SACE

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Scenari

special issue

Newsletter by SACE Economic Research

contents:

Russian economy has contracted significantly during 1H 2009 and forecast for the full year are rather negative. Oil prices dynamics and capital outflows play a key role but it is the credit crunch that has strongly affected Russian economy.

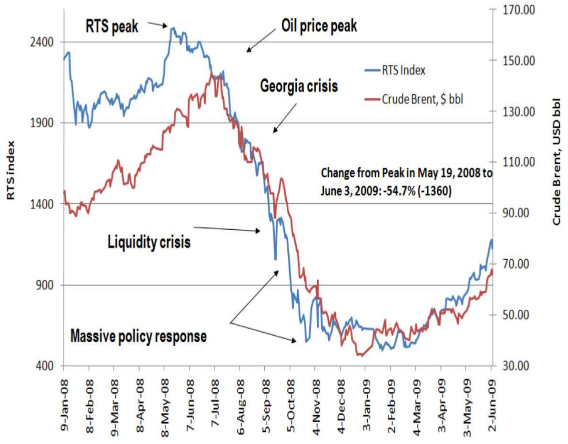
Credit and liquidity risk are still in place despite the prompt anti-crisis measures introduced so far by the government and the Russian central bank (CBR) in order to boost liquidity. The major reason of concern is the increasing level of non-performing loans (NPLs). The exact amount is uncertain, ranging from 10% to 40%, due to the different accounting standards used by CBR and by international general procedures.

Underestimating the NPLs correct level could lead to insufficient countermeasures to face the potential evolution of the crisis. Since 2000 Russia has increased the level of foreign reserves. Thus the country will preserve its ability to pay. Nevertheless 2H 2009 will be a tough period for Russian banks, especially medium-size banks, that will be able to survive only with the state support, waiting for a strong recovery in hydrocarbons prices which timing is still highly uncertain.

Russia: Oil and Turmoil

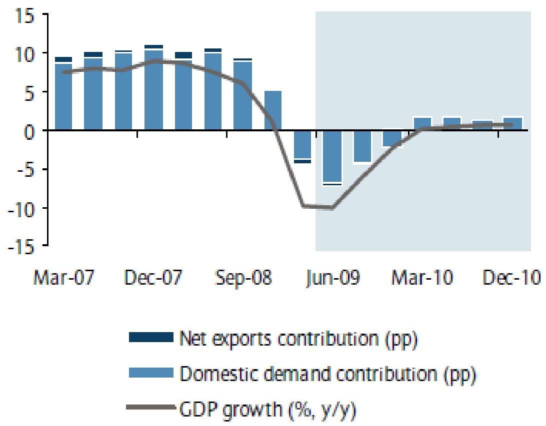
Low oil prices and capital outflows caused a sharp contraction of GDP for during 1H 2009. GDP growth rate is expected to be negative in 2009: forecasts range from -6.5% to -9%. After 1998 crisis, the Russian experienced an increasingly robust GDP growth mostly driven by high oil prices and massive capital inflows. These growth drivers sharply reversed after summer 2008 affecting Russian economic performance.

Oil down and capitals out...
(bps, LHS; USD per barel, RHS)



Source: World Bank

...have affected Russian GDP growth
(%)



Source: Barclays Capital

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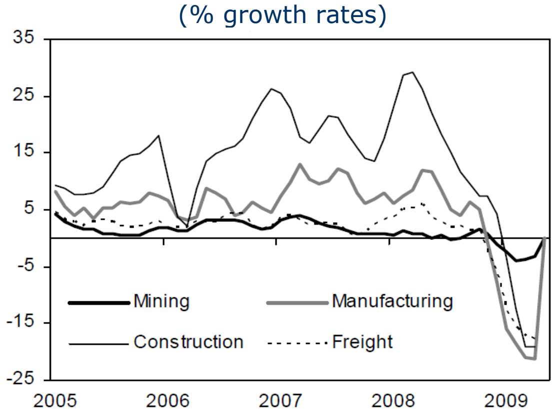
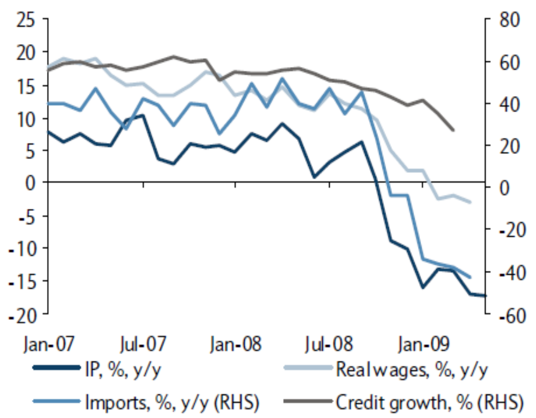
Anyway recession is mostly the result of the credit crunch. The breakdown of activity data shows that Russia's mining sector performance has been relatively stable and it is less suffering than other sectors like construction or manufacturing. The reason is that banks reduced their willingness to lend money even if government and monetary authorities promptly inject liquidity into the system. Nevertheless, high oil prices are essential for the Russian economic recovery in order to boost liquidity in the country.

Mining sector dynamic has been less volatile...
(% growth rates)



Source: Rosstat, Haver Analytics

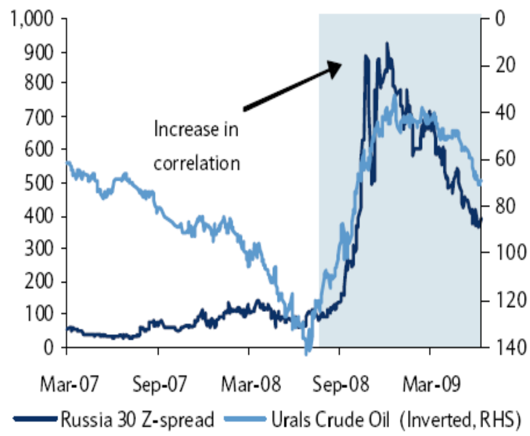
...while credit growth has significantly decreased.



Source: Haver Analytics, Barclays Capital

Banks in Russia are experiencing high credit and liquidity risk. Russian banks, although they appear to be relatively well capitalized, are suffering the weakening of the international economy, the deterioration of domestic environment and the sharp squeeze on access to external liquidity. A further and significant deterioration in asset quality is expected, posing a threat to bank capitalization and profitability.

Increasing correlation between oil prices and credit and liquidity risk
(bps, LHS; $ per barrel, Inverted RHS)

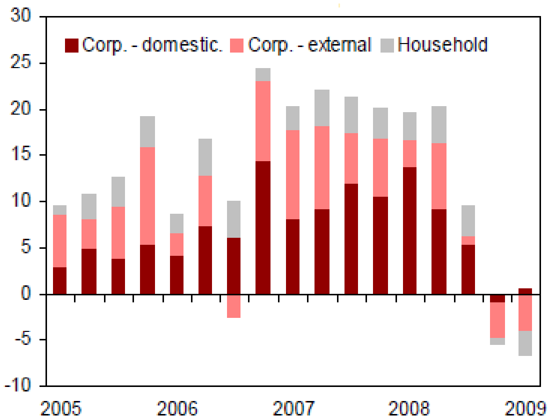


Source: Markit, Barclays Capital

There are several reasons behind the asset quality deterioration. Firstly, this is due a too much rapid credit growth during the previous five years. Favourable global conditions before the crisis egged on banks in being less selective in taking new risks. The second reason is the banks' high exposure to real estate and construction sector. In Moscow, real estate prices have fallen by almost 30%. Collaterals collected by Russian banks in order to hedge their exposure suddenly lost their value. Finally, asset quality is influenced by the quite significant level of foreign currency lending representing about 25% of total loans. Since July 2008 to February 2009, Russian ruble has depreciated by almost 50% against US dollar, leading to a sharp increase in customer defaults and restructured loans.

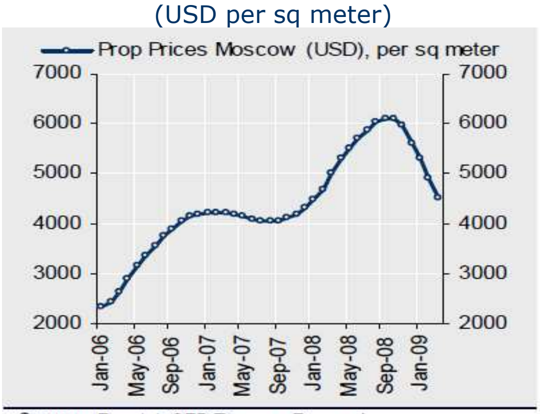
Asset quality deterioration is determined by…

…too much rapid credit growth …
(in % GDP)



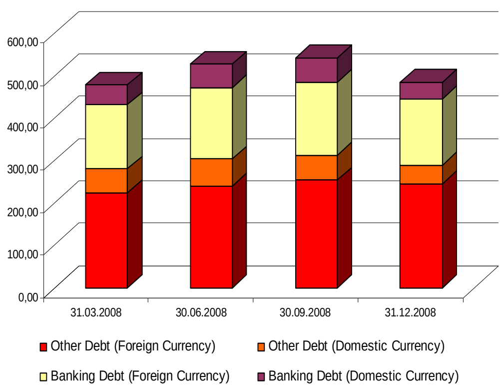
Source: CBR; Rosstat; GS Global ECS Research

…the decrease of property prices…
(USD per sq meter)



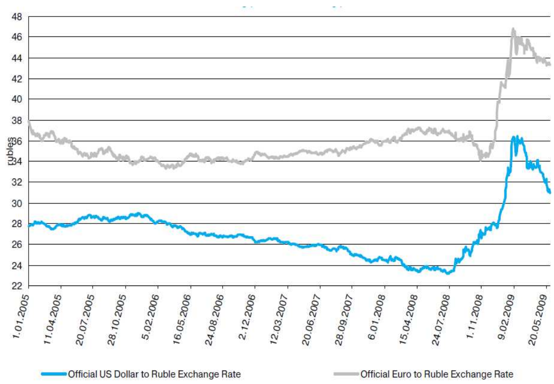
Source: Rosstat, CEB Treasury Research.

…high foreign currency exposure…
(bn USD)



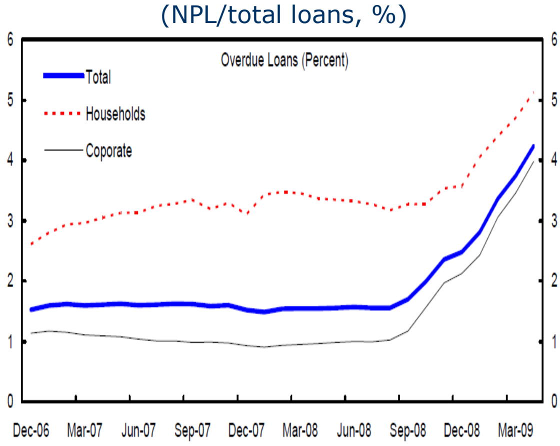
Source: CBR

… strongly hit by the ruble depreciation.



The rise of non-performing loans is a major reason of concern. At the end of 1Q of 2009, according to CBR, NPLs rose to 4.3% of gross total loans from 2.5% at the end of 2008. The share of non-performing loans may climb to 20% by the end of 2009, as the head of the Russian deposit insurance agency declared in May. However, there is not an unanimous consensus on the figures for 2009. The estimates provided by the Russian authorities differ quite significantly from those provided by independent institutions/agencies. The range is wide: from 10% (CBR) to 35-40% (S&P's).

NPLs: major reason of concern
(NPL/total loans, %)



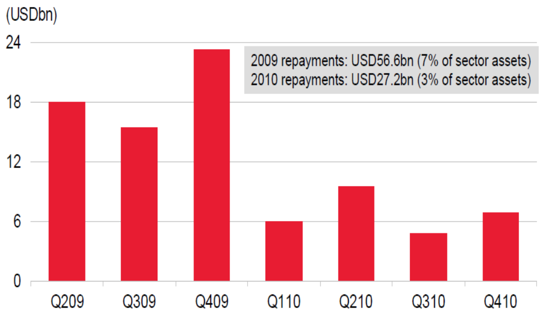
Source: CBR and IMF

The real size of the problem is still unclear. The reason behind the inconsistency of the figures is due to the different accounting methods to calculate

NPLs. In Russia when a debtor misses a repayment, banks are required to report as a delinquent only the amount missed, while internationally banks report the entire outstanding amount of the loans value. Furthermore, according to Russian standards, restructured loans are not accounted as non-performing. CBR announced that as of April 1, 20% of total bank assets were restructured loans. This proportion is likely to increase.

But if the problem is underestimated, the measures could be insufficient. According to the finance minister Alexei Kudrin, Russia will issue $14.7bn in bonds to recapitalise its banking system for the period 2009-10. Only banks with a minimum of 50 billion rubles ($1.6 billion) in assets would be eligible for recapitalisation, this implies the funds will be limited to the top 55 banks (out of a total of about 1,000 banks). At the end of June, Vladimir Putin decided the five largest state-controlled banks - Vneshekonombank, Sberbank, Vneshtorgbank, Gazprombank and Rosselkhozbank - should lend up to $16 billion to struggling corporations over the next three months.

Bank External Debt Repayment schedule
(USD billion)



[a] Payment schedule at end-2008, excludes new debt contracted or pre-paid in 2009 to date
Sources: CBR, Fitch

Russian foreign debt repayments due in 2009 amount to $60 billion. To some extent, Russian banks will be able to manage the liquidity and funding challenges they face, thanks to continued regulatory liquidity injections, owner support, their own accumulated liquidity cushion, cash generated from amortizing loan books and some remaining debt refinancing possibilities. However, a liquidity risk still exists and will not be completely eliminated.

Russia has enough resources to face these tough times. The amount of foreign reserves is still high enough to avoid major crisis ($402 billion plus almost $200 billion piled up in Reserve and National Welfare Funds). Loan losses are likely to rise in the years ahead and the financial sector will be even further impacted if oil prices do not start to significantly recover. Government has provided key support measures for the banking system and particularly to leading players (such as all state-owned and strategic banks). Foreign parental banks will continue providing support to their subsidiaries. Nevertheless, SACE believes medium-small banks are going to suffer and for this reason it will limit its exposure on these counterparts.

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