Special Study

Russian Regional Banks

Russia

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Evaluation Department
(EvD)

European Bank
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(Russia)

1. Subject of the evaluation

This evaluation concerns the EBRD's relationship with six Russian banks with regional networks. All six banks are privately owned and closely held (with a small number of major shareholders). The EBRD has equity stakes in five banks and provides capital support in the form of subordinated debt to three.

Evaluation context: Bank X – a typical outlook

In 2010 the bank's management anticipated further increases in corporate loan defaults and deterioration of the loan portfolio quality, very slow or no growth of the loan book and a relatively high cost of funding, which in combination would have a strong negative impact on the bank's profitability. It is anticipated that, overall, the bank's refinancing options will remain weak during the next year, specifically due to the closure of capital markets. However, it is also anticipated that given the reduced growth expectations, the bank's refinancing requirements will decrease quite substantially, allowing the bank to retain a sufficiently well-balanced and strong balance sheet in the short term. To deal with the new challenges in 2010 the bank is focusing on liquidity and loan portfolio quality management, as well as cost optimisation. In the immediate future the bank will continue lending to well-selected clients with a strong financial position, reducing exposure to riskier clients.

2. Rationale of the operations

The operations under review were driven by a similar rationale, namely to stimulate competition in the regions and expand intermediation by providing medium-term funds to support MSMEs. The six banks all compete for MSME business with state-owned and private federal banks. Equity and subordinated debt, where provided by the EBRD, were designed to help increase lending capacity when this was limited by the existing capital base, and also to encourage improvements in corporate governance standards and the application of sound banking principles.

3. Achievement of objectives

Common objectives of EBRD cooperation with these banks included diversification of their funding base, lengthening of maturities and enhanced financial intermediation in the MSME sector. Each of the banks suffered a contraction of the loan portfolio in the final quarter of 2008 and deterioration in portfolio quality. The deposit base at each bank also fell initially, although deposits recovered through 2009, in some cases to pre-crisis levels. Each of the banks benefited from the availability of liquidity support from the Central Bank of Russia (CBR), although some banks have preferred to make minimal use of this support.

In two cases institutional issues have contributed to some delay in the fulfilment of operation objectives. In the other four cases, while business has been affected by the global crisis, the EBRD's operations had either met or were on track to meet their objectives when the crisis took hold in the final quarter of 2008. The banks all have strong franchises in the regions in which they operate, competing effectively with state-owned and international banks. They appear to have reasonable expectations of emerging from the crisis period in a position to resume growth. Fulfilment of objectives is rated *Good* in the case of four banks. However, the rating is reduced to *Satisfactory* in two cases pending resolution of institutional issues.

4. Overall assessment

Most of the banks under review have experienced a proportionately greater fall in gross loan portfolio than in total assets in the crisis period. This was largely due to the need to preserve liquidity while scaling down the loan book. For this reason such transition objectives as increased financial intermediation and outreach have effectively been put on hold for the duration of the crisis. However, the Evaluation team considers that *Good* overall transition impact was being achieved prior to the crisis. The potential for further transition impact as partner banks emerge from the crisis is rated *Good*, but with *High* risk in most cases since realisation of the potential is dependent on continuation of effective crisis response measures and the condition of the real economy. Additionality is *Verified at large*. Some of the banks under review have benefited from a number of earlier EBRD facilities and programmes, and in some cases from equity or debt funding by other IFIs. Nevertheless, the Evaluation team considers that the repeat operations with the banks under review have been incrementally additional, principally because the risk profile of regional banking operations in the Russian Federation is still such in the eyes of commercial sources of finance as to make the funding of such operations unappealing without, as in the case of syndicated loans, a demonstration of the EBRD's confidence and support. Bank Handling is rated *Good* overall. The various operation teams have applied the Bank's frameworks and programmes well in seeking to improve the operational performance and management of the banks under review while expanding the volume of medium- and long-term funds available to the MSME sector in the regions. In the period of the operations considered in this evaluation, the Bank has extended and strengthened its representation on the ground through development of its network of resident offices in Russia. The success and effectiveness of future operations may be enhanced by using the resident office network more actively to improve communications with clients in remote areas.

5. Transition impact and additionality

5.1 Individual transition impact ratings

Bank A
Rating: Good TI realised to date; Good potential; High risk
Bank A adopted a strategy to develop as a universal bank with SME and retail lending and SME lending now amounts to around 15% of its gross loan portfolio, with retail loans amounting to around 25%. It plans to continue branch expansion when crisis conditions abate. A key achievement of the equity investment was the restructuring of the ownership to create a group of like-minded shareholders committed to regional expansion and the growth of SME lending. The risk to further transition potential is rated *High*. Although the bank has a well-considered approach to working through the crisis period, paying close attention to liquidity and asset quality, the outcome could be adversely affected by a prolonged downturn in the real economy.

Bank B
Rating: Good TI realised to date; Good potential; High risk
Approximately half of Bank B's loan portfolio comprises loans to mid-size corporate clients, but it is represented in a large number of regions. SME lending accounts for

around 30% of the loan book and about 20% of its gross portfolio comprises retail loans. The subordinated loan signed helped to improve the structure of Bank B's balance sheet, permitting it to extend the tenor of SME loans. The portfolio has contracted during the crisis, but the bank has taken the opportunity to tighten underwriting standards.

Bank C
Rating: Satisfactory TI realised to date; Good potential; High risk
The EBRD adopted a pragmatic approach to resolving institutional issues with this bank, seeking agreement with the various parties involved that could lead to significant organisational change. The EBRD credit line was accompanied by a corrective action plan that included streamlining of the shareholding structure and this was accomplished. As of mid-2009 Bank C appeared to be on track to achieving its transition benchmarks with some delays due to the difficult market environment.

Bank D
Rating: Good TI realised to date; Good potential; High risk
A consulting assignment was designed to strengthen Bank D's risk management function and internal control framework. Bank D appears to have responded well to the EBRD's interventions on the operational side, with the achievement of transition benchmarks regarded as being on track in late 2009 after making allowance for implementation delays resulting from the crisis. However, capital constraints may impede further growth.

Bank E
Rating: Good TI realised to date; Good potential; Medium risk
The regional expansion programme put in place following the EBRD equity investment brought about a four-fold increase in the number of branches and regions covered. Regional exposure amounts to around 50% of the total loan book. Bank E is a strong mid-sized bank with a strong franchise and an established and diversified customer base. The bank is regarded as having a relatively conservative business model compared with some of its peers and is on track to continue meeting transition objectives after some delay resulting from the crisis.

Bank F
Rating: Good TI realised to date; Good potential; Medium risk
Bank F is a full-service MSME bank with a strong local franchise. The current crisis has resulted in a number of bank failures, leaving Bank F as one of two remaining independent banks in the region with the capacity to attract some of the failed banks' clients on a selective basis. Many of the transition objectives associated with the syndicated loan have been delayed. Bank F is currently focused on maintaining liquidity, loan portfolio quality and stability of the customer deposit base.

5.2 Additionality

Even before the current crisis, the banks under review typically had a high-risk profile in the eyes of international providers of finance. The EBRD's approach, characteristically building on a TFP line or tranched credit line for MSME lending before introducing partner banks to the international market by way of syndication, has been incrementally additional. The EBRD's investments have been accompanied by an appropriate institution building programme or corrective action plan to stimulate improvements in corporate governance, risk management and operational procedures. A further aspect of the EBRD's additionality has been the provision of funding for SMEs with longer tenors than available from other sources. Acknowledging that the various forms of EBRD financing have frequently been accompanied by other IFI funding, the Evaluation team considers that the additionality of the operations under review is *Verified at large*.

6. Bank Handling

In October 2005 the Board approved the Russian Federation Mortgage Framework and in July 2006 the Subordinated Loan Framework for Russian Mid-Sized Banks. As of January 2008 there were unutilised amounts of these frameworks and in that month the Board approved the Multi-Product Framework for Medium-Sized Banks to take over and supersede the earlier frameworks. The overall objective was to provide equity and a variety of debt funding products to selected Russian medium-sized commercial banks having limited resources to continue growth. The FI Group reported to the Board on utilisation of the 2008 framework as of 30 June 2009, with an updated report as of 31 January 2010. Noting that all Russian banks were affected by the crisis, the reports observe that in many cases partner banks had to slow down lending and/or stop some products. Most banks concentrated on restructuring existing loan portfolios, recovery of non-performing loans, short-term lending to selected existing clients and building their deposit base. While the liquidity situation stabilised in 2009, with many banks repaying short-term Central Bank loans provided as liquidity support, overdue and bad loans remained the main concern, with some banks experiencing ongoing difficulties with instability of sub-borrowers and associated credit risks. The findings of the present evaluation support these conclusions. Banks interviewed by the Evaluation team during work on this study expressed appreciation of the EBRD product range and of the support given by the EBRD during the crisis. The Evaluation team considers that banks that have received this support are in a stronger position than they would have been otherwise to weather the crisis and emerge with the potential for further growth.

In May 2009 the ERRD's Technical Cooperation Committee approved a proposal for Assistance and Training in Loan Workouts and Corporate Recovery for Russian Banks. The framework umbrella will be funded by the EC and is intended to provide selected banks with assistance in the restructuring of impaired loans and improving their treatment of non-performing loans through optimal workouts. The evaluation team considers that such assistance and training enhance the prospects for *Good* remaining transition potential with partner banks. It can be noted that some banks regard the crisis as offering opportunities to consolidate their position in the retail and SME segments and to increase their deposit funding.

The crisis approach adopted by the EBRD to banks in Russia is summarised well in this extract from an internal information note in June 2009: "In response to the new challenges presented as a result of the crisis, with the objective to achieve maximum potential impact and wider reach of EBRD financing, the focus in Russia has been changing during the last nine months in favour of transactions with (1) larger and more systemically important financial institutions, both locally-owned… and foreign-owned… and (2) existing client banks which will be able to weather the crisis."[1]

Bank Handling is rated *Good*.

7. Key issues and lessons learned

7.1 Using regional banks to extend banking services

The Russian regions are at once over- and under-banked. While there are still

[1] BDS08-009 (Rev 1) (Addendum 10).

around one thousand licensed banks, many parts of the country have little or no access to banking services. The MSME segment in the regions remains underdeveloped and under-banked, and long-term funding for business development is scarce. As demonstrated by the banks reviewed in this study, regional SMEs and retail customers can be reached efficiently by locally based banks targeting regional clientele and having appropriate local knowledge and experience. Such banks can be good competitors to state-owned and foreign banks by offering tailor-made services, flexibility and speed of decision making. It also emerges from the present study that there is a role for mid-sized centrally headquartered banks seeking to expand in the regions. Technical cooperation funds have financed expert consultants working with banks on their regional expansion programmes. The TC assignments have covered a broad range of banking skills, focusing in particular on strategy development, lending processes (including risk management, banking products, corporate governance and internal control), management information systems and organisational efficiency.

Lessons:

It is important to support bank expansion in the regions by providing dedicated long-term funding together with appropriate institution building, financial and operational covenants. In some cases commitment from the client can be more important than a track record in MSME lending. Experience has shown that technical assistance to transfer know-how and standards can be quickly assimilated by committed partner banks. Follow-on funds in many cases will still be additional because of the high-risk profile of regional banks in the eyes of the international commercial market.

The EBRD should monitor a partner bank's commitment to the MSME sector, reconfirming the commitment before proposing additional funding. In the cases under review, the evidence is that the banks concerned intend to develop MSME business further post-crisis when conditions permit. However, instances have been observed where banks, having previously expressed commitment to serving the MSME sector, have not developed appropriate credit procedures and risk policies. Resulting losses have prompted them to turn away from MSME business.

Institution building programmes and corrective action plans should be designed to meet the strategic objectives and operational and training needs of clients. These programmes should be tailor-made to match the client's identified needs. Strategy development should encompass a detailed business plan with both long-term goals and clearly specified milestones and benchmarks. Consultants should be chosen who understand the environment in which clients operate as well as possessing the requisite professional skills. Planning and goal setting for technical assistance assignments should be a participative process involving the EBRD, the partner bank and the consultants.

7.2 The role of subordinated debt in providing capital support for long-term development

Capitalisation remains a question of top priority for all Russian banks, especially for those operating in environments perceived to have added risk such as MSME banking in the regions.

Lesson:

Experience has shown subordinated debt to be an effective instrument to provide capital support, in addition to providing comfort to main shareholders and management and demonstrating the EBRD's commitment to the long-term development of a local bank. The EBRD subordinated debt facilities play an important role in an environment characterised by a shortage of long-term funding and lack of risk appetite in the market for funding of this nature.

7.3 Factors contributing to the success of bank equity investments – generic lessons

The following generic lessons have been synthesised by the Evaluation team from lessons derived by the EBRD operation teams in self-assessment papers prepared as input to this evaluation.

- Where necessary the EBRD should work to **streamline, rationalise and consolidate the client bank's ownership structure**. When substantial institutional development is required, success is more likely to be achieved if there are a small number of committed shareholders.

- The **institution building programme** should identify the key areas where improvement is needed and **implementation should be accompanied by close monitoring of progress** by the operation team and by the Bank's nominee on the supervisory board.

- The equity investment should be complemented by **dedicated financing facilities** such as MSME and mortgage credit lines. **Clearly specified eligibility criteria** are beneficial in loan agreements. Lines of credit should be accompanied by an appropriate level of technical assistance. These measures can help less experienced partner banks to define appropriate strategies and focus on identifying and developing their target customer groups.

- **The following characteristics may indicate the suitability of a potential bank partner:**
    - ➢ independence of shareholders and management from political interference
    - ➢ existence of a strong local franchise
    - ➢ a diversified customer base or willingness to expand and diversify the customer base
    - ➢ good asset quality, a diversified asset base, strong income streams and a record of profitability
    - ➢ willingness of shareholders to accept dilution and the entry of a strategic investor at the appropriate time.