

# Russian Banking System Development: Growth in credit creation will not add to investment activity

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By steadily lowering the refinancing rate, the Russian monetary authorities aim to foster bank lending to the non-financial sector. The liabilities of the banking system are expanding rapidly – their annual growth is expected to reach 15%. However, bank lending to corporate clients and households continues to stagnate, adding to the volume of “non-performing” liquid assets. Banking sector liquidity rose above RUR2.9 trillion up to the end of first half of 2010, which is comparable with the last year levels, when banks moved their funds into forex assets against the background of “smooth” depreciation. At that time, foreign currency liquidity could potentially generate income as translation gains, but now these assets do not generate any income. A sizable portion of free funds is tied up in state-owned banks – as much as 45% of all liquid assets. The liquidity level is comparable for all groups of major banks, and even decreased slightly for small banks in recent months. This essentially means that reallocation of these funds in the form of loans to the economy is decided by three or four state-owned banks. The share of liquid

assets at Sberbank grew by over 11%, whereas in the pre-crisis period it accounted for just 3% of total assets (a reserve of RUR650 bln). However, according to the executives of these state-owned banks, corporate lending risks are still high and have hardly subsided.

The Russian banking system is potentially ready to resume lending to the non-financial sector. In 2009, household deposits grew 25% and corporate deposits rose 15%, while loan portfolios shrank over the same period. This helped to balance the ratio of loans to deposits in the non-financial sector, with the gap standing at less than 5% of the banking sector's equity. Net bank lending to companies settled at RUR 4.4-4.5 trillion – the level observed in the early 2008, while households' net credit to banks widened noticeably, from RUR2.0 to RUR4.6 trln.

The major obstacle to growth in credit creation in 2010 is the systemic gap between the parameters that determine credit supply and demand. The Russian banking system has relatively costly and short-term liabilities. In the period of

economic and financial crisis, commercial banks re-directed their attention to domestic resources. In 2009, the share of household deposits in the total banking liabilities increased from 21% to 26%. At the same time, foreign borrowing, which is traditionally cheaper and longer-term, dwindled from 17% to 12%. The funds provided by the monetary authorities to the banking system as anti-crisis measures were also very expensive and short term. Only one exception was the CBR loan to Sberbank in the amount of RUR500 bln for 10 years at 8.5% per annum. However, the latest news is that Sberbank intends to make early repayment of this debt to its shareholder.

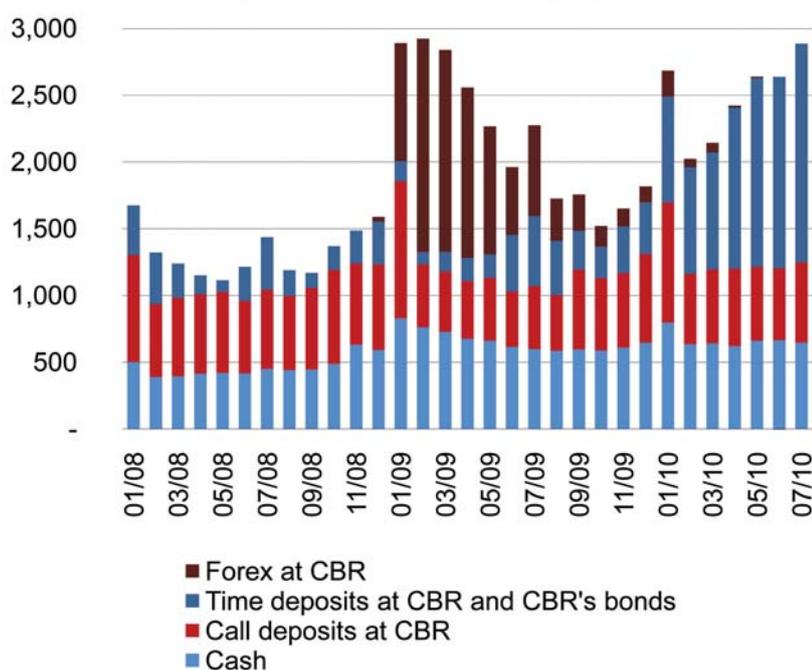
Low demand for loans is a result of low profitability in the industry and the uncertainty of the emerging environment, including economic growth and inflation. Substantial demand is observed for refinancing debts from prior years, but this demand for loans is fraught with high risks.

Thus, the gap is gradually narrowing – if loans do not become longer term, at least they are being offered at lower interest rates. Profitability in the industry is growing in step with the improving economic environment. However, the debt of companies operating in the real sector in the form of bank loans did not change in 2009, growing by a slight 0.3%. In January-June 2010, there were slight movements with ruble-denominated loans inching up 4.3%.

Lending activity is expected to pick up in the second half of 2010. According to our projections, growth in corporate debt to the banking system will total 15% this year and will differ by loan structure.

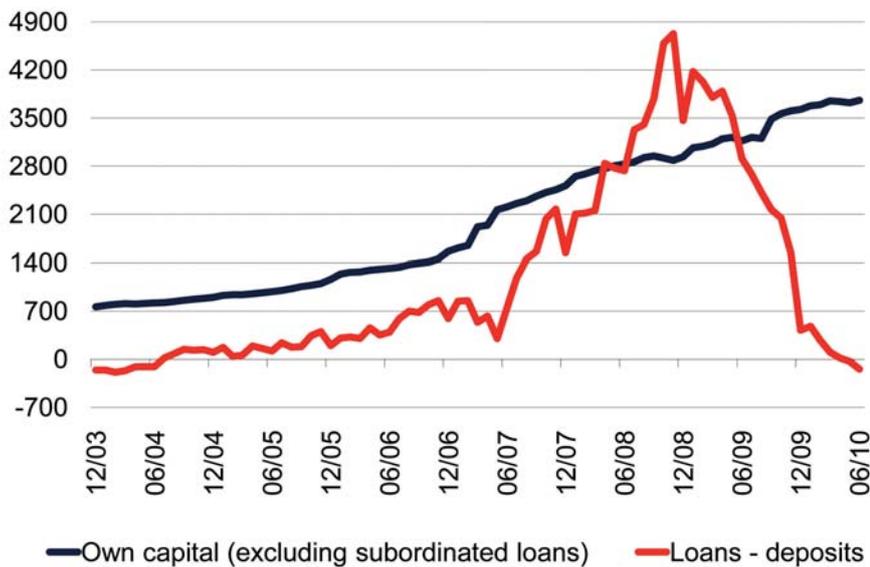
Growth in ruble-denominated corporate loans with maturity of up to one year is expected to be significant and reach about 50%. During 2009, there was a deficit of working capital and current assets. Recovery in these segments began only at the year end and continued in 2010. Following this trend, the level of debt in the form of ruble-denominated bank loans with maturity of less than one year is expected to reach at least the level of 2006.

Liquid assets of the banking system



Source: CBR, CSI Bank of Moscow

### Excess of loans over deposits of the non-financial sector (net of bonded debt) and total equity capital of the banking system, RUR bln



Source: CBR, CSI Bank of Moscow

Ruble-denominated corporate loans with maturity of more than one year will grow less noticeably: by 6-7% in 2010. In 2009, there was an opposite trend – long-term loans climbed 24%, whereas short-term loans dropped 33%. Such movements were not generated by expanding investment activity (fixed capital formation fell by 18.2% in real terms and by 14.5% in nominal terms). Long-term loans were issued to prospectively viable enterprises to restructure their prior-year debts. Concurrently, enterprises in the non-financial sector experienced a deficit of working capital and current assets that resulted from uncertainties and risks in the economy and high interest rates. Moderate growth in corporate loans with maturity of more than one year will depend on the degree of improvement in the general economic environment, growth in corporate profitability, and interest rate cuts. This process may liven up the investment activity.

Overall, ruble-denominated corporate loans will grow 21% in 2010, while corporate loans in foreign currency are expected to decline 2%. Therefore, the amounts due from Russian companies on bank loans in 2010 will rise 15% in the context of upward bound ruble-denominated loans and declining debt on loans in foreign currency. Short-term loans (which fell in 2009) will move up again, and long-term loans will be growing at a slower pace. In general, corporate loans will be issued to underpin current production activities and, to a minimum extent, investment activity. Forecasts call for the growth

model to be driven by external demand and not investment.

### There are two reasons for the decline in consumer loans: weak economic growth and changes in household credit activity.

Household debt on bank loans shrank 11.8% in 2009, which, other things equal,

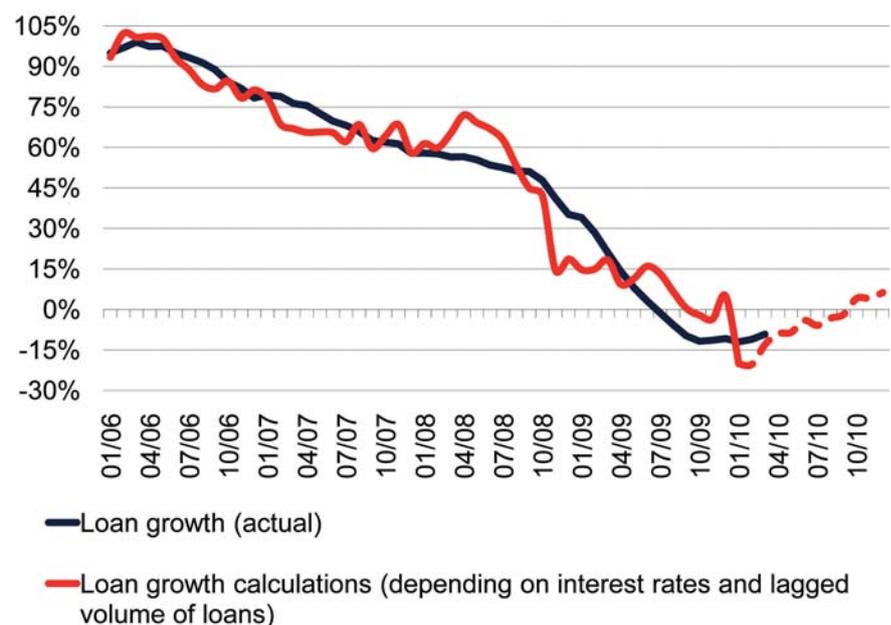
is facilitating its growth in the current year due to the base effect. We do not expect any upswing in this segment of the credit market in 2010 and, based on annual performance, this indicator will vary from -2% to +4%, which is tantamount to stagnation.

The low activity of the consumer lending market will be determined by such factors as slowing growth in nominal household income (versus the pre-crisis level) and changes in the borrowing activity of households. The projection, based on moderately optimistic changes in household income and interest rate reductions, should be viewed as the upper limit for possible estimates for the current year. The respective estimates indicate that growth in consumer loans can hardly go beyond 3-4% in 2010.

In 2009, investments in securities were chosen by banks as a major alternative to lending activity. Total bank investment in bonds rose by RUR 1,488 bln over the year. Apart from high liquidity, investment in bonds has an additional advantage over credit creation – it is easier for banks to obtain refinancing from the CBR via direct repo transactions or Lombard loans.

However, debt securities have not become a real substitute for bank loans among corporate borrowers. Bonds of the non-banking sector accounted for

### Growth in consumer loans, change in % Y-o-Y



Source: CBR, CSI Bank of Moscow

Note: The graph shows that the loan growth curve is calculated on the basis of movements in household income and interest rates and describes rather accurately the actual increase in loans. The macroeconomic factors suggest that nominal household income will grow 10-11% in 2010, underperforming the current interest rates on loans.

only one fourth (RUR 399 bln) of the total increase in the banking bond portfolio in 2009 and less than 2% (!) in 1H 2010.

Government securities, both federal and municipal, and CBR bonds were the main investment instruments for banks in 2009 and 1H 2010.

The volume of bonds issued by non-banks almost tripled y-o-y in 2009, from RUR 251 bln to RUR 737 bln.

Nevertheless, the bond market remains negligible compared with volumes on the loan market, constituting a modest 4% of new loans issued in 2009.<sup>1</sup> Therefore, it is too early to expect bonds to become a plausible alternative to lending. In 1H 2010, the volume of issued bonds by non-financial sector fell by 20% and equalled only 2% of new loans.

Another important task for Russian banks in the coming years will be to clean their balance sheets of bad debt.

Data indicate that the share of overdue loans has broadened over the first half of this year. Overdue corporate loans grew to 6.4% on July 1, 2010 (from 6.0% on January 1, 2010) and the increase in overdue consumer loans reached almost 7.6% (from 6.9% on January 1, 2010). The ratio of provisions for possible losses to loans (more accurately reflecting NPL value than past due debt) reached 10.9% for consumer loans and 11.2% for corporate loans (from 9.9 and 10.8% respectively). In 2009, over 80% of the banking sector profit was allocated to provisions for possible losses (versus 52% in 2008 and 20% in 2007). However, neither banks nor borrowers have a clear picture of the actual extent of bad debts, as a significant portion of loans issued last year was channelled into debt refinancing in hopes for economic recovery and improvement in the financial position of borrowers – the latter hardly a realistic prospect for all.

An interesting situation is emerging. In 2008, Russia's non-financial sector acted as a net borrower of the banking sector with the amount of borrowing reaching RUR 2,255 bln. In 2009, companies and households were already net creditors of the banking sector, moving RUR 2,585bln into banks. In 2010, the banking sector, no matter how paradoxical it may seem, will remain a borrower of the non-financial sector, with the amount of borrowing equal to RUR 860-870 bln. This means that even with growth in lending to the non-financial sector in the current year, the banking system will raise substantial funds from companies and households to be used for other purposes, for example to spur banking liquidity and foreign assets, investment in the financial market or repayment of the CBR's foreign debt.

#### Major banking liabilities, end of month, % of total

	12.05	12.06	12.07	12.08	03.09	06.09	09.09	12.09	03.10	06.10
<b>Liabilities (RUR bln)</b>	<b>9696</b>	<b>13963</b>	<b>20125</b>	<b>28022</b>	<b>28527</b>	<b>27776</b>	<b>28182</b>	<b>29430</b>	<b>29284</b>	<b>30417</b>
Capital	15.4	14.3	15.3	14.1	15.6	17.1	18.8	19.3	20.1	19.7
Bank of Russia loans	0.2	0.1	0.2	12.0	11.5	7.2	5.6	4.8	2.3	1.7
Interbank transactions	4.0	3.4	4.1	4.4	4.3	4.5	4.4	4.8	4.9	5.1
Foreign liabilities	13.7	17.1	18.1	16.4	16.2	14.8	13.4	12.1	11.8	11.8
Household deposits	28.9	27.6	26.2	21.5	22.1	23.8	24.2	25.9	27.0	28.3
Corporate deposits	24.4	24.4	25.8	23.6	22.6	24.0	24.7	25.9	25.6	25.4
Deposits of federal and local governments	2.0	2.2	1.5	1.0	1.2	2.4	2.4	1.0	1.5	1.8
Issued securities	7.6	7.2	5.8	4.1	3.7	3.6	3.8	4.1	4.3	4.2

Source: CBR, CSI Bank of Moscow estimates.

#### Major banking assets, end of month, % of total

	12.05	12.06	12.07	12.08	03.09	06.09	09.09	12.09	03.10	06.10
<b>Assets (RUR bln)</b>	<b>9696</b>	<b>13963</b>	<b>20125</b>	<b>28022</b>	<b>28527</b>	<b>27776</b>	<b>28182</b>	<b>29430</b>	<b>29284</b>	<b>30417</b>
Cash and precious metals	2.7	2.6	2.5	3.0	2.4	2.2	2.1	2.7	2.1	2.1
Accounts with CBR	7.3	7.5	6.9	7.5	6.7	6.3	3.9	6.9	6.7	7.8
Interbank transactions	6.3	5.8	5.4	5.2	5.1	5.1	5.0	5.4	6.0	6.2
Foreign assets	9.1	9.9	9.8	13.8	14.2	13.8	16.0	14.1	13.9	12.7
Households	12.1	14.7	16.1	15.5	14.6	14.3	13.8	13.1	13.0	13.0
Corporate sector	47.0	45.3	47.2	44.5	46.1	47.1	46.8	44.5	45.0	45.1
Government	6.6	5.2	4.1	2.0	3.1	3.3	3.7	4.2	4.5	4.2
Property	2.4	2.4	2.2	1.9	2.3	2.4	2.5	2.7	2.7	2.7

Source: CBR, CSI Bank of Moscow estimates.

<sup>1</sup> Bank loans to corporate borrowers totaled RUR19.1 trln in 2009. However, the amount of debt has not changed due to the matching volumes of repayments and prolongations.