

Eurozone Crisis and Its Impact on Russian Banks

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The European sovereign debt crisis, which has been expected by many experts since the first attempts to put out the financial fire of 2008, recently had most adverse effect on the balances of European banks.

The financial crisis and the state support of the banking sector badly reflected on the economy and budget of the EU states, and not only of the peripheral, but of the principal participants. The maximum negative effect investors felt from Greece, which lost the ability to service its sovereign debt. As a result of the revealed problems, a chain of downgrades followed (post factum, ritually) of Greece and the other European states. Growing investor concerns about the EU problems led to a surge in yields on European sovereign debt. European banks – the main holders of this debt – fully felt the effect of the credit and market risks crystallising when they had to increase reserves for these bad assets. The situation has not only brought pressure on profit and capital sufficiency, but also squeezed liquidity. In addition to the deteriorated quality of assets deteriorated, problems in the European financial sector, growing like a rolling snowball, have weakened the confidence of principal clients in credit organisations. Additional problems were brought about by losses from currency operations related mainly to atypical fluctuation of EUR/CHF rate. As a result, in August-September 2011, the shares of European banks were leading the financial market downfall, whereas yields on their debt liabilities soared.

The problems of European banks are closely connected with the sovereign debts crisis and vice versa. Besides, the current situation, unlike in 2008, is worsened by the reduction, if not loss, of investor and market confidence in the ability of financial regulators and monetary authorities to find a solution to the problem. It is this political component that plays the leading role in defining scenarios for future development.

Up to a certain moment, Russian banks only to insignificant extent felt the problems of their European colleagues; this which was mainly expressed by less opportunities to attract funding from foreign banks. Domestic credit organisations, supported by liquidity and rates, have easily compensated for this lack of borrowing opportunities in the domestic market. Problems of Europe's banks were felt much stronger in the recent months, when the global financial markets started to fall as the financial state of European banks worsened. Widespread sell-off of risky assets and withdrawal of capital by subsidiary credit organisations in favour of their head structures had an adverse effect on the ruble. Russian banks got involved in the speculative race. The result was surging interest rates on the domestic market, in particular on the interbank credit market. However, timely support through liquidity injections by the Bank of Russia and the Ministry of Finance helped and continues to help banks to operate normally in the environment of higher rates.

At the same time, independence of Russian banks from foreign funding is very interesting, along with their almost complete switch to domestic sources of funding, which defines today's key risks in the sector. Within recent months, the Russian money market, where banks are the principal players, is being financed, to almost full extent, by the Bank of Russia and the Ministry of Finance. Therefore, as of late October 2011, the total liabilities of banks in the direct REPO with Bank of

Russia and MinFin deposits almost two times exceeded assets of banks on the accounts of the regulator. It should be noted that the Bank of Russia attracts funds at rates below those on the interbank market. This situation does not have any critical sides until the financial regulator is prepared to meet the needs of the banking sector. On the other hand, the situation can hardly develop in any other way, but still such high dependency of the banks on the lender of last resort is not exactly a healthy sign.

Russian banks were also affected by the above-mentioned fall of the global financial markets. Russian markets immediately followed, which led to significant negative revaluation of banks securities portfolios. These portfolios, consisting mainly of debt, were built up in the post-crisis period because of absence of opportunities to fund good quality borrowers. As a result, a risk has been accumulated, crystallisation of which can absorb the major part of annual income.

Meanwhile, the reduction of business volume by the Russian subsidiaries of large foreign banks, in our opinion, may have a negative effect on the competitive environment in the domestic banking sector. That is especially true in the light of the state banks' strengthening positions in the beginning of 2008 crisis. It is precisely the largest European subsidiaries, who have wider opportunities of funding and business experience of various markets, act as the key competitors of the state-owned players, and together with largest private banks, they help balance the Russian banking market.

Absence of direct impact of European banks' problems on the activity of Russian credit organisations, however, does not cancel the sensitivity of the Russian financial sector to external shocks. Further escalation of problems in Europe may actually trigger such shocks, in which case the Russian banking sector is likely to suffer.