

As Economic Conditions Look Up, Kazakh, Russian, and Ukrainian Banks are Slowly Switching to Recovery Mode

By Standard & Poor's Financial Services Ratings Group

Industry Credit Outlook

Banking systems in Kazakhstan, Russia, and Ukraine (KRU) appear to be slowly but surely recovering from the worst of the financial and economic crisis of 2009-2010. This is demonstrated by 11 upgrades and over 30 outlook changes in a positive direction we've taken on financial institutions in these three countries since April 1, 2010, compared with just two downgrades. As macroeconomic conditions have improved and banks' operating environments stabilised, we've seen pressure on their financial and business profiles gradually abating. We expect that this gradual improvement in credit quality will continue and translate into an increasing number of upgrades over the next 12 months. Ratings in the sector will remain low compared with the international average, reflecting the still high industry and economic risks prevalent in these regions. We anticipate that positive rating actions will continue, given our expectation of the following main industry trends:

- A slowly declining stock of problem loans;
- Stabilising credit costs at moderate levels;
- Enhanced loss-absorption cushions through provisions built up, strengthened capitalisation from shareholders' capital injections, or a recovery in retained earnings and lower asset growth expectations;
- A high share of liquid assets;
- Growth in customer deposits;
- Improved refinancing prospects;
- A rebound in profitability through a stabilisation in the net interest margin and more emphasis on cost controls;
- Continued external support, including government support; and
- An improving regulatory environment.

If the current macroeconomic trends continue, we expect negative rating actions would be in the minority, reflecting either merger and acquisition-related risks or negative trends in the financial profile, such as liquidity, asset quality, and capital, related to unsustainable growth or negative earnings performance.

It is important to note that the impact of the global economic crisis on banking systems in the KRU differed in severity by country. Hardest hit were the systems in Ukraine (foreign currency B+/Stable/B; local currency BB-/Stable/B) and the Republic of Kazakhstan (foreign currency BBB/Stable/A-3; local currency BBB+/Stable/A-2; Kazakhstan national scale 'kzAAA'). Financial institutions in the Russian Federation (foreign currency BBB/Stable/A-3; local currency BBB+/Stable/A-2; Russia national scale 'ruAAA') were the least affected of the three nations, due to strong government support to the real sector of the economy and the banking system, lower lending leverage, and lower dependence on foreign funding in the banking system, among other factors. At present, Ukraine still remains the most fragile, in our view, because it experienced the largest decline in output during the crisis, and inherited very high structural weaknesses and imbalances.

Nonetheless, we believe the banking systems in all three countries face similar remaining challenges:

- Diversifying and expanding their franchises;
- Recovering problem loans;
- Finding creditworthy new lending opportunities;
- Maintaining adequate provisions;
- Diversifying and stabilising funding while reducing funding costs;
- Maintaining adequate liquidity cushions;
- Strengthening capitalisation;
- Enhancing risk management;
- Strengthening corporate governance;
- Improving profitability;
- Optimising cost structures; and
- Overcoming the difficult competitive environment and dominance of the largest banks.

Macroeconomic developments: Good medium-term growth prospects, but significant structural hurdles remain

Our moderately positive outlook for KRU banking systems is largely based on our forecast of improving macroeconomic fundamentals over the medium term. For 2011-2013, we forecast average annual GDP growth of about 4% in Russia and Ukraine and about 7% in Kazakhstan (Table 1).

Table 1. Kazakhstan, Russia, and Ukraine: Main Economic Indicators by Country

	Republic of Kazakhstan	Russian Federation	Ukraine
Real GDP growth (%)			
2010e	7	4	4.2
2011f	8	4.5	3.8
2012f	7	4	4.5
2013f	6.5	3.7	4.2
Consumer price index growth (%)			
2010e	8	6.86	9.4
2011f	9.5	9	11
2012f	8	10	11
2013f	8.5	11	11
Domestic credit private and NFPEs/GDP (%)			
2010e	46.79	45.5	67.19
2011f	46.79	45.19	62.07
2012f	46.79	46.49	62.27
2013f	46.79	48.11	62.76
Financial institutions' contingent liability/GDP (%)			
2010e	46.79	22.75	33.6
2011f	46.79	22.6	31.04
2012f	46.79	23.24	31.14
2013f	46.79	24.05	31.38

*e-Estimate, f-Forecast, NFPEs-Non-financial public enterprises
Source: Standard&Poor's*

Stronger growth prospects in Kazakhstan are supported by rising commodity production volumes and prices, with oil output expected to double over the next 15 years. In Russia, robust growth prospects in 2011 from increased government consumption in a pre-election year and domestic credit growth are unlikely to be sustained; medium-term growth depends overly on key export prices. In Ukraine, economic growth is subject to external demand and is therefore highly uncertain.

KRU economies depend highly on the commodity sector, which leaves them vulnerable to external shocks and continues to weigh on their macroeconomic development. The oil sector in Kazakhstan accounts for nearly 60% of total exports and 25% of GDP. Russia has a similar concentration, with oil exports comprising 64% of total exports and 20% of GDP. Chemicals and steel make up more than 60% of the export basket in Ukraine.

Inflationary pressure and real exchange rate volatility in KRU continue to weigh on macroeconomic growth, consumer confidence, and banking sector fundamentals. In our view, Ukraine appears more vulnerable than Kazakhstan and Russia in this regard.

High economic imbalances in KRU are underpinned by a dramatic increase in real estate prices in main cities before the recent downturn, followed by a slightly less dramatic decrease. While major corrections have occurred, we believe that KRU economies remain prone to asset price bubbles. In Russia, an additional factor is proportionately large and volatile equity markets.

Relatively high political risk due to uncertain presidential succession in Kazakhstan, uncertainty regarding the presidential election in Russia in 2012, and the fragility of the new government in Ukraine undermine economic stability.

Industry development: Lending growth is cautiously resuming and government involvement in the banking sector remains high

All three banking systems have emerged from the crisis with a substantially high level of government involvement in the banking sector. This has been through government recapitalisation, nationalisation, or acquisition of private-sector banks by state-owned banks.

In Russia, the dominance of state-owned Sberbank and JSC VTB Bank, which currently account for over 35% of the system's assets, distorts competition in a way that is unfavourable for private-sector banks' creditworthiness.

In Kazakhstan, acquisitions by national welfare fund Samruk-Kazyna of majority stakes in three defaulted banks and government capital injections in other two large banks have increased the government's ownership to 25% of total system assets from less than 5% in 2008. We think the government's ownership will reduce considerably over the medium term through direct disposals.

In Ukraine, state banks now control 21% of banking assets since the government's bailout of three medium-size private banks.

We classify all three countries as "supportive" of their banking systems regarding the propensity of their respective governments to intervene and support systemically important banks. We believe the past three years

have proven the willingness of the KRU governments and their regulators to support the banking sector to prevent systemic collapse. Yet their actions were insufficient to avoid some banking defaults. As the KRU banks and banking systems are increasingly larger, it will become more and more costly and challenging to provide support during a crisis.

Despite good growth potential of KRU banking systems, there is some likelihood that more foreign banking groups, especially those lacking critical mass, might start exiting KRU in the medium term, as illustrated by the recent decisions of HSBC Bank PLC and Barclays Bank PLC to end their retail operations in KRU.

We observe that lending growth in KRU is slowly picking up, but it will likely remain constrained over the next 12 months because of a large stock of problem loans, particularly in Ukraine and Kazakhstan and because banks remain risk averse. Moreover, there are few highly creditworthy borrowers and there is lower credit demand on the part of borrowers.

We expect inflation-adjusted credit growth in Ukraine and Kazakhstan to be flat over the next 12 months, with slightly better prospects for Russia, with a forecast of about 5%. We expect corporate and unsecured consumer

finance loans in local currencies across the three countries to spur growth, while residential mortgages are expected to show the lowest growth (Table 2).

The ban on consumer loans in foreign currencies in Ukraine introduced in 2009 still remains in place. Positively, loan growth across KRU banks will be largely supported by customer deposits growth.

Asset quality: Trending upward despite a significant stock of problem loans

Asset quality is very important to the creditworthiness of KRU banks and remains one of the main rating factors. In our opinion, problem loans bottomed out in Russia by midyear 2010, and by year-end 2010 in Kazakhstan and Ukraine. Some rated Russian and Kazakh banks already showed signs of asset quality improvement in the fourth quarter of 2010 and the first quarter of 2011 due to a high emphasis on recoveries, improved performance of restructured loans, and much better performance of a new generation of loans. We anticipate gradual recovery over a few years, thus highlighting the banks' vulnerability to adverse developments and constraining their growth.

Our current estimate of problem loans, including overdue loans, restructured assets (where the original terms have been altered), foreclosed real estate and other assets recovered in loan

Table 2. Forecast of Main Banking Indicators in Kazakhstan, Russia, and Ukraine at Year-End 2012

	RUSSIAN FEDERATION			REPUBLIC OF KAZAKHSTAN			UKRAINE		
	2010	2011f	2012f	2010	2011f	2012f	2010	2011f	2012f
Banking sector overview									
Banking assets to GDP	75	78	83	62	65	68	89	90	91
Asset growth	15	20	25	4	8	15	7	12	15
Equity to assets	14	13	12	11	11	12	15	15	14
Gross loan growth	13	20	25	-6	10	20	1	10	13
Deposit growth	23	20	20	14	15	15	28	28	25
Banking sector asset quality									
Share of problem assets* to total loans	35	22	15	50	45	38	50	45	40
Loan loss reserves/total loans	9	8	5	31	25	18	15	14	12
Credit costs	1	2	2	1	1	1	3	2	2
Banking sector liquidity and funding									
Loans-to-deposits ratio	86	86	90	132	128	140	182	170	165
Liquid assets to total assets	14	12	11	11	9	9	13	11	10
Retail deposits to total liabilities	29	28	27	21	20	18	34	35	35
Retail deposits to GDP	22	22	22	12	14	16	26	27	27
FX borrowing to total liabilities	14	16	20	24	26	30	28	29	30
Banking sector earnings									
Return on adjusted assets	2	2	2	12	5	3	-1	0	1
Return on adjusted equity	12	15	17	N.M.	42	23	-10	-1	2
Net interest margin	6	6	6	3	3	4	6	6	6

* Problem assets include overdue loans, restructured assets (where the original terms have been altered), foreclosed real estate, and other assets recovered in loan workouts, and nonperforming assets sold to special-purpose vehicles, N.M.--Not meaningful.

workouts, and nonperforming assets sold to special-purpose vehicles, is about 50% in Kazakhstan and Ukraine and about 25% in Russia. We estimate that problem loans are likely to decline by about 5%-10% in each country over the next 12 months and that it will take a few years for asset quality in KRU to return to precrisis levels. We base this forecast on the assumption of sustainability of GDP growth and relative exchange rate stability in KRU.

We expect credit costs in KRU in 2011 to remain on par with 2010. Ukrainian banks will likely have the highest credit costs of up to 2.5% compared with 1.5% in Russia and 1% in Kazakhstan. The Ukrainian and Russian banking systems are also lagging behind Kazakhstan in writing off problem loans, partly due to legal procedures and tax disincentives. The highest write-offs among KRU banks are by Kazakh banks, encouraged by the government's efforts to ease regulations on write-offs and workouts.

The magnitude of improvements in asset quality is likely to be far from uniform and will depend on the performance of restructured corporate loans; the effectiveness of collections; and the size of exposure to the most troubled sectors, such as construction and real estate, single-name loan concentrations, and the proportion of loans in foreign currencies to unhedged borrowers. We expect the peak of restructuring in KRU to come in 2011-2012, at a time when many borrowers still remain in the vulnerable financial position. We do not exclude the possibility of a new rise in problem loans at some KRU banks from failed restructurings because many borrowers' financial standing is still weak.

Profitability: Gradually improving after a dismal performance in the past few years

The outlook for KRU banks' profitability over the next 12 months is moderately positive, but this compares with dismal financial performance across many KRU banks in the last few years. In 2010, the Ukrainian banking system still remained in the red with a \$1.6 billion loss. The Kazakh banking system reported a profit of \$9.6 billion and a return on assets (ROA) of 11.96% in 2010, following a loss in 2009. The Russian banking system recorded a profit of \$19 billion and ROA of 1.8% in 2010. The legacy of asset quality problems, coupled with stagnant lending and still elevated funding costs, continue to present a hurdle to bottom-line results in all three countries.

We believe that the majority of rated KRU banks would be able to generate sufficient earnings in 2011 to absorb credit risk charges and support capitalisation, in view of limited dividend payments. Standard & Poor's expects earnings to rebound faster at those banks that have recognised asset quality problems and created adequate provisions earlier in the credit cycle, work out problem loans more aggressively, and resume credit growth prior to peers.

We expect the net interest margin to stabilise across KRU banks thanks to normalising funding costs and a slow restart of lending. The cost-to-income ratio is likely to improve due to continued optimisation of administrative expenses, including of staff levels and branch networks.

Funding and liquidity: A high share of liquid assets, slowing deposit growth, and resuming capital-markets borrowing

We observed gradual restoration of liquidity and funding in KRU in the past several months. The remaining challenges are for the banks to maintain sustainable medium-term funding sources and liquidity cushions. Most positive rating actions over the last 12 months reflected, among other factors, improved liquidity positions, and growth in customer deposits. Over the next 12 months, we expect liquidity to be somewhat depleted, because lending growth is slowly picking up, but remain overall acceptable.

In the last two years KRU banks' funding progressively shifted from capital markets to domestic customer deposits, which at year-end 2010 accounted for 73% of liabilities in Russia, 64% in Kazakhstan, and 55% in Ukraine. This improved the loan-to-deposit ratios to 86% in Russia, a still high 132% in Kazakhstan, and a still very high 182% in Ukraine at year-end 2010, helping KRU banks to reduce their reliance on state funding and offset foreign debt repayments.

Boosted by resumed customer confidence in the banking system and assisted by government stability measures, customer deposits increased by 23% in Russia, 14% in Kazakhstan (without SPV deposits), and 11% in Ukraine in 2010. Nevertheless, the customer deposit base remains volatile and prone to panic-led customer behavior, such as bank runs. We

anticipate that deposit growth over the next 12 months might be pressured by resumed consumer and corporate spending, along with high inflation, which is driving real interest rates into negative territory. Deposit growth will be unevenly distributed among banks depending on the aggressiveness of their deposit pricing, brand name recognition, and access to government deposits.

International wholesale market borrowing is opening up. Total foreign debt outstanding by KRU banks totalled \$17 billion in Kazakhstan, \$28 billion in Ukraine, and \$144 billion in Russia at year-end 2010, accounting for 24%, 28%, and 14%, respectively, of total liabilities. A considerable reduction of foreign debt outstanding by Kazakh banks reflects a \$7.9 billion debt write-off of three defaulted banks amid their debt restructuring, which accounted for about 6% of Kazakhstan's GDP. Domestic bond issuance is also growing, supporting the banks' profits and refinancing prospects.

Capitalisation: A growing need for shareholder capital injections

For the majority of rated KRU banks, capitalisation represents a weakness in light of the challenging operating environment, providing only a limited cushion against potential adverse market developments. We have observed wide differences in the capitalisation levels of KRU rated banks, mostly due to recapitalisation of some banks by shareholders or the state during the crisis, while other banks face significant capitalisation shortfalls. The average Standard & Poor's risk-adjusted capitalisation ratio after adjustments for concentration risks was 7% at year-end 2010. This was much lower than reported regulatory capital adequacy ratios of 18.1% in the Russian banking system, 20.8% in Ukraine, and 17.9% in Kazakhstan at year-end 2010. We expect KRU banks' capitalisation ratios to fall in 2011 due to business growth, thus requiring additional capital injections by banks' shareholders to cover problem loans and support business growth, and in view of still weak internal capital generation.