

## **Анализ банковского сектора в России и прогноз его будущего развития**

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### **Аннотация**

В данной статье представлен анализ российского банковского сектора на современном этапе, вывод из результатов этого анализа и прогноз на будущее банковского сектора России. Рассмотрены основные тренды сектора, включая увеличение доли государственных банков, снижение ключевой ставки Центрального Банка России и стагнацию чисто процентной маржинальности.

**Ключевые слова:** банковский сектор, банковская система, денежно-кредитная политика, кредит, банковская инфраструктура, кредитный риск, анализ

## **Analysis of banking sector in Russia and forecast of its future development**

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### **Annotation**

This article presents an analysis of the Russian banking sector at the present stage, draws conclusions from the results of this analysis, and makes predictions about the future of the Russian banking sector. The main trends of the sector are considered, including an increase in the share of state-owned banks, a reduction in the Central Bank of Russia's key rate and stagnation of net interest margin.

**Keywords:** Banking sector, banking system, monetary policy, credit, banking infrastructure, credit risk, analysis.

The period of 2015-2017 turned out to be one of the most difficult times of the functioning of the banking system in modern Russia. The crisis situation in the banking sector has come in connection with economic and political circumstances. We will highlight the significant causes of the banking crisis in 2014, which contributed to the following dynamics of banking sector in 2015-2017 that we will discuss further.

1. The loss of the ability to acquire foreign loans by Russian banks, which were a cheap source of financing, due to the introduction of foreign sanctions. Countries like the USA, Canada, the EU countries and others have announced sanctions aimed at slowing the Russian economy. Due to the fact that loans of the Central Bank of the Russian Federation are not available to all commercial banks, this has led to such an internal problem as the lack of necessary resources for Russian banks.

2. The massive revocation of commercial bank licenses has undermined public confidence in deposits and banks, which is why in 2014 many people preferred to keep their savings at home.

3. In 2014, there was a serious macroeconomic shock - the depreciation of the Russian ruble.

4. Stagnation in the real sector of the Russian economy, which served as the reason for foreign investors stopping investing money not only in production, but also in Russian banks.

All of the factors listed above contributed to the trajectory of Russian banking sector development in the following years. The banking system, after experiencing a shock following the adoption of sanctions against Russia, has adapted to work in the new economic environment. The banking sector is an integral part of the country's economic system and largely reflects the main trends of its development, thus it has been majorly affected by these negative trends.

**Table 1.** Main indicators of banking sector

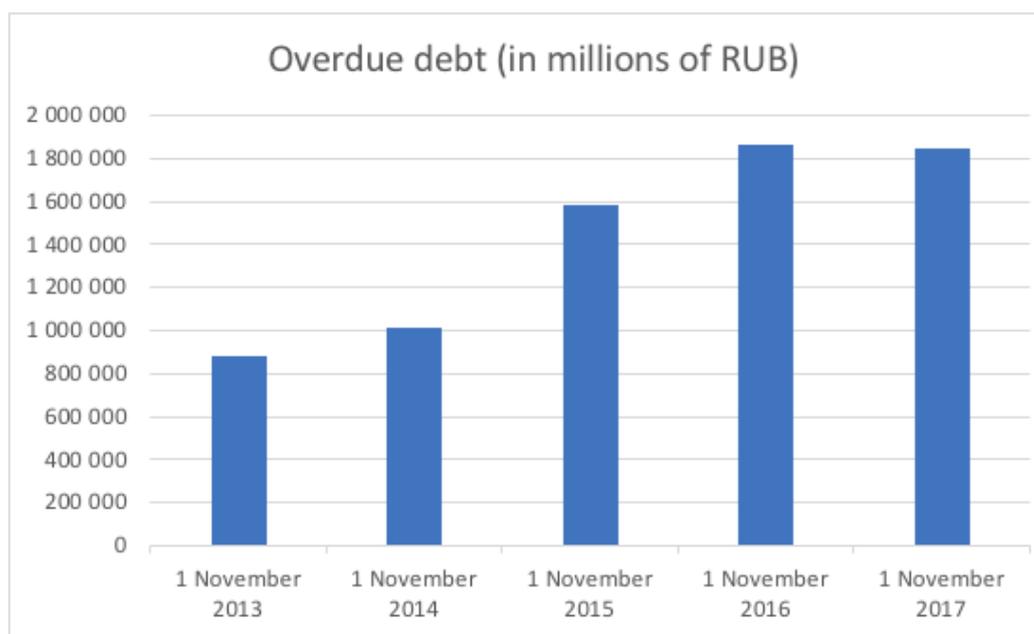
<b>Indicators</b>	<b>Unit</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>Average</b>
<i>Assets</i>	%	6,9%	-3,5%	6,4%	3,3%
<i>Stock portfolio</i>	%	21,1%	-2,8%	7,5%	8,6%
<i>Credit and other loans, total</i>	%	10,4%	-3,3%	4,5%	3,9%
Corporate	%	12,7%	-9,5%	0,2%	1,1%
Retail	%	-5,7%	1,1%	12,7%	2,7%
<i>Debt to the Central bank of RF</i>	%	-42,3%	-49,2%	-26,0%	-39,2%
<i>Customer deposits, total</i>	%	18,9%	-3,5%	7,4%	7,6%
Corporate	%	14,2%	-9,9%	7,4%	3,9%
Retail	%	25,2%	4,2%	7,4%	12,3%
<i>Capital</i>	%	9,1%	14,0%	4,1%	9,1%
<i>Net profit margin</i>	%	3,4%	3,8%	4,0%	3,7%
<i>ROAA</i>	%	0,2%	1,1%	1,0%	0,8%
<i>ROAE</i>	%	2,7%	11,5%	9,0%	7,7%
<i>C/I</i>	%	39,4%	47,7%	41,7%	42,9%
<i>Net profit</i>	trln, rub	0,2	0,9	0,8	63,3%
<i>Capital/Total assets</i>	%	12,7%	10,6%	11,4%	11,6%

In the table above, we may observe dynamics of the major banking indicators that allow us to observe how banking in Russia developed during recent years. Assets of banks on average grew by 3,3% despite all the negative conditions, which means that banks continue to grow their operations. However, it is important to mention that one of the features of the banking sector in Russia is its disproportion in the distribution of assets of the banking sector: approximately 20 of the largest banks own 60% of all assets. The concentration of assets is colossal, moreover, in connection with the crisis phenomena this disproportion has increased, leaving all the banks that occupy 200<sup>th</sup> place and below with only 3% of the market. In our opinion, Russia should strive to create a less monopolized banking market, which will have the opportunity to develop even small regional banks. [2]

The profitability ratios and return on assets are actually also quite promising, as most of the banks managed to even increase its net profit during crisis by 63,3% on average. Though again, these indicators are very much geared towards large state banks which had enough resources from CBR to maintain their operations rather than smaller banks which suffered from ceased access to foreign funds.

Another interesting trend that might be observed from this table is that there is a clear shift from corporate clients sector to retail banking, as there is a slowdown in deposits and loans in

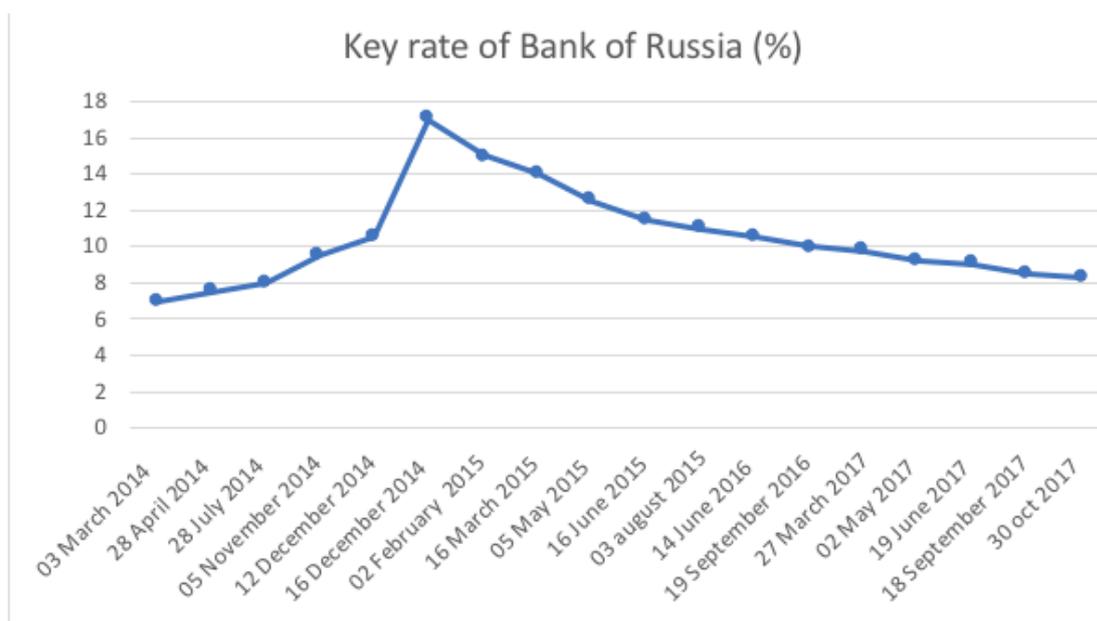
corporate sector with significant downfall in 2016, and on the contrary growth of retail banking in 2017. That might be due to the companies being more reluctant to acquire expensive debt financing, while the downfall in real income of consumers pushed them to get loans in order to finance their day-to-day expenses. That is a concerning fact as many of such loans are of a low quality and below in the graph you may observe that overdue debt was constantly rising during much of the period. [4]



**Fig. 1. Loans past due overview**

Actually, the largest part of the overdue debt is considered "bad" debt with overdue payments over 90 days which is approximately 97% of the total amount of overdue debt and is one of the main drivers of its growth. You may observe how it spiked in 2015-2016 mostly due to overall deterioration of the economy and fall in income of consumers. Though, currently it has somewhat stabilized in 2017 due to Central Bank's decrease of key rate and overall stabilization of the economy.

Overall most of the indicators presented had relatively positive dynamics with short downfall in 2016 which might be due the fact that effect from sanctions and extremely high key rate started to catch up around this year with most of the indicators recovering in 2017. Speaking of key rate, because all of the factors discussed previously the Central Bank of Russia in order to stabilize situation in the economy was inclined to drastically increase the key rate in order to target inflation. That had dramatic impact on the banking industry as cost of the debt for both consumers and companies also spiked. However, in the period of 2015-2016 CBR is continually decreases the rate as inflation and other risks begin to fade away coupled with growing consumer confidence and overall adaptation of the economy.



**Fig. 2. Dynamics of Key rate of CB of Russia**

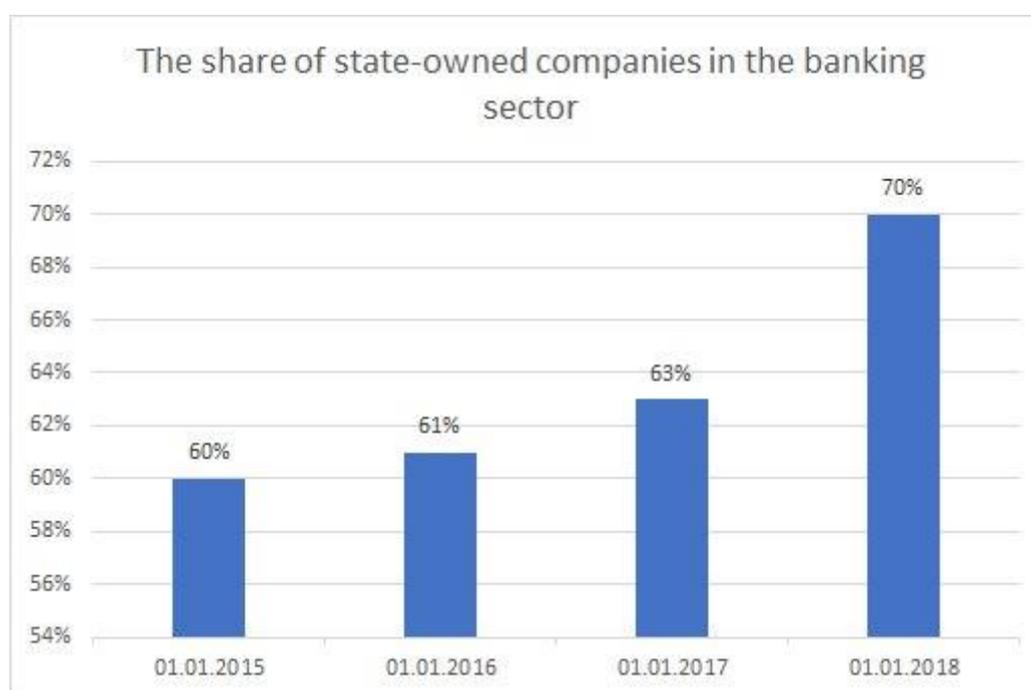
Now going back to the overview of banking industry in Russia the next important indicator that directly influences the bank's ability to provide credits is its capital or equity as there are specific requirements by CBR for amount of reserves that should be provided for loan provisions. If at any bank this indicator decreases and reaches only 2-3% of total assets, then the Central Bank of Russia appoints an audit of the effectiveness of such a financial institution, and in the future, it can revoke a banking license. The situation for the top 30 banks in Russia is actually quite positive they were able to increase their capital significantly in 2014 while being mostly stable through 2015-2017, while at the same time smaller banks especially those below 200<sup>th</sup> place actually experienced extreme downfall in 2015-2017. That puts these banks at a very unstable position as most of them would be unable to maintain their operations and provide for bad debts.

**Table 2.** Equity breakdown of credit institutions

Place of a credit organization by equity value	Equity of credit institutions as of:								
	01.01.2014	01.01.2015	Change (%)	01.01.2016	Change (%)	01.01.2017	Change (%)	01.11.2017	Change (%)
5	221037	263251	19,1	359641	36,62	357300	-0,65	352427	-1,36
30	28755	35204	22,43	34592	-1,74	36061	4,25	36753	1,92
100	7308	7330	0,3	7728	5,43	7023	-9,12	6721	-4,3
200	2640	2660	0,76	2358	-11,35	2035	-13,7	1855	-8,85
500	515	518	0,58	425	-17,79	347	-18,35	320	-7,78

Another important issue with banking industry in Russia is that there is clear trend of state banks starting to dominate the market. Based on the Russian banks' RAS financial statements, following the results of 2017, state banks and quasi-banks accounted for about 70% of the total net assets of the banking sector of the Russian Federation. At the beginning of 2017 this indicator was about 63%, and at the beginning of 2016 - about 61%. We should note that among the 20 largest banks, the concentration of state banks is even higher: as of the end of 2017, about 83% of assets were accounted for by state-owned banks and banks owned by state corporations - in particular. The growth of state participation in the banking system in 2017 was mainly due to the transfer to FCCS of the three largest private banks: PJSC Bank FK Otkritie, PJSC Promsvyazbank and PJSC BINBANK with taking into account the banks that are being sanitized by them or belonging to them. The withdrawal of licenses from private banks placed in the third or fourth decade also had its impact.

[5]



**Fig. 3. Share of state-owned banks**

Moreover, the overall number of banks is plummeting as more and more banks are unable to meet their current liabilities and maintain the required level of reserves. The number of banks for 2016 was 733, that is, in 2015 it declined by 101 banks. And the total number of banks since 2008 has decreased by 403 banks, which is 35.5%. Only in the first nine months of 2016 licenses were withdrawn from 84 banks. Number of active banks by the date of 01.10.2017 is equal to 574. This extreme sweeping of banks doesn't help to increase consumer confidence and as such banks suffer from harder access to deposits. Though on the other hand, the sector becomes more and more transparent with much less risky banks with shady operations.

Currently, the banking sector is strongly influenced by low economic growth rates, as well as the problem of the deficit of high-quality corporate borrowers. Additional risks in the corporate segment may be related to the planned reform of the financing of the housing construction sector, namely, the replacement of the participatory share of the population by bank project financing.

The quality of loan portfolios is affected by outstripping growth in consumer lending, including unsecured lending, characterized by higher default. Accordingly, the banking system continues to operate in a relatively high risk of insolvency of borrowers, whereas new issuances do not allow substantially improving the quality of assets.

In 2017, the cost of credit risk, which characterizes the level of new allocations to reserves, was 1.6% compared to 0.3% a year earlier (an abnormally low figure due to the dissolution of reserves by several of the largest banks at the end of 2016). Significant growth in reserves occurred in the second half of 2017 as a result of their creation for distressed assets identified by the transfer of banking groups PJSC "Bank FK Otkritie" and PJSC "BINBANK" under the management of the FCS.

The trend of lowering interest rates has not yet affected the value of the debt of the non-financial sector - the spread of the effective rate of large business to the banking rate for the first time became negative (minus 0,5-1,0% against 1,5-2,0% in 2012-2015). This will encourage the company to actively refinance its obligations in 2018 (primarily in the bond market) and will put considerable pressure on the net interest margin (NIM) of the banking sector.

The decrease in net profit in 2017 reflected mainly three key trends: 1) a significant increase in provisions for impairment losses on the loan portfolio; 2) the stagnation of the net interest margin (NIM) and 3) the deterioration in operating efficiency, expressed in the growth of operating costs relative to operating income (cost to income, CTI).

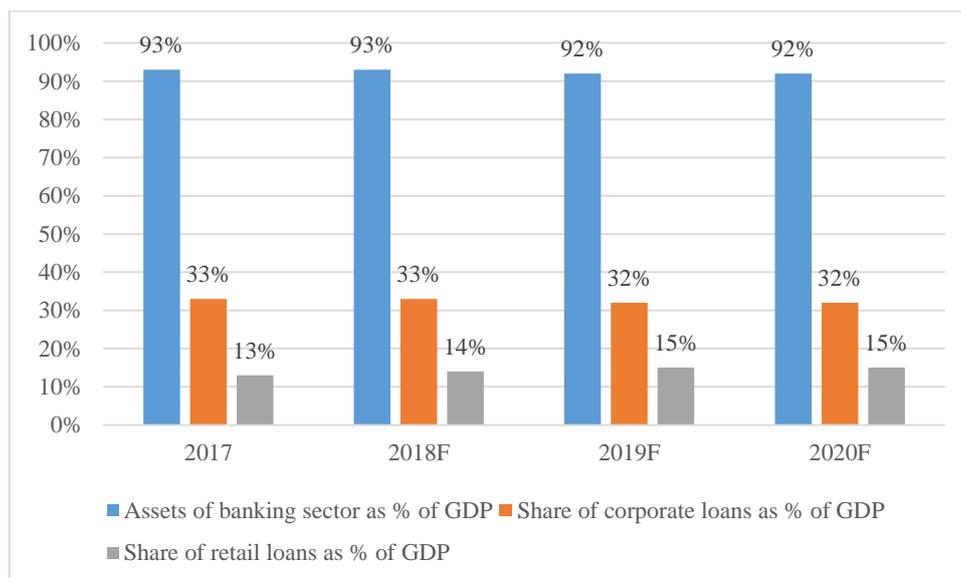
The growth of net interest margin as a whole for credit institutions<sup>5</sup> was minimal and amounted to 4.0% in 2017, compared with 3.8% in 2016. On the contrary, NIM, calculated only for the banking sector without NCOs, in 2017 fell to 4.4% compared with 4.5% in 2016. At the same time, NIM for the banking system without PJSC Sberbank was, according to our estimates, only 3.5%. This dynamic became particularly noticeable in the fourth quarter of 2017 due to a slower decline in the cost of funding compared to interest rates on loans and securities.

Also in 2017, CTI fell to 41.5% compared to the highest in recent years in the value of 47.7%, noted in 2016. Despite the banks' efforts to adapt operating expenses to the new business environment, we expect that from 2018 CTI will resume growth and will reach almost 50% by 2021.

[6]

### Growth rates of assets of the banking sector will stay moderate

Different analysts forecast the continuation of trends in the banking system of the Russian Federation in 2018. Our analysis of the data of CB of Russia are in line with these statements. As expected, growth will be 5.2%, which is less than 6.4% achieved in 2017. Some acceleration of lending to the population and enterprises will be accompanied by a stagnation in interbank lending and a slowdown in the growth of the securities portfolio. As a result, a recovery in the ratio of banking sector assets to GDP is not expected, and this ratio is forecasted to be approximately 93% in 2018.



**Fig. 4. Forecast of the assets of banking sector**

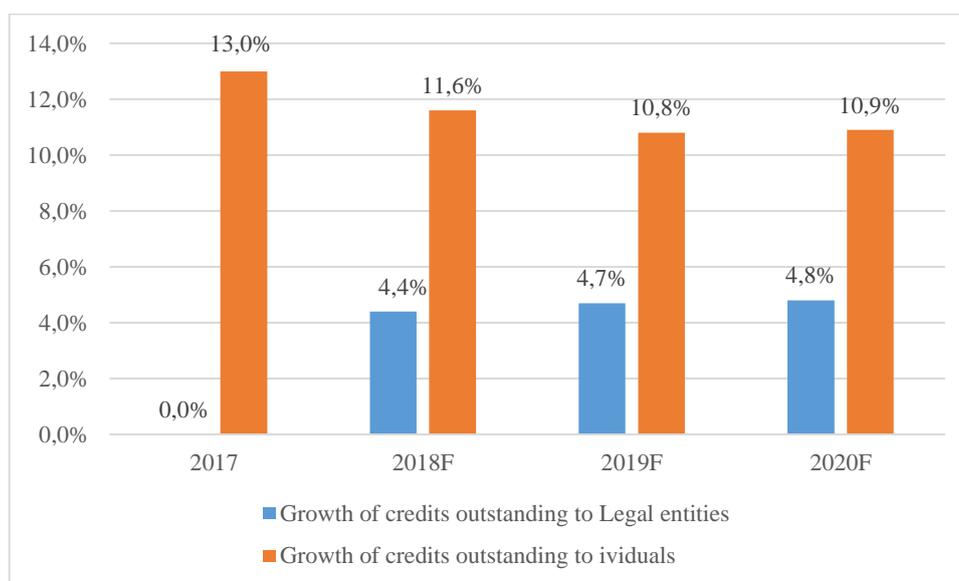
According to the forecasts, in 2018 the growth of the total loan portfolio will accelerate to 5.5% compared with 4.5% in 2017, which will be supported by lower interest rates, as well as partial recovery of corporate lending. The demand for loans will be supported by continued growth of real GDP, as well as individual sectors of the economy. A decrease in interest rates will be an additional incentive for borrowers after the fall of the Central Bank's key rate.

At the same time, banks' appetite for risk will remain conservative, as strengthening regulatory pressure on asset quality will deter the banks' readiness to weaken underwriting standards, primarily with regard to lending to non-financial organizations.

Lending to retail customers will grow by 11.5% in 2018 and will remain the most dynamic segment. This will be due to the recovery in real income growth (according to forecasts, in 2018 it will be 1.0-1.5% vs. minus 1.7% in 2017), as well as lower interest rates (including unsecured loan products). Analysts and investment banks predict outstripping growth in mortgage loans (by 12.8%), while other retail lending will grow by 11.4%. The share of retail lending in relation to GDP will increase and will reach 15% by 2020 (13% in 2017).

According to forecasts, the portfolio of loans to non-financial organizations will grow by slightly less than 5% in 2018. The increase in the portfolio will be constrained by a slowdown in real

growth in industrial production and investment in fixed assets in 2018 (which will limit the demand of non-financial organizations for credit resources), as well as increase in the growth of bond borrowings (as have been mentioned, companies have switched to this type of credit financing). The reduction in interest rates will support the growth of the nominal portfolio, however in real terms the growth of corporate lending will continue to be close to zero. A key driver of loans will be refinancing of credit portfolios of non-financial companies.



**Fig. 5. Expected growth rates of credits outstanding**

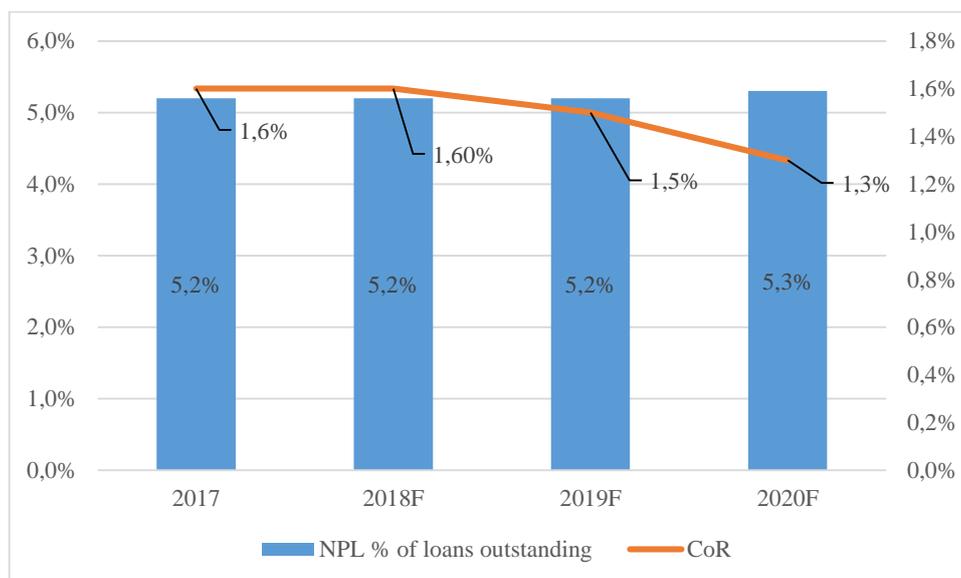
### **Cost of risk (CoR) will stay high in the short- to middle-term future**

Despite the change in the structure of bank credit portfolios and the rate of their growth, the share of overdue debts has not changed in recent years, as already have been mentioned. Analysts believe that this situation will continue in the coming years, and the overall level of overdue loans (for a period of 1+ days in accordance with the accounting principles applied by the Central Bank of the Russian Federation) will be 5.2-5.3% for the period until 2020. [3]

Given the slow pace of economic growth, the problem of a lack of high-quality corporate borrowers in the next few years will continue. Additional risks in the corporate segment will probably be related to the planned reform of the financing of the housing construction sector, namely, the replacement of the shared-equity construction with bank project financing. This may lead to an increase in lending to high-risk industries (including housing construction) from the current level of 80-85% of fixed capital.

The quality of loan portfolios will also continue to be affected by outstripping growth in consumer lending, including unsecured lending, characterized by higher risk of default. Accordingly, the banking system will continue to operate in a relatively high risk of insolvency of borrowers, while

new issuances will not significantly improve the quality of assets. Taking into account all these factors, the achievement of pre-crisis level of non-performing loans of 4% is not expected.



**Fig. 6. Forecasts of non-performing loans dynamics**

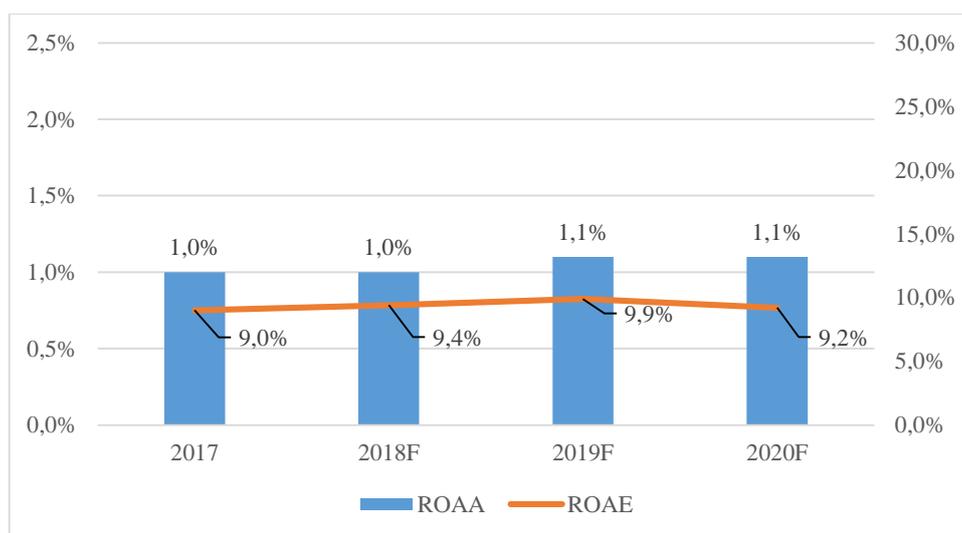
We believe that the value of CoR in 2018 will remain at the same level and will be 1.6%. The key factors of the increased allocations for new reserves will be a general tightening of the regulator's approach to assessing the quality of assets and the inability of banks to significantly improve the quality of new issuances.

According to estimates, the cost of credit risk will begin to decline after 2018, when the creation of reserves for existing potentially difficult loans will be basically completed.

#### **The profit will stagnate because of pressure on NIM and decrease of contributions for provisions of bad loans**

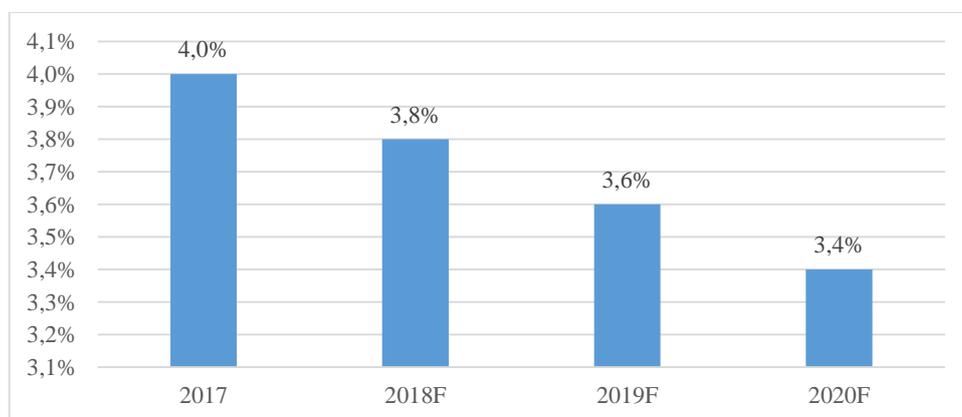
In 2017, the net profit of the Russian banking system under RAS decreased compared to 2016: the return on average assets (ROAA, the calculation according to the Central Bank of the Russian Federation) fell to 1.0% compared to 1.1% in 2016, while return on average equity (ROAE) fell to 9.0% from 11.5% in 2016.

According to forecasts, in 2018 ROAA will be 1.0%, which will correspond to last year's level. We believe that the net profit indicators of banks will stagnate at the previous levels in the long term: in the period until 2020 the ROAA will not exceed 1.2%. As the volume of allocations to the reserves smoothly decreases, the contraction of the net profit of banks will be restrained by the compression of NIM. The fall in net income margins is a long-term factor reflecting a sharp slowdown in inflation in Russia to below 3% and the continuing decline in the CBR's key rate, as well as greater elasticity of loan rates compared to deposit rates. [6]



**Fig. 7. Return on average assets and average equity consensus forecast**

According to our estimates, the NIM (calculated for all credit institutions) will decrease from 3.8% in 2018 to 3.4% in 2020. The dynamics of NIM in the banking sector alone (without NCOs) will be comparable, although the indicators will be slightly higher: according to the updated forecast, which takes into account the more significant compared to the forecast decrease of NIM in the fourth quarter of 2017, we expect a margin decrease in 2018 to 4.2 -4.3%. NIM, calculated without PJSC Sberbank (3.5%), shows even greater vulnerability of the banking system to this trend.



**Fig. 8. Net interest margin dynamics consensus**

In the structure of the margin, interest incomes from loans to individuals are expected to grow at a faster pace, while the role of interest income from lending to legal entities and securities will decline. Changes in the structure of NIM will be due to the actual stagnation of corporate lending and low interest rates on debt obligations amid continued growth in the most attractive sectors of consumer lending (especially in mortgages).

Another factor that will put pressure on the dynamics of net profit in the forecasted period is an increase in operating expenses relative to operating income. Despite the banks' efforts to adapt operating expenses to the new business environment, we expect that from 2018 CTI will continue to grow and will reach almost 50% by 2020.

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