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Valeriy Piven
Director, Financial Institutions
Ratings Group
+7 (495) 139-0483
valeriy.piven@acra-ratings.ru

Irina Nosova
Director, Financial Institutions
Ratings Group
+7 (495) 139-0481
irina.nosova@acra-ratings.ru

Victor Antonov
Associate Director, Financial
Institutions Ratings Group
+7 (495) 139-0480, ext. 221
victor.antonov@acra-ratings.ru

Armen Dallakyan
Managing Director, Head of
Financial Institutions Ratings Group
+7 (495) 139-0482
armen.dallakyan@acra-ratings.ru

Contacts for media

Alexey Churilov
Manager, External Communications
+7 (495) 139 04 80, ext. 169
media@acra-ratings.ru

For more details, please see ACRA's forecast titled [Banking system to remain stable amid slow economic growth](#) dated October 14, 2019.

New requirements for systemically important credit institutions to improve financial system stability and creditworthiness of largest banks

The Bank of Russia's new approach to defining and regulating systemically important credit institutions

The Bank of Russia has published a presentation for public discussion on January 23, 2020, titled "On defining systemically important credit institutions and related regulation approaches." Among other things, the document details the introduction of differentiated capital add-ons for systemic importance and a new credit risk concentration ratio (N30) as well as a mandatory transition of all systemically important credit institutions (SICIs) to using internal ratings in credit risk calculations.

A differentiated approach to determining systemic importance buffers is justified

Although all SICIs have equal status, their impact on the stability of the financial system is not identical and is determined primarily by their size and positions in specific banking niches. Sberbank and VTB Bank are expected to remain the dominant players in the coming years and be the primary pillars of financial system stability should any adverse scenarios materialize. In this regard, ACRA believes that it is reasonable for Sberbank and VTB Bank to receive larger capital requirements for systemic importance as compared to other banks.

New capital requirements are likely to limit the growth of SICIs. ACRA expects, however, that the largest banks will have enough time to prepare themselves for the new requirements should they be approved. ACRA believes that increased capital buffers may lead to higher capital costs for banks, which could result in higher interest rates for loans or lower lending volumes in the most risky products.

At the same time, ACRA believes that expanding the use of capital buffers is reasonable considering the high asset concentration in the Russian banking sector. The top 30 credit institutions account for over 80% of assets, which, in ACRA's opinion, supports the validity of differentiating the capital adequacy requirements for SICIs and other banks.

The effects of additional limitations for credit risk concentration will vary based on SICI specialization

ACRA notes that capital buffers were not enough to substantially reduce systemic risks in some cases where banks, including SICIs, lost creditworthiness and were taken over by the Banking Sector Consolidation Fund (BSCF). Therefore, the Bank of Russia's proposition to apply a more conservative approach in assessing credit risk concentration looks reasonable. In particular, the regulator is considering introducing a new statutory ratio (N30) that limits credit risk (without risk weighting of assets) per one borrower (or group of related borrowers) which may not exceed 25% of the bank's core capital. Expanding the definition of related companies (including by considering economic ties) would enable a more conservative approach to assessment of existing risks and determine the amount of capital sufficient to cover them. High loan portfolio concentration is typical of many Russian banks, which poses a material risk to their financial stability. In

ACRA's opinion, SICIs with a high share of corporate loans in their portfolios are most susceptible to tighter concentration limits. ACRA also notes that subsidiaries of foreign credit institutions are less prone to concentration risks as they have sufficient capital and their risk-taking approach is conservative.

The overall effect of these new requirements will be determined by the methods for incorporating specific risk types into the ratio calculation base (in particular, risks associated with lending to government-run companies) and by the treatment of collateral and guarantees/suretyships as debt security. Using risk weights in the ratio formula may make the application of the N30 ratio less efficient.

The use of internal ratings could have a moderate effect on capital

In addition to changing the approach to concentration assessments for SICIs, a mandatory transition to internal ratings for measuring credit risk may have a significant effect. Historically, internal ratings allow banks that start using them to free up capital. Although regulations enabled the implementation of this new risk assessment model as far back as 2015, it is still far from being widespread, which suggests its effect on capitalization has been mixed and could be moderate if made mandatory for SICIs. Currently, the majority of SICIs have no need for a new approach, as their capital is sufficiently high while credit demand is weak. At the same time, introducing internal ratings may offset to some extent the impact of new capital buffers and risk concentration requirements on SICIs' compliance with capital adequacy ratios. Sberbank, which will be the most affected by the increased capital requirements, is already using internal ratings.

New requirements could limit credit activity

ACRA believes that the Bank of Russia's proposals will help improve the stability of the financial system, however notes that the introduction of capital buffers may limit the increase in credit activity of SICIs. In 2019, the corporate portfolio of credit institutions grew by 1.2% y-o-y, which was largely due to relatively low economic activity.

Consumer lending along with more active involvement with the SME segment have become the main channels for increasing loan portfolios for a number of SICIs. Capital buffers may limit the willingness of SICIs to continue increasing the loan portfolio in these areas. While reduced bank activity in the unsecured consumer lending segment is justified, the effect from new restrictions in the mortgage segment may have a negative impact on the housing construction sector.

At the same time, those SICIs whose capital requirements remain the same will not be able to fully replace the industry leaders due to both a disparity in the scale of their activities and the existing limitations for business growth, which are directly related to the ability to increase capital and expand the resource base.

The new approaches to regulation are generally in line with the practices of developed countries

In international practice, national regulators are responsible for the size of buffers for systemic importance for banks: there are examples of both differentiated buffers and single buffers for all financial institutions in the banking system.

International experience shows that capital buffers for systemic importance have a positive effect on the creditworthiness of banks and the stability of the banking

system. Differentiated capital buffers, in turn, make it possible to limit systemic risks, and this has a positive effect on the competitive environment of the banking sector.

Differences in the size of capital buffers for systemic importance are particularly characteristic of banking systems where the SICIs differ significantly in size. In Germany, for example, the O-SII (Other Systemically Important Institutions) buffers for Deutsche Bank and Commerzbank are 2% and 1.5%, respectively, while the buffers for the next five most systemically important banks are 1%, and 0.5% of risk-weighted assets for the next five after that.

Another tool of regulation is the TLAC/MREL requirements (Total Loss Absorbing Capacity/Minimum Requirement of Own Funds and Eligible Liabilities). Use of TLAC/MREL in different countries began in 2019 and involves the issuance of subordinated bonds to cover possible losses. A buffer like this, whose cost is lower than the cost of core capital, can help mitigate regulatory requirements for various capital add-ons and reduce the possible state costs to rescue systemically important banks. TLAC/MREL requirements are used in addition to the basic requirements for capital buffers and are intended to help improve the stability of the banking system.

In the EU, MREL requirements apply to all major banks and are determined by the local regulator, whereas TLAC requirements apply only to globally systemically important banks. Currently, the TLAC requirement in the Eurozone is 16% of risk-weighted assets (excluding capital buffers), or 6% of the financial leverage ratio denominator. In 2022, this value should increase to 18% and 6.75%, respectively. MREL requirements are applied on a differentiated basis to all banks depending on the Bank's strategy, as well as capital requirements and other factors.

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Analytical Credit Rating Agency (Joint-Stock Company), ACRA (JSC)
75, Sadovnicheskaya embankment, Moscow, Russia
www.acra-ratings.com

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