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AS RUSSIAN LENDING BOOM CONTINUES, BASICS OF CREDIT RISK MANAGEMENT REMAIN CRITICAL

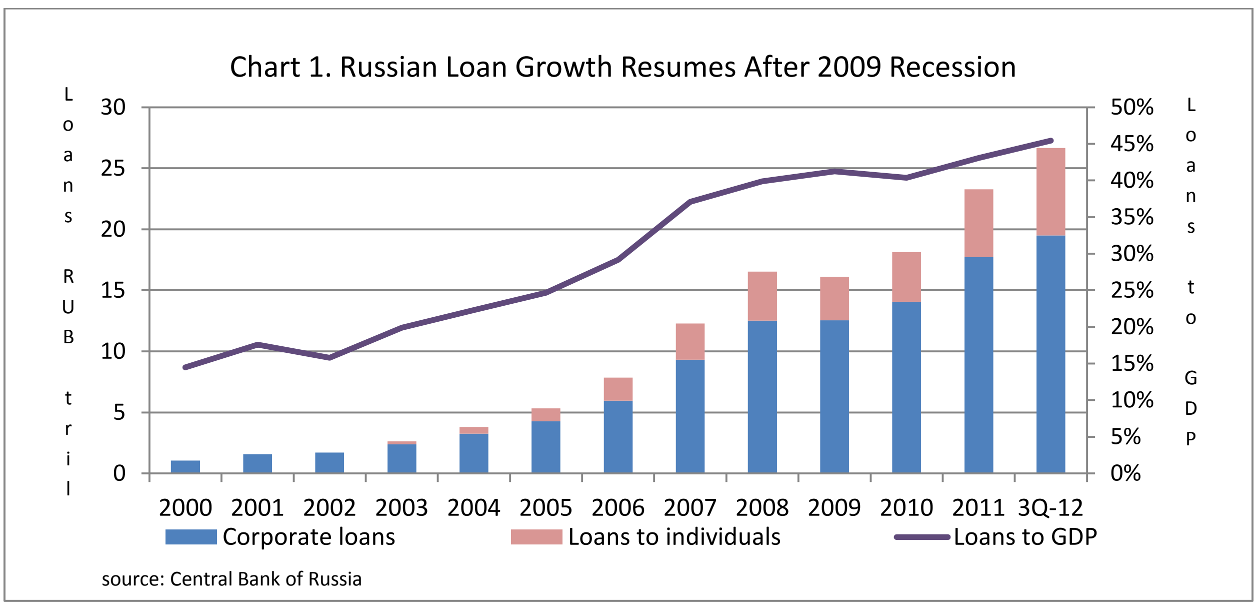
(The paper is based on a presentation by Scott Bugie at the Cbonds Russia Risk Conference on November 21, 2012 in Moscow, Russia.)

Main points

- Russia's state banks are leading a long-running credit boom that resumed after a pause during the recession of 2009.
- The basics of credit risk management are policies that are clearly stated and communicated, promote risk diversification, safeguard against risky directed and related-party loans, and anticipate the impact of future economic downturns.
- Certain characteristics of the Russian market -- a data deficit, the ownership structure of banks, the moral hazard of state control, the high correlation of the economy to oil prices – make it difficult to apply the basics, leading to higher potential credit risks at banks.
- The next downturn likely will result in a repeat of the high rate of loan losses of 2009-2010, and perhaps will be even more damaging if the state does not provide the same support that it did during those years.

The global financial crisis – five years old and counting – has showed once again that relying on complex models to manage and regulate risks – credit risks as well as the numerous other risks that banks face -- does not always work out for the best. Just as simple measures in regulation have been relatively good predictors of problem banks (see, for example, the paper titled 'The dog and the frisbee' presented at the Jackson Hole economic policy summit in August 2012), the basic principles of credit risk management have been critical to navigating the pronounced credit risk cycles of the banking industry. This is particularly relevant in Russia, a country with a concentrated economy and high inherent lending risks.

The global crisis hit banks in Russia just as it impacted banking systems all over the world, partly due to the globalization of capital flows and the significant cross-border investment in the industry, but also because of certain characteristics of the Russian market that hinder the application of the basics of credit risk management. Russian banks likely will suffer high losses in the next downturn, at great cost to the government and to the detriment of bank creditors. Greater progress in reducing obstacles and applying the basics would help limit future losses.



State Banks Lead Russian Lending Boom

The darkest point of the global crisis was the second half of 2008, when Lehmann Brothers defaulted and bank debt markets, including Russia's, froze. Since then credit growth in mature markets has been stagnant, with deleveraging in some countries. In contrast, in Russia (and in certain other developing markets) the robust credit expansion of the 2000s resumed with gusto soon after the recession of 2009. Bank loans to the private and state enterprise sectors increased RUB 10 trillion, from 41% to 45% of GDP, from the beginning of 2010 through the third quarter of 2012 (see Chart 1). Loans to individuals doubled during that period.

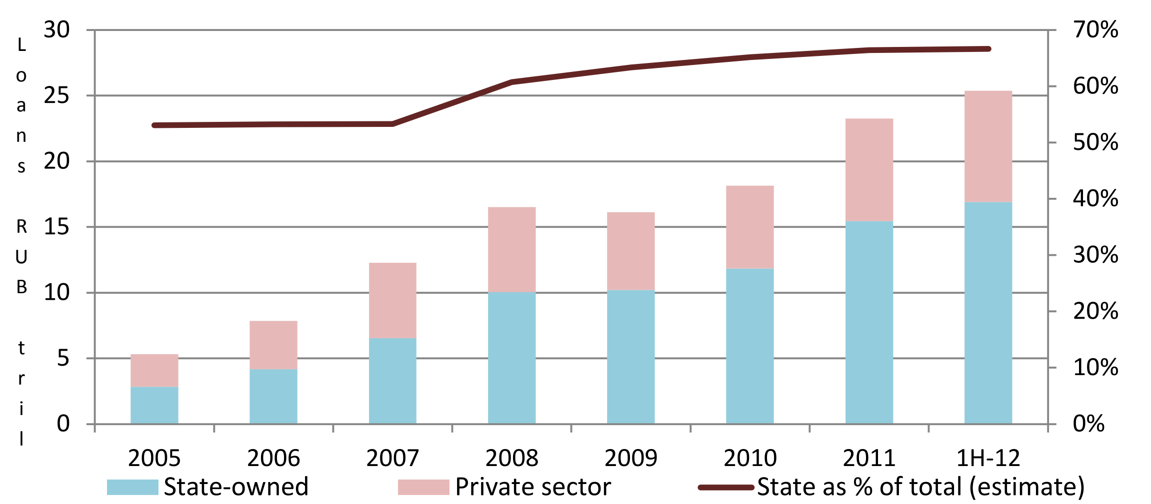
This fast-paced increase in debt is to be expected in Russia, where debt financing is much less developed than in other countries. Russia's ratio of total debt (borrowings of the government, non-financial corporations and households) to GDP of approximately 80% in 2012 is roughly one third of that of most mature markets, and less than a one-fourth of that of more highly indebted countries such as Spain and Japan. But because of certain characteristics of the domestic economy and market, the Russian banking industry is more vulnerable to losses in a downturn.

Russian state banks already represented more than half of the lending market prior to the crisis. Their share of system-wide loans has increased in the post-crisis years, to approximately two thirds of total domestic loans (see Chart 2). Some of the expansion was through the acquisition of troubled institutions, such as Bank of Moscow, acquired by VTB Bank in 2011, and Bank Globex and Svyaz-Bank, bailed out by Vnesheconombank (VEB) earlier during the crisis.

The aggressive growth of state-controlled banks places additional competitive pressure on private sector banks. It also raises the stakes of moral hazard: state banks have a funding advantage and can act with confidence that the government would bail them out of future troubles. The government can direct its banks to increase credit supply or to support particularly industries or companies as needed.

Private sector banks feel the pressure keep up the pace and retain their market share. Moreover, the increased lending by the Central Bank of Russia (CBR) to banks in 2012 has amplified the credit boom, particularly to individuals, and boosted the consumer sector.

Chart 2. State Banks Increase Dominance in Domestic Lending

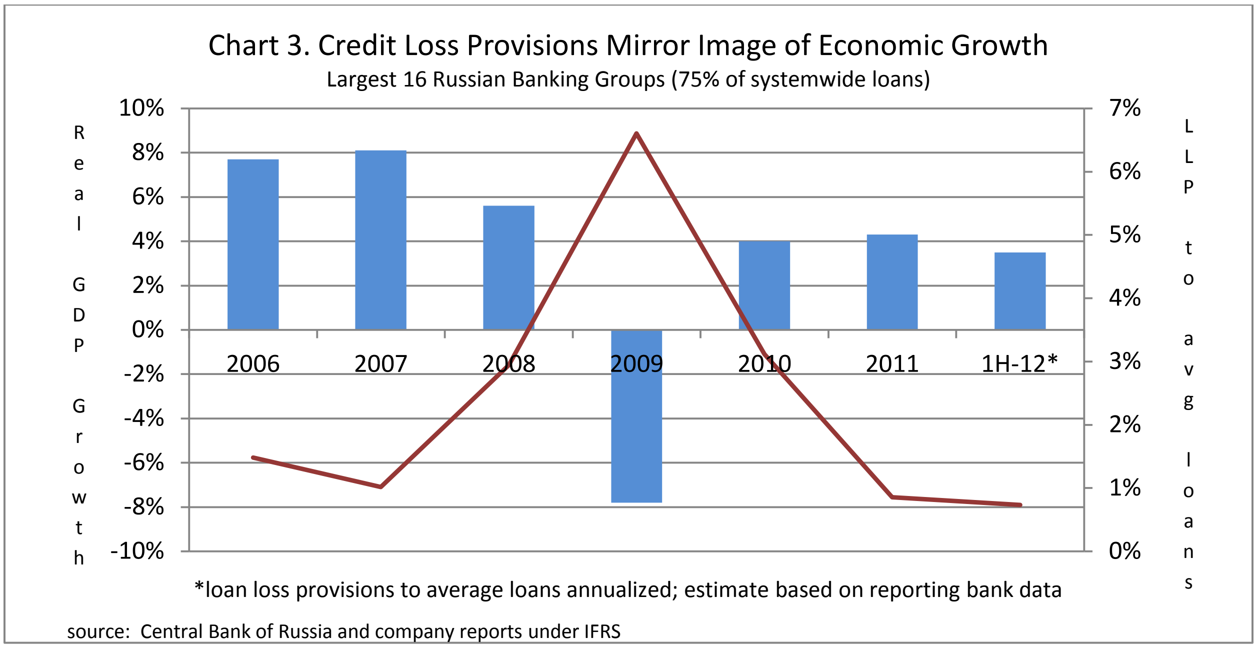


source: Central Bank of Russia and company reports

Highs and Lows of Credit Cycle

During booms the seeds of future busts are planted. All borrowers look better in a boom – which means that lenders must counter their enthusiasm with credit risk policies that anticipate from the start the consequences of the next severe downturn. The uncontrolled credit boom and subsequent crash of the Kazakhstan banking industry during the previous decade should serve as a cautionary tale for the Russian banking system. Simple rules established at the top are critical to set the tone in credit risk management and can limit the damage when the boom ends.

The most recent credit cycle in Russia shows the highs and the lows of the Russian market. So far in 2012 the reported rate of credit losses under IFRS is relatively low. Through first half 2012 the annualized system-wide rate of net new loan loss provisions to average total loans for the largest banks in the system was approximately 0.7%. In 2009, at bottom of the cycle, the rate was almost 10 times greater (see Chart 3). The recent cycle of Russia is typical; default statistics from the major credit rating agencies show that the annual corporate default rate about one year after the trough of a recession is about fifteen times greater than the lowest annual default during the periods of economic expansion.



Loss Rates May Tick up in Second Half, But Correction Behind Most Russian Banks

The first half 2012 results likely understate the rate of losses, due to the significant reversals of credit loss provisions taken in prior periods at some institutions, for example Sberbank, Alfa-Bank and ZAO Raiffeisen. Moreover, the moderate slowdown of the Russian economy in the second half of 2012 likely will push up loan loss rates from the first half of the year. And banks tend to take larger provision in the second half of the year as they conduct a thorough end-of-year review of their portfolios. It is also important to point out that certain banks were slower to recognize losses than others, resulting in a wide dispersion of loss rates across institutions. Private sector groups such as MDM Bank and URALSIB Bank are still struggling to reestablish adequate profitability and steady underwriting results after the crisis. But the Russian banking sector and economy is Russia is mostly through the correction triggered by the recession of 2009, and loan loss rates in 2012 and 2013 likely will remain low by Russian standards.

Basics of Credit Risk Management

A summary statement of the fundamentals of credit risk management is: policies and procedures for credit underwriting, monitoring, and problem loan workout that are clearly stated and communicated, that promote risk diversification, that safeguard against unhealthy or uneconomic internal influences from owners and commercial managers, and that take into consideration the low points of the economic cycle. The following six fundamentals pertain to Russia and most banking markets:

1. Establishment of clearly defined policies and criteria for credit underwriting and monitoring and for bank's overall credit risk profile. An institution should clearly define its risk appetite.
2. Separation of credit underwriting and review from the commercial relationship with the customer.
3. Diversification of credit risk by geography, by economic sector, and by borrower. This means avoidance of risk concentrations.
4. Restriction of loans to related parties (including companies controlled by a bank's owners).
5. A borrower's capacity to repay should take precedence over the value of collateral.
6. A bank should engage in periodic stress testing of the entire credit portfolio, including securities and off balance sheet commitments -- in particular to understand and manage correlation risks and 'tail' risks that occur in an economic downturn.

Russian Market Presents Obstacles

Certain characteristics of the Russian market make it difficult for financial institutions to apply the basics. Some of the obstacles reflect the structure of the Russian economy, while others are a consequence of the legal infrastructure and corporate practices in the country. Clearly Russia is not alone in this regard.

The largest obstacle likely is the incompleteness and sometimes poor quality of data on borrowers. This makes all six fundamentals stated above difficult to implement – reliable data is the lifeblood of credit risk management. Russian companies are slow to publish, or do not publish, accounts. Financial statements may be unconsolidated and exclude subsidiaries, sometimes due to offshore structures outside the scope of reporting. Official data on bankruptcies is lacking. The tendency of troubled Russian companies to work out problems with lenders outside of bankruptcy proceedings means that information on default rates are incomplete. The Russian lending market has a relatively short 20-year track record – and the time series of meaningful information is even shorter because of the noise from the chaotic 1990s. Because of this it is extremely difficult to project a typical running rate of annual loan losses in Russia. In Russia and elsewhere, banks should avoid the pitfall of modeling with data that do not apply. The models should be an aid to the application of the basics of portfolio management, and institutions should have clear view of the potential risks in a severe downturn.

Closely linked to the above is the opacity of information with respect to the owners of companies and the assets and interests of the owners. The grey area between government and private sector adds a layer of opacity. This presents an obstacle to diversification by sector or individual borrower. Related-party lending is the Achilles heel of the Russian banking industry.

Exceptions to policies limiting single party or sectorial concentrations occur frequently in Russia. These exceptions may corrode the good work done by bank credit risk managers. The exception loans may be to pet projects of owners, to affiliates or business partners, or loans that further state interests (including cross-border loans to countries such as Belarus or Cyprus). Bank policies should delineate the process of exceptions by defining the hierarchy of authorizations, setting the allowable frequency of exceptions, and estimating their impact on the risk organization of a bank.

Russia is a concentrated economy, and borrower credit quality linked to oil prices. The economy dominated by state enterprises and large corporations (including some that own banks) in the energy and metals sectors. This presents a large obstacle to diversification. Stress tests of portfolios should take into account the full impact of a decline in oil prices such as that which occurred in 2009. The industry is limited to a certain extent in its capacity to diversify due to the concentration of the economy and the country's corporate structure.

State control of majority of banking sector creates potential conflict of interest of the state owning and regulating financial institutions. This conflict must be carefully managed carefully to avoid the moral hazard of state banks operating as if they will be rescued by the government if they are in trouble. A last point is that the widespread practice of lending in foreign currency in Russia adds another layer of risk to a borrower's capacity to repay.

Next Reckoning May Be a Few Years Away

The current boom will end – it is not a questions of if, but rather of when, and of how the correction will play out in Russia. The extent to which individual institutions follow the basic rules will to a great extent determine which institutions will survive the next significant downturn and which will falter. Bank of Moscow and MezhProm Bank are two prominent examples of institutions that did not make it through the most recent correction in Russia. These two cases illustrate the dangers of related party lending and concentrations in loans to single borrowers.

Significant state intervention prevented the damage from being greater during and after the recession of 2009. The direct capital support, including recapitalization of state banks, subordinated loans granted by state institution Vnesheconombank to private sector banks, and the financing deal to rescue Bank of Moscow, totaled over $50 billion, or approximately 3% of Russia's GDP. And this excludes the benefits of the CBR's significant emergency funding and the regulatory forbearance and encouragement of the restructuring of the loans of marginal borrowers.

Due to the relatively small size of the Russian banking sector and the comparatively moderate use of debt financing in the economy, the next reckoning for the Russian banking industry is likely a few years down the road. The Russian government also has sufficient resources and control via its ownership and control of the majority of the industry to provide support as it did during the most recent severe downturn.

Two final characteristics of the credit market in Russia are noteworthy. The first is that Russian banks often have significant equity holdings, but that that credit risk but policies may not cover equity stakes. Banks should ensure that capital appropriately covers equity risk. The second is that use of real estate as collateral is undeveloped in Russia, while the real estate construction sector is highly important in the developing economy. The commercial real estate sector is unpredictable due to its weak legal infrastructure, and residential real estate sector is stunted. The next downturn will surely result in heavy losses in loans to this sector.

The pending law on consolidated supervision that addresses lending to affiliated borrowers in theory should help. Market-wide credit risk management would surely benefit if the law is passed and the Russian Central Bank makes a serious effort to implement it. In practice, changing the insider lending culture has been difficult to accomplish in Russia.

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