8	4.6	4.7	5.4	5.8	5.8
Budget balance (general government, ratio to GDP)	–1.5	2.9	1.9	2.5	–1.7	–4.0	2.5
National Wealth Fund (end of period, ratio to GDP)[1]	4.1	3.9	6.9	11.3	10.7	11.7	11.8
General government gross debt (end of period, ratio to GDP)	12.6	12.0	12.3	13.8	14.0	16.0	16.2
Current account balance (ratio to GDP)	2.3	6.9	3.8	5.5	3.1	2.1	3.7
Net private capital flows (end of period, ratio to GDP)	–2.0	–3.8	–1.6	–4.3	–4.1	–3.1	–2.7
Gross external debt (end of period, ratio to GDP)	31.1	28.1	28.9	26.8	29.8	30.0	29.9
Gross international reserves (incl. gold, end of period, ratio to GDP)	27.5	28.5	32.6	33.0	35.1	38.2	37.6
CBR key rate[2] (end of period)	7.75	7.75	6.25	6.0	4.5	4.25	4.5
	Period average in USD or RUB						
Urals grade crude oil price (USD/barrel)	53.0	70.0	63.6	48.2	39.7	41.7	59.8
RUB per 1 USD	58.33	62.54	64.73	66.10	69.13	71.94	74.34
RUB per 1 EUR	65.87	73.87	72.51	72.90	76.20	82.04	89.70

Source: Rosstat, Central Bank of Russia, Ministry of Finance.

[1] The predominant part of this fund is also included in Russia's gross international reserves.
[2] The central bank's one–week repo rate.
[3] Preliminary data.

1.2 Continued banking sector stabilization and strengthening after the 2014/2015 crisis

Following the contraction of credit in 2015 and 2016 triggered by plunging oil prices and sanctions, lending to resident sectors, excluding the interbank sector, re-emerged as a driver of growth as the lending business expanded in 2017 and accelerated in 2018 through early 2020 (to +6.7% year on year, in real terms and exchange rate-adjusted, see table 2). The recovery was largely driven by retail loans, whose growth rate increased from 10% in 2017 to 15% in 2019 and the first quarter of 2020 (year on year, in real terms and exchange rate-adjusted). Across the lending spectrum, mortgage loans continued to meet high pent-up demand for housing but slowed down somewhat, partly due to CBR regulatory intervention. As a share of total household loans, mortgage loans, which had previously been expanding strongly from a relatively low base, hovered between 42% and 44% in the pre-pandemic years. Unsecured consumer lending, also subject to CBR regulatory intervention, expanded most strongly up to mid-2019. While the growth of unsecured consumer loans levelled off thereafter, such loans continued to make up about 50% of total retail credit in late 2019. Corporate loans, in contrast, moved from stagnation in 2017 (–1%) to modest growth in the following years (+3% in the first quarter of 2020, year on year). For households, foreign exchange risk is not really an issue, given that forex lending to households remains below 1% of retail lending. For enterprises, foreign exchange risk has been easing somewhat. In recent years, corporates have reportedly improved their forex risk-hedging capabilities (Fitzgeorge-Parker, 2020), and enterprises' forex lending exposure has declined slightly (to below one-fifth of loans).

Benefiting from high post-crisis real interest rates, deposits expanded markedly initially (+10% in 2017 in real terms and exchange rate-adjusted). Subsequently though, deposit expansion lost some steam (+4% at end-March 2020 year on year) in view of slowly declining real interest rates. With some variations due to exchange rate volatility, the share of forex deposits in total deposits remained slightly below one-quarter in this period (table 2), and the respective share in retail deposits hovered around one-fifth. In a remarkable development, government agencies stocked up their funds held at commercial banks from 5% to 8% of total deposits. The modest economic revival and the recovery of credit growth contributed to a drop in the ratio of nonperforming loans, from 10% (narrow definition) respectively 18% (broader definition, including doubtful loans)[5] at end-2017 to 9% respectively 16% at end-March 2020. Loan loss provisions have continued to be somewhat smaller than the volume of nonperforming loans when defined narrowly and continued to follow the latter's gentle decline. Thus, the loan loss provisions remain at slightly more than half the level of nonperforming loans when broadly defined.

Other areas also displayed stability or improvements over the pre-pandemic years. The banking sector's liquidity remained stable in 2017 and up to early 2020 (highly liquid assets to total assets at around 11%). The ratio of large exposures to total sector assets remained on a declining trend and shrank from about 25% to 20%. Not least due to sanctions and continuous deleveraging, banks' net external assets further rose to a record of 7.5% of total assets at end-March 2020 (table 2).

[5] *For details about the narrow and broader definitions of nonperforming loans, see explanations in footnotes 2 and 3 of table 2. For a more elaborate discussion of these matters, see Barisitz (2019), pp. 64, 70.*

After some banking turbulences, which had put pressure on profitability in 2017 (Barisitz, 2018, p. 61–64), banks' profits recovered again and grew dynamically in the following years, mainly driven by the largest banks, and buoyed by credit expansion and rising confidence. Thus, return on assets (ROA) as well as return on equity (ROE) approximately doubled from 2017 to 2019 (to 2.0%, respectively 19.5%). Meanwhile, banks' aggregate capital adequacy ratio remained above 12%.[6] At the same time, the modest share of (majority) foreign-owned credit institutions in banks' total assets slightly declined further (from 12% to 10%) in the above period.

1.3 Regulatory and other central bank measures to bolster banking sector recovery

As shown in table 2, the market share of directly or indirectly (majority) state-owned credit institutions (in total banking sector assets) rose from an already relatively high level of 62% in 2017 to 68% in 2018 and 69% in 2019 (Raiffeisen Research, 2020). The lion's share of assets is held by the three biggest banks (Sberbank, VTB and Gazprombank). They are followed by privately-owned banks (like Alfabank, Tinkoff Bank and Sovcombank) as well as other state-owned credit institutions. The jump to 68% in 2018 is related to public bailouts of medium-sized players in response to the turbulences of 2017. Thus, the CBR had acquired transitory ownership of failed Otkrytie Bank (which, in turn, had taken over failed B&N Bank in 2017)[7]; moreover, Promsvyazbank (that had also encountered serious difficulties in 2017) was nationalized. Since 2018, Otkrytie Bank has been recapitalized and restructured with money from the CBR's Banking Sector Consolidation Fund with the aim of later privatization. Promsvyaz has been converted into a specialized public credit institution servicing the defense industry and state procurement. Altogether, in 2017–2018, the CBR reportedly spent about USD 11 billion on recapitalizing failed system-relevant entities (Raiffeisen Research, 2019, p. 45).

Although household debt in Russia remains relatively low compared to other countries when measured as a ratio of GDP (about 16% in mid-2019), vigorous retail lending, notably mortgage loans and (up to mid-2019) unsecured consumer loans, substantially lifted households' debt burden in proportion to disposable income, which prompted the CBR to raise risk weights several times in 2018–2019. The CBR furthermore introduced surcharges to the respective risk coefficients from October 2019. This appears to have (temporarily) reined in the swift expansion of lending activity in the mortgage and consumer loan segments. Meanwhile, the CBR continued its cleanup of the banking sector (removing mostly smaller players featuring nonviable business models or fraudulent practices). Accordingly, the total number of operating credit institutions further declined from 561 at end-2017 to 434 at end-March 2020 (table 2). Moreover, in 2018, 149 banks with less than RUB 1 billion in terms of capital were relicensed with a more restrictive license under which they are prohibited from most foreign operations but subject to simplified regulatory requirements. Finally, the CBR phased in Basel III macroprudential buffers, gradually raising the capital surcharge for systemically important

[6] *The regulatory minimum capital adequacy ratio (N1.0) for credit institutions in Russia is 8.0% (CBR instruction no. 139-I).*

[7] *The merger of the two banks was completed in January 2019 (King, 2020).*

Table 2

Russia: selected banking sector stability indicators

	End-2017	End-2018	End-2019	End-March 2020	End-June 2020	End-Sept. 2020	End-2020
	%						
Credit risk							
Total loans (annual real growth, exchange rate-adjusted)[1]	+1.8	+6.2	+6.3	+6.7	+4.8	+4.7	+3.8
Loans to households (share in total loans)	31.1	33.6	36.9	36.4	36.6	36.9	37.7
Nonperforming loans (share of total loans, narrow definition)[2,7]	10.0	10.1	9.3	9.4	9.5	9.3	9.0
Nonperforming loans (share of total loans, broader definition)[3,7]	17.5	16.7	16.0	16.1	16.7	16.3	16.3
Market and exchange rate risk							
Foreign currency loans (share in total loans)	14.5	12.7	10.6	12.4	11.1	12.2	11.7
Foreign currency deposits (share in total deposits)	23.5	24.1	21.2	24.7	21.5	23.2	22.7
Liquidity risk							
Total deposits (annual real growth, exchange rate-adjusted)[4]	+10.1	+6.4	+5.3	+3.9	+2.4	+0.9	+1.7
Loan-to-deposit ratio	95.2	93.2	95.2	95.8	96.0	95.7	95.5
Banks' external assets (share in total assets)[5]	11.0	12.2	11.2	11.9	11.0	12.2	11.4
Banks' external liabilities (share in total liabilities)[6]	5.7	5.6	4.3	4.4	3.9	4.6	4.2
Profitability							
Return on assets	1.0	1.2	2.0	2.0	1.7	1.7	1.7
Return on equity	8.3	11.5	19.5	19.0	15.9	16.0	15.7
Shock-absorbing factors							
Capital adequacy ratio (capital to risk-weighted assets)[7]	12.1	12.2	12.3	12.2	12.8	12.7	12.5
Tier 1 capital ratio (Basel III)[7]	8.5	8.9	9.3	10.1	10.5	10.4	9.7
Loan loss provisions (ratio to total loans)[7]	9.3	9.1	8.7	8.8	9.0	9.0	8.9
Memorandum items							
Total banking sector assets (ratio to GDP)	92.8	90.6	88.4	94.6	96.1	103.5	105.5
Share of majority state-owned banks in total banking assets	61.5	68.0	68.6	.	.	.	.
Share of majority foreign-owned banks in total banking assets	12.3	9.6	9.5	10.2	10.0	9.8	.
Total number of operating credit institutions	561	484	442	434	427	417	406

Source: Central Bank of Russia, Raiffeisen Research, OeNB calculations.

[1] *Loans and other placements with nonfinancial organizations, government agencies and individuals (resident sectors, excluding interbank transactions). Annual credit growth adjusted for exchange rate effects by applying the same exchange rate to consecutive year-end balances. As the US dollar accounts for the lion's share of the foreign exchange credit portfolio, we use the USD/RUB exchange for the entire volume to simplify the calculation.*

[2] *Share of problem loans (category IV) and loss loans (category V) in total loans including interbank loans (according to CBR regulation no. 254).*

[3] *Share of doubtful (category III), problem (category IV) and loss loans (category V) in total loans including interbank loans (according to CBR regulation no. 254).*

[4] *Deposits and other funds of nonfinancial organizations, government agencies and individuals (resident sectors, excluding interbank transactions). Annual deposit growth adjusted for exchange rate effects by applying the same exchange rate to consecutive year-end balances. As the US dollar accounts for the lion's share of all foreign exchange deposits, we use the USD/RUB exchange for the entire volume to simplify the calculation.*

[5] *Funds placed with nonresidents, including loans and deposits, correspondent accounts with banks, securities acquired.*

[6] *Funds raised from nonresidents, including loans from foreign banks, deposits of legal entities and individuals.*

[7] *Some data starting in April 2020 may not be fully comparable with previous data due to the application of temporary regulatory forbearance measures aimed at cushioning the economic impact of the COVID-19 pandemic.*

banks between 2017 and end-2019 (from 0.35% to 1%) and the capital conservation buffer (from 1.25% to 2.5%).[8]

2 Pre-pandemic development of European banks in Russia (2017 to 2019)

2.1 Slightly increasing market presence, with differing underlying trajectories

In a market dominated by state-owned banks, European banks[9] slightly increased their footprint in Russia between 2017 and 2019 from 4.1% to 4.4% of sector

[8] *The CBR also introduced a countercyclical capital buffer, which however has been held at 0% of risk-weighted assets since its inception.*

[9] *Data used in the study for the European banks come from banks' regulatory reports subject to local Russian reporting standards unless specified otherwise. In other words, the data are not directly comparable with data based on IFRS or European reporting principles.*

assets[10] while many foreign peers strongly decreased their exposures and cross-border lending after the 2014 Crimea crisis. In these three years, the total assets of European banks grew by 20% in local currency (by 9% to EUR 53 billion[11] – see table 3), and their loan book by 22% (by 10% to EUR 33 billion). The share of non-ruble loans declined gradually from 32% to 20%, to the equivalent of EUR 6.4 billion, in line with de-dollarization patterns observed in Russia since the 2014 crisis. The three leading European banks covered in the study, which are the only foreign banks recognized as significant institutions in Russia,[12] remained committed to the market, accounting for around 70% of foreign banks' exposures.[13] One is Austrian (Raiffeisenbank Russia), one is French (Rosbank/Société Générale) and the other one is Italian (UniCredit Bank Russia). Notably, while being universal banks, these institutions have a different business mix and different business models. They also developed with different dynamics in the period. The external ratings with which they entered the COVID-19 crisis were similar to or slightly superior to those of most local market leaders.

2.2 Dynamic revenue growth, but profitability ratios facing some pressure

Ahead of the COVID-19 pandemic, the net interest income of European banks in Russia grew at a dynamic rate of 24% on a local currency basis from 2017 to 2019 (by 13% to EUR 2 billion when converted into euro). Their net fee and commission income grew at an even faster pace, namely 38% (or by 25% to EUR 630 million), representing 22% of the operating income of the European banks as of end-2019, with a slightly increasing trend. At the same time, however, European banks' net income declined by 3% in local currency terms (or by 12% to EUR 800 million), on the back of higher impairments, so that their share in profits generated by the Russian banking system gradually declined from 13% to 3%. At the same time, their cost-to-income ratio deteriorated slightly, from 50% to 52%, with strong disparities among the individual banks. Unlike their Russian peers and despite initial better performance, the European banks operating in Russia have seen their profitability ratios go down. On average, their ROE gradually declined by 2 percentage points to 13% in 2017–2019, subject to heterogeneity among individual banks, whereas for the banking system as a whole, ROE measures actually increased strongly on average, by 11 percentage points to 19%. In the same vein, the European banks' average ROA declined from 2.1% to 1.7%, while the system-wide ROA grew by 1 percentage point to 2.0%. Regarding liquidity, European financial institutions had a higher share of highly liquid assets out of total assets (25% on average) than state-owned banks (15%) or the banking system as a whole (20%).

[10] *This figure does not include head office financing of Russian corporates by holdings, which increases their total exposures to Russia.*

[11] *For the European banks, we use average yearly (not year-end) exchange rates to provide the euro equivalent for ruble-denominated amounts.*

[12] *As per the local methodology set by CBR ordinance no. 3737-U (July 2015). Based on 2020 data, 12 banks qualified as systemically important financial institutions, accounting for about 75% of total assets of the Russian banking sector.*

[13] *An international American bank (Citi) also maintained its activities. While its business is of a material size, its footprint is smaller than the one of the European banks, and it does not qualify as a significant institution in Russia. In 2021, Citi Bank announced plans to abandon its retail activities in in a number of other countries, including Russia, amid of a group-wide restructuring, signalling a misalignment of retail profitability with its new strategy.*

2.3 Improving credit quality, compliance with capital requirements ensured

Local currency impairment balances were mounting at the European banks in Russia ahead of the COVID-19 crisis (+80% to EUR 400 million during the 2017–2019 period when converted into euro), but developments were mixed (e.g. releases were required in different years by different banks), which makes comparisons between banks more difficult. Based on year-end loans, the cost of risk went from 82 basis points to 113 basis points on average, which was below the levels measured for state-owned banks (195 basis points in 2019) and the banking sector as a whole (258 basis points), reflecting a lower degree of risk-taking at European banks in Russia than among their domestic peers. Specific IFRS 9 impacts appeared in the financial statements for 2019 for the first time, with an overall positive impact on profit or loss for the European banks. Overdue installments were also on a decreasing trend, from 5% to 3% of loans on average in 2017–2019. Nonperforming loan levels continued to broadly decrease during the period for the European banks disclosing this information, yet with different trends regarding the coverage ratios for nonperforming loans.

As outlined above, capital requirements were tightened by the Central Bank of Russia in the years ahead of the crisis. Subject to new requirements phased in from January 2016 onward, capital buffers had to be applied additionally to minimum capital ratios for significant institutions, while minimum requirements were kept constant.[14] The European banks operating in Russia complied with the capital requirements and kept their capital ratios[15] broadly stable from 2017 to 2019.

3 Macroeconomic and banking sector developments during the COVID-19 crisis

3.1 Rather mild recession on the back of comparatively small service sector, limited restrictive measures and targeted fiscal stimulus

After continued weak growth in the first quarter of 2020 turned into a steep decline in the second quarter (–7.8% year on year due to tight lockdowns and sharply contracting oil prices), Russia's COVID-triggered recession softened somewhat in the third and fourth quarters of 2020. Overall, annual GDP declined by 3.0% (table 1), putting Russia into a quite mild recession compared to many other countries. According to preliminary data, the Russian economy contracted another 0.7% in the first quarter of 2021 (year on year). The relative mildness of this recession can be explained by Russia's comparatively small service sector (since services are much more vulnerable to lockdowns than industry or agriculture), the rather moderate restrictions imposed in the fall of 2020 (in contrast to other countries re-imposing lockdowns), and a forceful fiscal policy response of about 4.5% of GDP (including tax and social security benefits, debt guarantees and capital injections) (IMF, 2021, p. 6). Nonetheless, the sharp drop of the oil price (–34% on average in 2020, followed by an offsetting increase of 24% in the first quarter of 2021, year on year) and the OPEC+ production ceiling agreement in force from May 2020 constituted important recessionary factors, even if the OPEC+ agreement contributed to the

[14] *4.5% for the CET1 ratio (that is, for the CBR's equivalent, N1.1), 6% for the tier 1 ratio (N1.2), and 8% for the total capital adequacy ratio (N1.0).*

[15] *For the European banks disclosing capital ratios with different standards, capital ratios tend to be higher using international (IFRS with Basel III methodology) standards compared with local Russian ones, in a context where risk-weighted assets are also defined differently.*

subsequent partial recovery of the oil price and even if the decline was cushioned by the exchange rate flexibility of the ruble. Overall, shrinking private consumption was the driving force of economic contraction, whereas fixed investment also shrank substantially.

On average, the ruble lost 11% of its value against the US dollar and 13% against the euro in 2020 compared to 2019. This slide, combined with price spikes for some food items, pushed CPI inflation up to 4.9% in December 2020 and 5.5% in April 2021 (year on year), clearly exceeding the CBR's target. Lending priority to combating the deep crisis, the CBR then cut the key rate further from 6% to 4¼% in the summer of 2020 (a post-Soviet historic low). In March and April 2021, the CBR raised the rate again in two steps to 5%, citing continuing elevated inflation expectations, signs of swifter-than-expected domestic economic recovery in early 2021, and lingering geopolitical uncertainties. After years of fiscal surpluses, the general government budget deficit reached 4% of GDP in 2020. The shortfall was financed with new domestic debt rather than by tapping the National Welfare Fund (NWF). The NWF funds amounted to 12% of GDP at end-March 2021 (see table 1), with liquid assets accounting for two-thirds thereof.

The much lower prices and quantities of oil and gas exports cut into Russia's current account surplus, which was more than offset by rising private net capital outflows, reflecting stepped-up deleveraging by banks and corporations. While Russia's gross foreign debt consequently declined to EUR 391 billion at end-March 2021, this corresponded to an increase of 3 percentage points of GDP to 30% (year on year) – given the sharp drop of the ruble; at the same time, the country's substantially larger international reserves remained more or less stable at EUR 491 billion, reflecting an increase of 5 percentage points of GDP to 38%.

3.2 Banking sector enters regime of regulatory forbearance and remains a pillar of growth

In response to the crisis, the CBR provided measures of temporary regulatory forbearance and encouraged credit institutions to use any capital buffers built up since early 2020 (see above). A new regime of regulatory lenience on asset (loan) valuation and provisioning, introduced at end-March 2020, allowed banks to delay reclassifying restructured loans and to postpone the build-up of provisions for potential loan losses until April 1, 2021 (for corporate loans) or July 1, 2021 (for retail loans and loans to SMEs). The goal is, among other things, to facilitate credit restructuring for debtors under stress, given the crisis circumstances. Apart from the encouragement to use available capital buffers, the CBR reduced risk weight add-ons on pre-crisis mortgages to zero, while retaining risk weight add-ons for new mortgages. Furthermore, regulatory changes restricted the use of dividends in 2020 and imposed a 15% income tax rate for dividends transferred out of Russia. Meanwhile, the CBR also continued its cleanup policy, ridding the sector of poor-quality banks: by the end of 2020, the number of operating credit institutions had further dropped to 406 (table 2).[16]

Overall annual credit growth in 2020 eased yet remained at a pace of 4% year on year (in real terms and exchange rate-adjusted). This continued robust growth

[16] *Bank mergers have so far been quite rare. According to President Putin, about 300 banks are regarded as sufficient to service the Russian economy (Pugsley, 2020).*

amid the recession was supported by further falling interest rates and by targeted government subsidies. Loans were also needed as tide-over credits to close (temporary) cash flow gaps during the pandemic, and credit demand was not dampened at all by the forbearance regime. While retail loans continued to grow dynamically on balance, having just lost some momentum, mortgage loan growth re-accelerated to a rate of 16% in 2020 and expanded even faster in the first quarter of 2021 (year on year). Mortgage credit is supported by a preferential state program providing interest rate subsides that cap loan rates at 6.5%.[17] Despite the recession, property prices have been rising on the back of low interest rates and growing demand for residential property. Given the unrelenting acceleration of mortgage lending, the CBR decided in mid-May 2021 to increase surcharges to the respective risk coefficients from August 2021 (once the preferential state program expires). Loans to some strategically important companies also benefited from state-subsidized interest rates (featuring a rate cap of 5%), and other support schemes shored up lending to SMEs in distressed sectors of the economy. Other factors underpinning the continued growth of banking assets were expanding investments in securities (+28% in 2020, in real terms) notably government bonds, which contributed to financing the 2020 budget shortfall, and the depreciation of the ruble over the year.

In contrast to lending, bank deposit growth slowed down markedly to 2% (table 2), and in the case of household deposits to 1%, in 2020 (in real terms and exchange rate-adjusted). In this respect, the impact of forced saving through lockdowns and restrictions has apparently been more than offset by a combination of factors, including reduced incomes and increasing joblessness, dwindling interest rates amid rising inflation, a new savings tax to help fund the government's response to the pandemic[18] and the growing attractiveness of alternative investments in the Russian stock market.[19] Forex deposits (mainly denominated in US dollars, and a smaller share in euro) have been losing their attractiveness because of nominal interest rates in those currencies approaching zero and because of heightened uncertainty. Meanwhile, government agencies' share of total deposits slightly declined to 7% (fully ruble-denominated, at end- 2020).

Given the CBR's temporary forbearance regime from Q2/2020, the transmission of credit losses to banks' prudential ratios has been limited since then; therefore, while nonperforming loans as well as provisions were largely reported stable through end-2020, these indicators may become less and less reliable the more time passes by. Likewise, as depicted in table 2, reported capital adequacy and the tier 1 capital ratio remained more or less unchanged, and reported ROE and ROA almost upheld their high levels of late 2019. As of late 2020, restructured loans came to about 12% of total loans (IMF, 2021, p. 16). The real extent of problem loans on banks' balance sheets can be expected to start emerging in mid-2021, when remaining forbearance measures are to be lifted.

[17] *The goal of this program, launched in April 2020 and due to expire in July 2021, is to support home buyers and the residential construction industry through the crisis. Required down-payments have been cut to 15%.*

[18] *This is a 13% tax on interest from bank accounts or dividends from securities if the respective balances exceed RUB 1 million (EUR 11,000 at end-2020). The tax was introduced in April 2020.*

[19] *Many individual depositors seized the lucrative but partly risky opportunity to reshuffle funds, which triggered a surge in stock market investments by the general public (Kuznetsov, 2020). Thus, the number of Russian individuals with investment accounts for trading stocks on the Moscow stock exchange more than doubled in the course of 2020 to 8.8 million (BOFIT, 2021). The number reportedly further grew to around 11 million by early April 2021 (Fitzgeorge-Parker, 2021).*

4 Focus on main COVID-19 pandemic crisis impacts on European banks in 2020

4.1 COVID crisis stopped European banks' lending expansion

European banks in Russia saw their assets grow by 10% in 2020 in local currency, which corresponds to a decline of 3% to EUR 51 billion. Their share of banking system assets was overall unchanged, with a slight decline to 4.2%. After years of dynamic growth, their (corporate and retail) loan book did not expand but declined by 1% in domestic currency (decreasing by 13% to EUR 29 billion), while domestic peers continued to report broadly modest loan growth. This trend may be driven by different risk appetites and a niche-player position, implying more conservative risk-taking by some European banks, and less reliance overall on certain volume-driven products like mortgages. European banks were able to access support measures defined by the Central Bank of Russia during the pandemic, including lending-related ones like specific moratoria mechanisms targeting certain categories of borrowers. The share of foreign currency loans also tended to increase in 2020, reaching 24% after years of gradual decline (+4 percentage points, primarily through corporate loans).

4.2 Moderate crisis-related profitability contraction driven by provisioning

In the pandemic crisis, European banks in Russia saw their net interest income dry up. Interest income declined by 11% and interest expenses by 22% in 2020, causing the cost-to-income ratio to decline further by 1 percentage point (to 51%) and net interest income to decrease by 13% to EUR 1.8 billion (while remaining stable in ruble terms). Net fee and commission income declined by 9% to EUR 735 million (while growing by 4% in ruble terms). The main driver is impairments, which exhibited a rather mild increase of 27% in local currency, with some European banks provisioning less than their peers. Between them, the European banks in Russia continued to account for just 4% of the profits generated in Russia's banking system. Masking continued strong disparities between the individual European banks, their average ROE declined just 1 percentage point to 12% even during the crisis but stayed below the system-wide total of 16%. Their ROA reached 1.6%, broadly unaffected by the crisis but continuing its declining path, slightly below the system-wide average of 1.7%. The liquidity of the European banks was not put at risk by the crisis, either; the average share of highly liquid assets in total assets increased by 6 percentage points to 31%, while remaining stable for state-owned banks and the banking system as a whole. Loan-to-deposit ratios tended to decline strongly in 2020 (by 12 percentage points to 79%[20]).

Expressed in local currency, the impairments of European banks increased by 27% in 2020, compared with an 11% increase to EUR 440 million. As a share of year-end loans, their cost of risk moderately increased from 113 basis points to 161 basis points on average.[21] The capacity to generate a lower cost of risks than the market leaders may be supported by the niche player positioning. Additionally, while the impact of IFRS 9 on profit or loss was positive in 2019, the tendency

[20] *The loan-to-deposit ratio of the European banks declined in a stronger manner than the banking system total, therefore increasing the gap with the 93% banking system average (which was fairly stable over time).*

[21] *This 0.5 percentage point risk cost increase (to 161 basis points) highlights that the European banks tended to generate lower levels of provisions than the state-owned banks (270 basis points, +0.8 percentage point) and the Russian banking system as a whole (313 basis points, +0.5 percentage point) in 2020.*

Table 3

Russia: selected indicators for European banks

	End-2017	End-2018	End-2019	End-2020
Total assets (liabilities) of European banks	*Billion*			
Total assets measured in RUB	3,211.6	3,868.2	3,853.0	4,254.2
Total assets measured in EUR (yearly average exchange rate) (memo)	48.6	52.4	52.9	51.2
	%			
Annual growth measured in RUB	-	20.4	–0.4	10.4
Annual growth measured in EUR	-	7.8	1.0	–3.3
Share in banking system assets	4.1	4.5	4.4	4.2
Total loans	*Billion*			
Lending measured in RUB	1,987.5	2,388.0	2,417.8	2,399.9
Lending measured in EUR (yearly average exchange rate) (memo)	30.1	32.4	33.2	28.9
	%			
Share in total Russian banking sector loans	5.1	5.4	5.1	4.5
Annual growthmeasured in RUB	-	20.2	1.2	–0.7
Annual growth measured in EUR	-	7.5	2.7	–13.1
Corporate loans	*Billion*			
Lending measured in RUB	1,210.3	1,499.1	1,389.0	1,376.3
Lending measured in EUR (yearly average exchange rate) (memo)	18.3	20.3	19.1	16.6
	%			
Share in total Russian banking sector loans to enterprises	4.7	5.3	4.7	4.3
Retail loans	*Billion*			
Lending measured in RUB	763.1	873.6	1,007.3	1,004.3
Lending measured in EUR (yearly average exchange rate) (memo)	11.6	11.8	13.8	12.1
	%			
Share in total Russian banking sector loans to households	6.3	5.9	5.7	5.0
Foreign currency loans	*Billion*			
Lending measured in RUB billion	639.1	664.8	469.1	566.2
Lending measured in EUR (yearly average exchange rate) (memo)	9.7	9.0	6.4	6.8
	%			
Share in total loans of European banks	31.8	26.9	19.6	24.5
Share in total foreign currency loans of Russian banking sector	11.3	11.8	9.3	9.1
Total impairments	*Billion*			
Impairments measured in RUB[1]	(14.7)	(39.4)	(29.0)	(36.6)
Impairments measured in EUR (yearly average exchange rate) (memo)	(0.2)	(0.5)	(0.4)	(0.4)
Average ratios	%			
Loan-to-deposit ratio	94.0	91.1	91.2	79.1
Share of highly liquid assets	22.7	26.4	25.0	31.1
Return on average equity	14.5	14.1	12.8	12.0
Return on average assets	2.1	1.8	1.7	1.6
CET1 equivalent (N1.1) (minimum ratio = 4.5%)	11.1	10.4	11.3	12.9
Tier 1 equivalent (N1.2) (minimum ratio = 6%)	11.3	10.9	11.9	13.7
TCR equivalent (N1.0) (minimum ratio = 8%)	14.8	14.1	14.8	16.6

Source: Banks' regulatory reporting to the Central Bank of Russia (adapted by Fitch).

Note: Reporting does not follow IFRS/European reporting standards but is subject to local Russian reporting standards, which limits data comparability.

[1] Reflecting not only loan loss provisions but also other types of impairments.

reversed in 2020 given the sensitivity of the IFRS 9 framework to crisis environments. For credit quality, no strong impacts can be seen in terms of overdue installments, which remained at a level of between 3% and 4% despite the economic downturn. The capital situation of the European banks improved in 2020, with an

increase of 2 percentage points on average, as they all increased their capital levels even amid the crisis. Besides, some signs of additional restrictions on capital outflows from Russia were visible in 2020,[22] the treatment of such flows being a sensitive topic for European banks.

5 Assessment of current banking risks and shock-absorbing factors with particular focus on European banks

5.1 Credit risk remaining a central risk driver as crisis-related measures end

With an uneven recovery, one can expect credit risk considerations to continue looming large in 2021.[23] Nonperforming loans remain relatively high for the banking sector as a whole (see above), while reliable information on credit quality is more difficult to come by since the introduction of regulatory lenience at end-March 2020. As for mortgage loans, the government stimulus program appears to have been efficient as an anti-crisis measure, yet in some regions, house price rises seem to have offset the positive impact of the program, which may imply risks of overheating in the housing market. Mortgage lending as well as unsecured consumer lending remain potential hot spots of risk, having since prompted the CBR to intervene to counter acceleration tendencies.

Regarding credit risk in the nonretail area, the CBR observed an increasing concentration risk trend for significant Russian banks in the studied period (CBR, 2019), as banks are financing a number of large nonfinancial corporations which are gradually increasing their debt levels. Having conducted industry surveys, the CBR announced that it was considering the introduction of macroprudential tools to limit concentration risk, focusing on highly indebted companies and stressing heterogeneous risk measurement methodologies used by banks.

Overall, according to CBR assessments in mid-February 2021, the peak of loan restructuring has passed, and 20% to 30% of restructured loans might become bad loans. Therefore, additional provisions of 2% to 3% of banks' total loan portfolio may become necessary in the CBR's view to strengthen financial buffers against credit losses (Golubkova and Ostroukh, 2021; World Bank Group, 2021, p. 28). Taking total loans at end-2020, the need for additional provisions would thus amount to about USD 15 billion to 25 billion.

5.2 Ruble volatility, a risk to mitigate

Regarding foreign currency lending, both Russian households and companies have become less dependent on dollar financing in the past few years. The de-dollarization of the Russian economy has been strong since the 2014 crisis. The European banks followed this overall trend, but while the share of their foreign currency loans gradually decreased from 32% to 20% in the 2017–2019 period, it increased to 24% in 2020 (partly due to exchange rate effects). Like in the banking sector more generally, retail lending by European banks is almost ruble-only business, but a significant share of their corporate financing is still made in other currencies (mainly USD and EUR). While exchange rate and liquidity risks are therefore less

[22] *See tax on dividends reported above.*

[23] *A longer-standing issue relates to the legal framework of connected lending, which apparently still allows for related-party transactions on more favorable terms than corresponding transactions with nonrelated partners; moreover, some regulatory weaknesses likely persist with respect to requirements pertaining to external auditors' independence and professional standards (IMF, 2019, p. 16).*

important than credit risk (for the Russian banking sector in general as well as for the European banks), the volatility of the oil price and of the ruble exchange rate as well as uneven liquidity across the sector may give rise to temporary instability. Besides, foreign currency risks need to be adequately managed and anticipated at the parent company level with hedging strategies, which have an economic cost.

5.3 Sanctions risk still one of the major risks in the Russian context

Sanctions-related restrained access to Western financial markets for large Russian enterprises and banks appears to have a lesser impact now than a couple of years ago, given that the Russian economy has built up sizable financial buffers and seems to have pragmatically "adjusted" to the sanctions. Yet, sanctions risks still represent one of the biggest risks European banks operating in Russia are facing. Even when banks have adequate internal control frameworks, the issue is not to be underestimated as sanctions regimes are complex and require monitoring of a large number of transactions. Sanctions concern many systemically relevant companies in Russia but with specific restrictions and sometimes a limited scope. Banks need to continuously adapt their systems and keep up their sanctions expertise, given that the environment is subject to constant change, as highlighted by the sanctions-related pressures triggering the postponement of the Nord Stream II pipeline completion as well as by the latest US waiver of sanctions against the pipeline. Incentives are strong for financial institutions to comply with all the rules, especially in light of potential fines for breaches and reputation risk. The sanctions risk therefore remains elevated for the future as the situation continues to be volatile and sensitive to geopolitical developments, as illustrated by the escalation step taken by US authorities in April 2021, further limiting access for Russian bond issuers to international markets.

5.4 Climate risk as upcoming challenge

The need to reduce exposure to climate risk in light of its potential impacts on financial stability has been acknowledged by the central bank (CBR, 2020) and will increasingly impact banks. In general, Russia may be perceived as having potential to do more (Simola, 2020). For European banks active in Russia, risk mitigation measures related to climate risk and based on environmental, social, and governance (ESG) criteria will also depend on standards implemented by their parent companies. Some of them will be calibrated in order to reflect guidelines defined at the European level, a process also driven by the European Central Bank, which published a new guidance on climate-related and environmental risks in November 2020.

5.5 Bank capital and financial profile among shock-absorbing factors

Shock-absorbing factors have remained rather strong in recent years and even during the COVID-triggered recession, albeit not without pockets of weakness. Loan loss provisions (almost) cover nonperforming loans when narrowly defined. The banking sector appears well-capitalized and positioned to absorb potential credit losses, and that is particularly the case for the European banks in Russia, which strengthened their capital base in 2020. According to IMF estimates, credit institutions' total amount of capital available to cover a potential increase of loan losses (not including new profit generation) comes to about RUB 6.2 trillion (or USD 80 billion to USD 85 billion, which is about 5.6% of GDP) (IMF, 2021, p. 16). While

on the aggregate level, it seems that loan losses are manageable – even in the case of a longer (drawn-out) crisis – the loss absorption capacity is not evenly distributed among banks, and some smaller players might suffer. The European banks moderately increased their impairment balances overall in 2020, which tend to be proportionately lower than those of state-owned banks, with the capacity to make further provisions should the risk situation in Russia deteriorate.

The overall loan-to-deposit ratio (96% at end-2020) is fairly moderate, and depositors remain confident, even if relatively low or negative real interest rates have persuaded some to move funds to stock market investments. Noticeably, the European banks decreased their loan-to-deposit ratio in 2020 to rather low levels (about 80%) compared with local peers. Another factor providing a cushion are credit institutions' net external assets, which have remained at over 7% of total assets. The fact that state-owned banks account for the majority of Russian banking assets (about two thirds) implies that the authorities are directly responsible for the survival of most of the largest players, which may uphold confidence in uncertain times. If necessary, the CBR is equipped with ample liquidity for recapitalization measures (Banking Sector Consolidation Fund). Russia's international reserves (including gold) expanded by about 40% from end-2017 to late May 2021 and have attained a new historic record level (EUR 496 billion or 40% of GDP – in absolute terms the fourth-largest reserves of the world), outstripping the country's gross international debt by almost a third.

While current account and budget data deteriorated markedly under the impact of the COVID-19 crisis and crisis-response measures (as mentioned above), total public liabilities remain very modest – about 18% of GDP at end-2020 – even if pronounced deficit financing in 2020 had pushed up the ratio by 4 to 5 percentage points. Meanwhile, Russia's comfortable net positive international investment position expanded to 34% of GDP (at end-2020), and the country's budget balance reverted to surplus (in early 2021, see table 1). Overall, the authorities could mobilize substantial funds should banking problems emerge, a scenario whose implications remain untested in the case of European banks due to their resilient performance.

6 Outlook for Russia's banking sector and European banks in Russia after the crisis

Like across the globe, the development of Russia's banking sector and economy will depend on or be strongly influenced by the further development of the COVID-19 pandemic and the effectiveness of vaccines used. While infection rates have declined from early 2021, as of May 2021, they were still stagnating at an elevated level, while vaccination is only progressing hesitantly. Meanwhile, Russia (notably Moscow) had already lifted some of its few remaining lockdown restrictions in early 2021, so that perspectives for economic and banking recovery may substantiate themselves, provided that current tendencies carry on. This, however, is by no means certain given the most recent emergence of new aggressive virus variants.

The second half of 2021 may well be a test for the market, as regulatory forbearance for asset (loan) valuation and provisioning is slated to expire. The government support program for housing and residential construction is also planned to end in mid-2021. Therefore, the real extent of problem loans on banks' balance sheets should start to re-emerge in mid-2021. Nonperforming loans will likely go up by some margin. Given banks' available financial buffers, the sector should be

able to bear that. In any case, against the backdrop of the recent (subsidized) re-acceleration of mortgage lending growth, the mortgage and housing markets warrant careful monitoring, as confirmed by the CBR's most recently announced regulatory changes. The same goes for consumer loans. Regarding prospective dis-investment of banks nationalized in 2017–2018, the authorities seem to be sticking to their plans to sell the rescued outfits (notably the largest, Otkrytie), but are currently confronted with uncertain market conditions. Unless highly unexpected events intervene (like a major worsening of the pandemic, a – possibly connected – deep and durable decline of the oil price, or a severe escalation of geopolitical tensions and sanctions), economic recovery should stabilize the expansion of banking activity and have a countervailing impact on deteriorating credit quality, which, in turn, would confirm Russia's role as an important profit source for European banks. That said, the still weak overall investment climate may rein in the potential extent of the recovery. The prospect of continued oil price and ruble volatility, persisting sanctions risks and moderate recovery trends would still provide a challenging environment for European banks active in Russia.

Regarding internal models allowing banks to use their own risk parameters and estimates to calculate capital requirements in the future, the CBR was reported as planning to ease capital buffer requirements for banks using internal ratings-based (IRB) models, and speed up this transition in the crisis context. In early 2020, IRB models were used only by Raiffeisenbank Russia (for corporates) and Sberbank. All the other significant institutions were encouraged by the CBR to gradually shift to IRB over a five-year horizon, with local lender Alfa bank planning to be one of the first banks ready to switch to IRB. As such, the transition to IRB will have additional impacts for Russian banks and the competitive landscape. This situation illustrates that the European banks in Russia can benefit from the advantages of such regulatory-driven tools like the domestic players. More broadly, the European banks were not found to be in an unfavorable position compared to their local peers regarding the regulatory regime.

Finally, dynamic digital transformation trends in the Russian banking market bring both risks and opportunities, as banks need to modernize in a competitive environment – in a context where market leader Sberbank rebranded itself as "Sber" in 2020, unveiling a new conglomerate-like business model with a broad range of nonbank services (e-commerce, food delivery, mobility, etc.). The pandemic served as a real test for the digital capacity of financial institutions, with the Russian market being perceived as advanced within the CESEE area. Even if branch activities were among the types of services maintained during the lockdown, online banking is on an increasing trend. In this regard, the European banks active in Russia pursue different strategies. Société Générale (SocGen) has reduced its branch infrastructure but nevertheless retains a large physical network spread all over the country. UniCredit's corporate-driven business model makes it less reliant on branches servicing retail customers. Raiffeisenbank Russia communicated to investors in 2019 a strategy to close around 25% of its branches by 2020 and to put further focus on the Moscow and Saint-Petersburg areas, reducing its geographical footprint in favor of digital networks leveraging on nationwide trends. Summing up, the European banks operating in Russia, with various degrees of profitability, will have to contend with the medium-term perspective of not only sustained sanctions risks and limited economic growth, but also intensified competition. To be

prepared for these challenges, they can be expected to go digital with more services, embrace cost discipline with restructuring measures and the like (mergers among SocGen subsidiaries being a case in point) and engage in selective risk-taking to preserve asset quality in the aftermath of the pandemic.

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