Bank of Russia

Q4 2022 – Q1 2023

FINANCIAL STABILITY REVIEW

Information and analytical review

Moscow
2023

SUMMARY

1. Global risks

In the spring of 2023, US banks came under stress for the first time since the global financial crisis of 2007-2009, the European market also experienced escalating challenges. This made central banks think about the regulatory efficiency and the need to develop new tools for maintaining financial stability. Over the years of ultra-low interest rates, financial institutions have accumulated hidden problems. Failed banks faced materialisation of interest rate risk due to deposit outflows and had to recognise losses from negative revaluation on debt securities. Depositors, especially uninsured, were able to withdraw their funds faster than during the previous crisis periods due to the development of online banking. The interest rate risk can materialise on a larger scale and be accompanied by the credit risk amid high interest rates not only at banks but also at non-bank financial institutions, which have significantly increased both their market share and leverage since the crisis of 2007-2009. The residential and commercial real estate may fall into difficulties in the countries where the market overheating was previously observed. During the COVID-19 pandemic in 2020, the resilience of the financial sector helped to curb the crisis trends in the economy; but the current financial sector turmoil, by contrast, may negatively affect lending, economic growth, and the ability of major central banks to reduce inflation.

Market expectations for the US Federal Reserve (Fed) key rate now have been substantially revised downwards with an expected decrease by 75 bps from the current peak of 5–5.25% by the end of 2023, whereas before the March volatility episode, the rate hike to 5.5–5.75% was forecast. This adjustment reflects the impact of materialisation of risks to financial stability on macro indicators (decline in economic activity), trends in monetary policy, and the rise in uncertainty as well. If inflation remains persistently high, coupled with stress in the financial sector, it can cause stagflation in the global economy for some time. Increasing geoeconomic fragmentation can become an additional aggravating factor, as it reduces cross-border capital and labour flows, erodes prosperity and slows global economic growth as a result.

The Russian economy and financial sector have largely adapted to the sanctions. The contagion effects associated with financial instability in leading countries are limited. Nevertheless, reduced demand and/or prices for Russian exports remains to be a sensitive channel for transmission of shocks in case of a global recession. Besides, the already imposed restrictive measures, as well as new sanctions, including secondary ones, can give rise to additional negative consequences. The economic and financial resilience of friendly countries with which Russia is strengthening economic and financial ties has become an increasingly significant factor in terms of contagion effects.

2. Vulnerabilities and resilience of the Russian non-financial sector

Vulnerability 1. Sanctions exposure of business

The ongoing sanctions pressure on the Russian corporate sector is having an adverse impact on the financial position of certain Russian companies and their prospects for development. Most companies, both domestic and export-oriented, face higher operating and capital costs due to the need to replace imported equipment and develop logistics corridors. The rapid reorientation of trade flows is hampered by the concerns of new trading partners about secondary sanctions.

Vulnerability 2. Exit of foreign investors from Russian asstes

Political pressure on foreign companies continues, leading in some cases to the suspension of their operations in Russia or even to their withdrawal from the Russian market. The relevant transactions are reviewed by a subcommittee of the Government Commission on Monitoring Foreign Investment in the Russian Federation, and they involve a significant discount to the market value and a tax paid to the budget. In some cases, a change of ownership is required to maintain the business continuity of socially important enterprises. However, such transactions can carry risks. Firstly, the large volume of foreign currency purchases, needed for transaction settlements, in the context of Russia's shrinking current account surplus of the balance of payments may adversely impact the FX market, so buyers are advised to evenly distribute the purchases of foreign currency over time. Secondly, the future prospects of companies tend to be increasingly uncertain: for example, when the company being sold by a non-resident is heavily dependent on funding, supplies of raw materials and components, equipment and technologies provided by the parent company. Thirdly, such transactions can increase the debt burden of the buyer and the acquired company, while the transactions are often funded by Russian banks loans.

Assessment of the resilience of Russian non-financial companies

At the end of 2022, most of the large Russian export-oriented companies had an acceptable level of the debt burden, demonstrating resilience to the changing market environment. The Russian oil and gas industry reported revenue growth amid high commodity prices. The metallurgy and mining companies showed some decline, which had no significant effect on their debt burden. However, at the end of Q1 2023, revenues of many export-oriented companies declined as the restrictions implemented by the Western countries in 2022 came into force.

Businesses are increasing funding by raising loans from Russian banks and issuing bonds. This funding partly offsets the reduction in external debt, however the credit crunch has generally been avoided. In the future, the loan demand will be driven, among other things, by the need to finance economic transformation projects.

In 2022, the adverse impact of sanctions on a number of industries required banks to restructure a significant amount of loans. Many banks have built up a large amount of loan loss provisions in advance. Certain loans are being restructured for the second time, but the rise in defaults is not observed. In general, the quality of corporate loan portfolios has remained stable.

3. Vulnerabilities of the Russian financial sector

Vulnerability 1. Further restriction of access to payment infrastructure in 'toxic' currencies

The situation with settlements and correspondent banking in 'toxic' currencies continues to deteriorate amid the expansion of sanctions and intensifying pressure on subsidiaries of foreign banks, operating in Russia. In this context, an increase in export and import transactions in the currencies of friendly countries and a similar transformation of the Russian FX market are being observed. The domestic FX market may suffer periodic imbalances, since the transition to the currencies of friendly countries is uneven (periodic mismatches of exports and imports volumes in Chinese yuan (CNY, yuan) occur; in certain periods deposits in 'toxic' currencies extensively convert into the yuan deposits, while the transformation of loan currency structure is lagging behind), and the Russian market does not fully interact with the global market. For example, December saw a temporary shortage of yuan liquidity, while late March–early April saw a shortage of euro liquidity, which was reflected in the increased cost of raising the respective currencies in swap transactions. At the same time, open position on FX swaps in the 'toxic' currency has significantly reduced (amid the exit of non-residents), and the yuan positions have gradually stepped up. To support FX liquidity, the Bank of Russia has launched yuan FX swaps (previously, such transactions were carried out in US dollars).

Vulnerability 2. Offshorisation of the citizens' savings

Until 2022, the outflow of private investors' funds into foreign (primarily US) equities was marked as a vulnerability of the Russian market. This was carried out via Russian stock exchanges where these securities were traded. Due to sanctions imposed against the Russian financial infrastructure, some of these investments have been frozen, and private investors have lost interest in such instruments. In addition, to protect investors from sanctions risks, the Bank of Russia has limited purchases of securities of issuers from unfriendly countries[1] for unqualified investors.

At the same time, the volume of citizens' transfers to their accounts with foreign banks and brokers increased significantly in 2022. These funds are largely used to finance overseas trip expenses and to purchase foreign goods and services, but the remainder reflect an offshoring trend for the citizens' savings. This carries risks for citizens, the banking sector (by reducing their liabilities), and the economy in general (due to higher borrowing costs). In theory, portfolio diversification (including across countries and industries) means higher returns on investments, but in case of unfriendly countries, its benefits may be offset by uncontrolled sanctions risks. A number of foreign financial institutions have already imposed restrictions on Russian customers, and these practices may expand in the future, including in relation to securities transactions.

Russian investors are still interested in cryptoassets, although there are no signs of a significant inflow of new users to the market. Due to the exit of foreign payment systems from the Russian market, P2P transactions and cash have dominated the channels of acquiring cryptoassets.

In general, the vulnerability associated with the offshorisation of savings is still limited (an increase by 4.1 p.p. to 19.2% from 1 January 2022 to 1 April 2023[2]), and citizens continue to invest mainly in RUB deposits (42.2% of household savings). Since the beginning of 2022, private investments in Russian equities grew by RUB 1.2 trillion[3], primarily in the OTC market. Maintaining public confidence in the stock market remains to be one of the key challenges, which depends on the prospects of Russian companies, their financial disclosures, and the stability of the regulatory and tax regime.

Vulnerability 3. Rising household debt

Q4 2022 saw increased banks' risk appetite in unsecured consumer lending. Before the introduction of macroprudential limits (MPLs), banks significantly loosened their lending standards: the share of loans with debt service-to-income ratio (DSTI) of 80% or more reached a record high

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[1] Directive of the Government of the Russian Federation No. 430-r, dated 5 March 2022 (as amended on 29 October 2022), 'On Approving the List of Foreign Countries and Territories Committing Unfriendly Acts against the Russian Federation, Russian Legal Entities and Individuals'.

[2] This indicator is calculated as the ratio of accumulated volumes of fund transfers by individuals to foreign banks and brokers, foreign currency cash and foreign securities to the volume of deposits and brokers' funds, cash, investments in securities, funds in individual life insurance and endowment life insurance.

[3] To assess inflows from retail investors, this figure is cleared of changes related to corporate actions, changes in the ownership of large blocks of securities, etc.

of 36%. The introduction of MPLs from 1 January 2023 has resulted in banks tightening their lending standards and thus the structure of consumer lending has improved: in Q1 2023, the share of loans with DSTI of 80%+ dropped to 29%, and the share of loans with an over 5-year term was 7% (excluding loans with credit limit). Most consumer lending banks managed to reshape their lending processes and came in line with macroprudential limits in Q1 2023, including due to the reduction of the loan amount offered to borrowers. Macroprudential limits affect credit cards segment with a lag, as they do not limit disbursements on previously issued cards, but restrict the issuance of new cards and the limits increase for borrowers with excessively high debt burden.

In Q1 2023, the portfolio of unsecured consumer loans increased by 2.5%. Accelerated growth in consumer lending in March (+1.4% MoM) is associated with both seasonal fluctuations and increased demand for loans amid rising household incomes. The impact of macroprudential limits on lending was smoothed out by structural factors, in particular the redistribution of market shares among banks. In Q1 2023, the largest banks with a historically high share of loans to borrowers with excessively high debt burden saw their consumer loan portfolios reduced by 1%, while other banks' portfolios grew by more than 3%.

Since banks have successfully adapted to new instrument and unsecured consumer lending continue to grow sustainably, the Bank of Russia has decided to reduce limits further in Q3. The share of loans with DSTI of 80%+ should not exceed 20% of all issued loans in Q3 (30% for MFO), whereas the share of loans with an over 5-year term should not exceed 5%. This decision will limit the debt burden of citizens and improve lending structure.

The quality of the unsecured consumer loan portfolio remains stable. The share of NPL90+ loans did not change over the quarter, and as of 1 April 2023, it amounted to 8.7%. The vast majority of restructured loans continue to be timely serviced by borrowers.

Vulnerability 4. Imbalances in the residential real estate market and risks of project financing

In 2022, a drop in the effective demand for housing led to an aggravation of previously accumulated problems in the residential real estate. Housing prices in the primary market grew due to the spread of risky mortgage lending practices implemented by banks along with developers. As a result, in Q1 2023, the price gap between the primary and secondary housing markets widened to 40%. In such environment, banks faced higher risks both in project financing of housing construction and in mortgage lending.

The growth in mortgage lending was accompanied by a noticeable decline in the quality of new loans. The share of DSTI 80%+ borrowers was higher than in consumer lending, reaching 40% in Q1 2023. The share of low-down payment mortgages (up to 20%) has exceeded half of all mortgage loans for the first time: in Q1 2023, it amounted to 51% versus 38% a year before. The widespread use of developers' preferential mortgage programmes has inflated the collateral value of housing, so that for low-down-payment mortgages the real loan-to-value ratio may exceed 100%. To limit the spread of high-risk trends in mortgage lending, the Bank of Russia has introduced increased provisioning for loans issued after 15 March 2023 at an effective interest rate significantly below the market and on 1 May 2023 established macroprudential add-ons for the low-down-payment mortgage. Announced measures before coming into force led to the reduction of the usage of schemes that inflate the housing prices by banks. However, in the end of 2022 banks' websites announced offers to reduce mortgage rate by means of one-off payments and not by means of higher housing prices. Such practices also bear risks for borrowers.

Amid declining sales in the primary housing market, banks increased lending to developers. At the same time, as of 1 April 2023, the loan coverage ratio for funds on escrow accounts dropped to 81% (the amount of outstanding loans not covered by escrow almost reached RUB 1 trillion). Given the extensive amount of new projects in the market, this level of coverage is acceptable, but the growth of housing construction lending increases the exposure of banks to correction in real estate prices.

Vulnerability 5. Interest rate risks of banks amid growing public debt

The recovery of the net interest margin supports the banking sector's resilience in case of materialisation of interest rate risk. However, the exposure of banks to interest rate risk exceeds the pre-crisis level: the share of short-term liabilities[4] remains higher than in early 2022. In the context of temporary regulatory easing of liquidity ratios, banks primarily try to increase lending rather than restore the liquidity buffer. During the reporting period, banks showed low demand for investments in fixed-coupon government bonds, which helped maintain long-term yields high. The latest episode of the US crisis proves that banks need to improve the balance of maturity of assets and liabilities, and use up-to-date approaches to calculating interest rate risk and liquidity risk. The Bank of Russia plans to evaluate the practice of managing interest rate risk in large banks, and will also develop new approaches to managing liquidity risk.

4. Assessment of the financial sector resilience

Banking sector

The financial position of credit institutions is improving. The capital reserve remains at RUB 6 trillion excluding the effect of temporary support measures.[5] The current regulatory easing provides partial support to financial results, although a large part of the regulatory requirements has already gone back to pre-crisis standards in early 2023. In 2023 the capital reserve has also been supported by the refusal to pay dividends by many banks (in 2022 only RUB 139 billion was allocated for this purpose, almost five times lower than in 2021).

Non-bank financial institutions

The accumulated financial cushion, coupled with the measures taken by the Bank of Russia, allowed NBFIs to withstand the impact of the materialisation of geopolitical risks, general stagnation, and a number of major insurance events in the commercial real estate insurance segment. At the end of the year, all segments of NBFIs (except for leasing companies) mainly reported profits, and Q1 2023 saw a recovery growth in their key performance indicators. At the same time, we note that losses from the asset freeze have not yet been fully reflected in the balance sheets of NBFIs and will be written off over several years. Aircraft leasing companies have turned out to be in the most affected segment.

[4] Cash in accounts and in deposits for up to 1 year.

[5] Capital reserve – overall potential to absorb losses without breaching capital adequacy ratios. The assessment is based on reporting forms 0409135, 0409123 and banks surveys as of 1 March 2023.