March 24, 2021

Debt is not as bad as its short-term nature

Placement of bonds by Russian regions

- **The downside to saving on interest for the regions of the Russian Federation is the limited number of sources of short-term liquidity.** Having taken out six-month budgetary loans instead of loans to replenish their funds, regions are not yet able to obtain new tranches from the Federal Treasury. At the same time, the problem of refinancing is still relevant, although it has been postponed by six months.

- **The high share of short-term debt recorded by the regions increases the refinancing risks in the sector.** Special attention should be paid to the repayment schedule during periods of growing debt load. By again resorting to bank loans, regions risk accumulating a high share of short-term debt this year, given the reluctance of banks to provide long-term loans at low rates. As a result, a high share of short-term debt negatively affects the regions' credit quality.

- **Issuers have adapted to the specifics of placing bonds.** From a different angle, the traditional nuances of bond placement can be looked at as a long-term market instrument distributed among a wide range of investors, which allows funds to be raised even at the beginning of the year. These nuances generally include the difficulties of bond redemption, unregulated interest rates (compared to loans), and the lengthy preparation needed for placement.

- **The bond market is shaped by experienced issuers, and new participants rarely emerge.** The planned volume of placements announced for this year (excluding Moscow) is almost 1.5x higher than the plan for 2020. However, the list of regions that intend to borrow is dominated by regular market participants; new issuers are still an exception.

Elena Anisimova
Senior Director, Head of Sub-sovereign Ratings Group
+7 (495) 139-0486
elena.anisimova@acra-ratings.ru

Media contact

Alexey Churilov
Manager for External Communications
+7 (495) 139-0480, ext.169
media@acra-ratings.ru

The need for refinancing short-term debt will remain in 2021

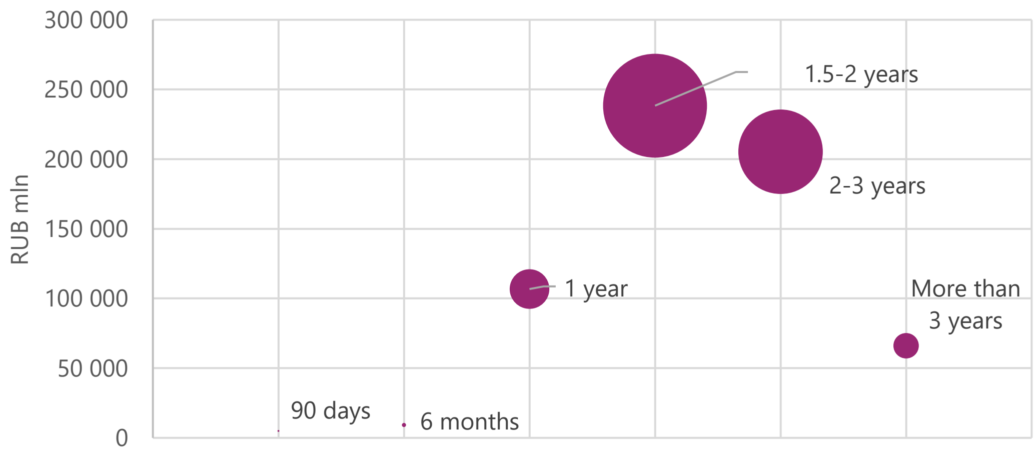
For more information, see ACRA's analytical commentaries "Debt for the long term: what should be done about the outstanding growth of regions' debt load?" from February 2, 2021 and "Refinancing treasury loans using budget loans: who will save money and how much?" from November 30, 2020.

The growth of the debt of Russian regions in 2020 due to budget loans and bonds cannot be called typical in terms of recent years. Although the measure to refinance loans in order to replenish the balances of funds using budget loans in the amount of more than RUB 200 bln proved to be timely and helped the regions reduce the cost of servicing their public debt, these funds must be returned in July. In addition, according to a draft decree of the Government of the Russian Federation[1], it will only be possible for regions to receive budget loans from the Federal Treasury after they repay budget loans received in 2020 (the limit set by the Treasury in 2021 exceeds last year's limit).

As of March 1, 2021, the Federal Treasury's data showed that a total of seven budget loans amounting to RUB 17.6 bln had been provided to the regions, while a year earlier 32 loans had been provided amounting to RUB 106.4 bln. As a result, the regions were able to benefit from lower interest expenses but were deprived of a source of short-term liquidity. Today they are still in need of refinancing, although in terms of time this has been postponed by six months.

There is reason to believe that as usual, these funds will be refinanced largely using bank loans, which will later be substituted by loans from the Federal Treasury Department (FTD). The logic behind this decision is clear, as loans are an accessible and understandable instrument for the regions. Nevertheless, procurements of credit resources do not always end with contracts being signed, and over the last two years this has been observed more and more often. In 2020, the regions unsuccessfully tried to procure credit resources or canceled previously announced procurements almost 700 times, and the volume of failed procurements exceeded RUB 0.5 tln. It is hard to call this mechanism for attracting liquidity effective.

Figure 1. Procurements of credit resources with maturities from one-and-a-half to three years make up the largest share of failed procurements in 2020*



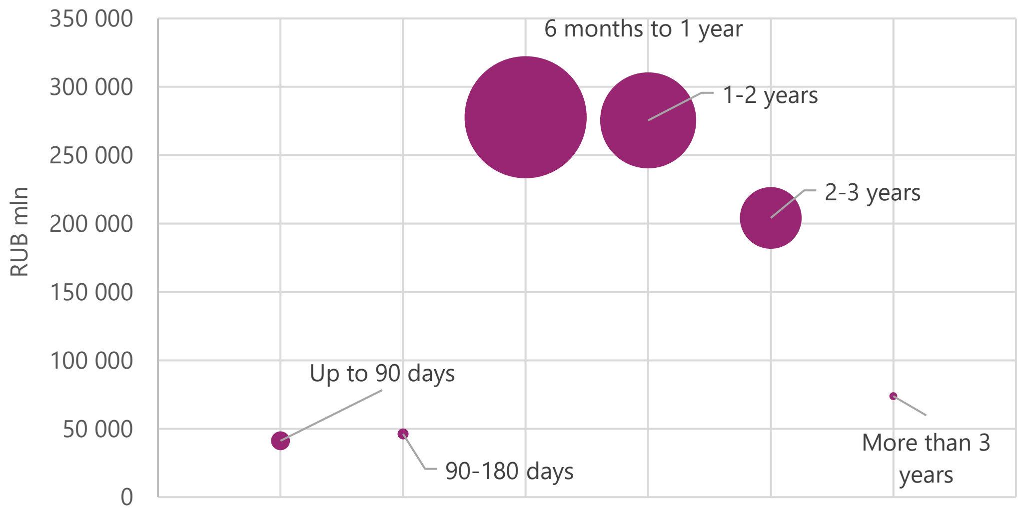
* Diameter of the circles corresponds to the number of failed procurements.
Sources: Cbonds, ACRA

[1] "On amendments to clause 1(1) of the Rules for providing regions of the Russian Federation (municipal entities) with budget loans to replenish budget account funds, which were approved by Directive of the Government of the Russian Federation No. 721 dated August 20, 2013."

Short-term loans were the most popular in 2020

Judging by successful procurements, the most popular lending term in 2020 was from six months to two years. In ACRA's opinion, the unwillingness to provide longer-term loans to regions was due to low rates, which are additionally regulated for the regions that participate in the budget loan restructuring program.

Figure 2. The most popular lending term in 2020 was from six months to two years*



* Diameter of the circles corresponds to the number of completed procurements.
Sources: Cbonds, ACRA

A higher share of short-term debt at a time when regions are forced to increase their debt load is a rather dangerous phenomenon that can affect their creditworthiness.

Besides the short-term nature of loans, there is another drawback resulting from the regulation of rates. The bond market is a single-lender market: as of January 2021, Sberbank provided 85% of loans to Russian regions and municipalities. Out of the remaining banks, no one lends to more than 2% of the market.

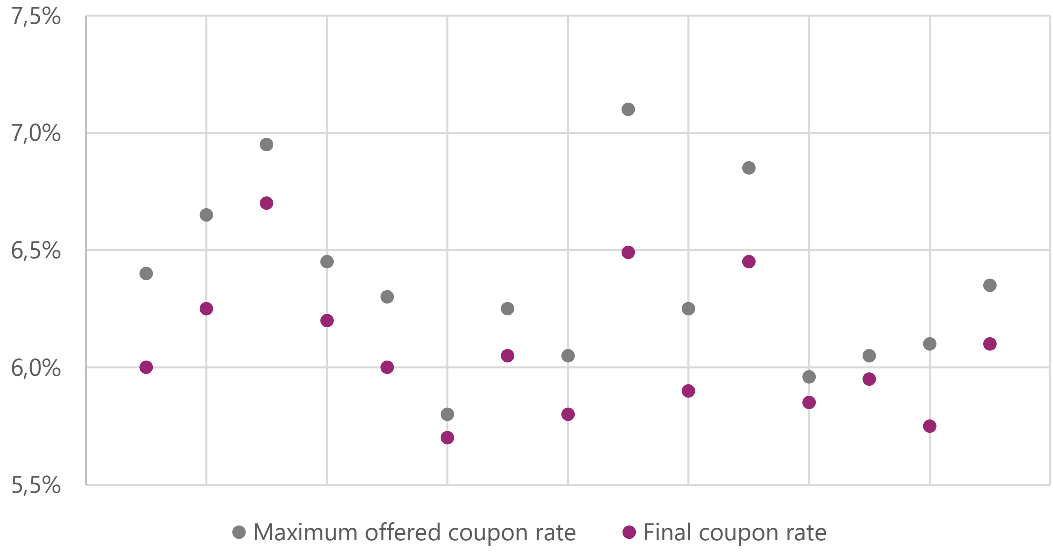
Nuances of placing bonds and the related advantages

If the loans mentioned above are refinanced using bonds, then the regions may face three nuances when placing them: a significant documentation preparation period, the inability to repay bonds ahead of schedule, and an unregulated (i.e., market) rate. The latter generates market demand and is a positive factor for the issuer as bonds are not bought by a single investor, and during the placement process the rate decreases as investor interest in the bonds grows. With loans however, a single participant often applies to purchase them, so it is impossible to reduce the lending rate in such cases.

Apart from banks, other collective investors such as investment funds, insurance companies, and pension funds invest in bonds during the placement. They buy about a third of bonds offered; the remainder is bought by banks, and only half of this volume is bought by Sberbank, whose share is about a third of outstanding bonds (compared to its 85% share of the lending market).

Here are some examples of declines in coupon rates during the process of placement: the offered coupon rate for the series 35018 bonds offered by the Yaroslavl Region was 6.3–6.4% p.a., but it dropped to 6%; the Ulyanovsk Region's series 34003 bond went down to 6.25% p.a. from the initial 6.45–6.65% p.a.; the Tomsk Region's series 35067 bond went down to 6.7% p.a. from 6.95% p.a., etc.

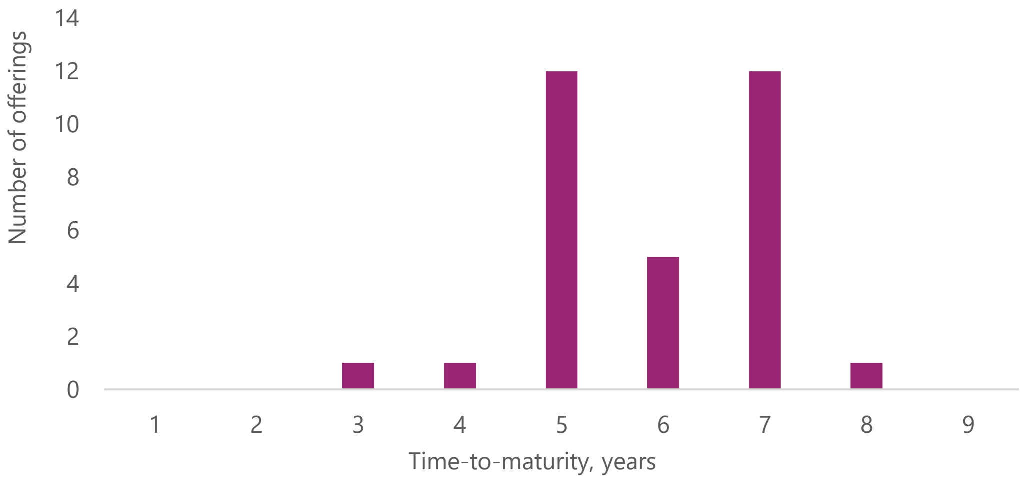
Figure 3. Decline in coupon rates for some bonds offered in 2020



Sources: Cbonds, ACRA

Unlike loans, bonds allow issuers to raise funds for a longer period, regardless of the amortization framework built into each issue. In 2020, bonds maturing in five or seven years were most popular among investors.

Figure 4. Number of bonds issued in 2020 broken down by maturity



Sources: Cbonds, ACRA

In 2020, the opportunity to raise long-term debt was used by both experienced issuers, including St. Petersburg, the Moscow Region, the Novosibirsk Region, the Belgorod Region, the Sverdlovsk Region, and some others, and new players (the Chelyabinsk Region), along with issuers who had not placed bonds for a long time (Bashkortostan, the Omsk Region, Krasnodar, and Krasnoyarsk).

The bond market is public, the place where issuers' actions create their public credit history and reputation and can affect the entire small segment of the sub-federal and municipal bond market. Issuers with a long history of investor relationships are fully aware of this.

Issuers resolve the problem of prolonged preparation of issuance documentation in different ways. Many regions do not hurry to offer their bonds in the first half of year but rather aim at the end of the year in order to have time to identify their funding needs and duly draw up the documents. This is quite convenient for issuers but creates an excessive concentration of offers in the sector at the end of the year.

Some issuers offer only a portion of the bond loan at the end of the year and may offer the remainder in the following year, thus having a source of liquidity at any time in the next year. For example, in 2020, bond loans “unveiled” earlier were offered by the Novosibirsk Region and St. Petersburg, which offered bonds that were initially offered as far back as 2017.

A specific feature of such “deferred” offers is the difference between the offered price and the par, since the coupon rate is fixed at the time of initial offer. For example, the Novosibirsk Region placed additional bonds at 97.8% of the par, and St. Petersburg — at 103.2% of the par.

In 2020, St. Petersburg, Udmurtia, and the Chelyabinsk Region offered only certain portions of their bonds, and therefore, they will be able to offer more bonds in the first half of 2021, if necessary.

The situation surrounding the early redemption of bonds is ambiguous. On the one hand, an issuer may redeem its outstanding bonds: this is beneficial if the coupon rate is higher than the current market rate, so that the issuer can substitute expensive debt with cheaper debt. On the other hand, it is obvious that the redemption of bonds at their offering price is a problem (as a rule, issuers sell their bonds at 100% of the par), while the redemption at a price exceeding the offering price may raise questions.

Most often, regions do not redeem bonds; usually, if they have free funds, they deposit such funds with banks, trying to compensate for the high interest rates on their bonds (it is relevant for those regions to whom this is permitted by law).

A way out of the situation may seem to be floating interest rate bonds, but in the periods of tighter monetary policy of the Bank of Russia, interest rates grow and debt service costs become less predictable. This approach is hard to apply under the current budgeting process.

Regardless of the increase in the key rate by the Bank of Russia and the expectations for its further growth, interest rates have been very comfortable so far. Consequently, regions may solve the problem of a growing share of short-term debt by using long-term debt obligations. This is relevant for many regions that often take out 1–2 year bank loans, including the Magadan, Novgorod, Murmansk and Ryazan Regions, as well as the Perm Krai that attracted short-term loans recently. Actually, this list is much longer.

The bond market is dominated by experienced issuers; new players are still rare

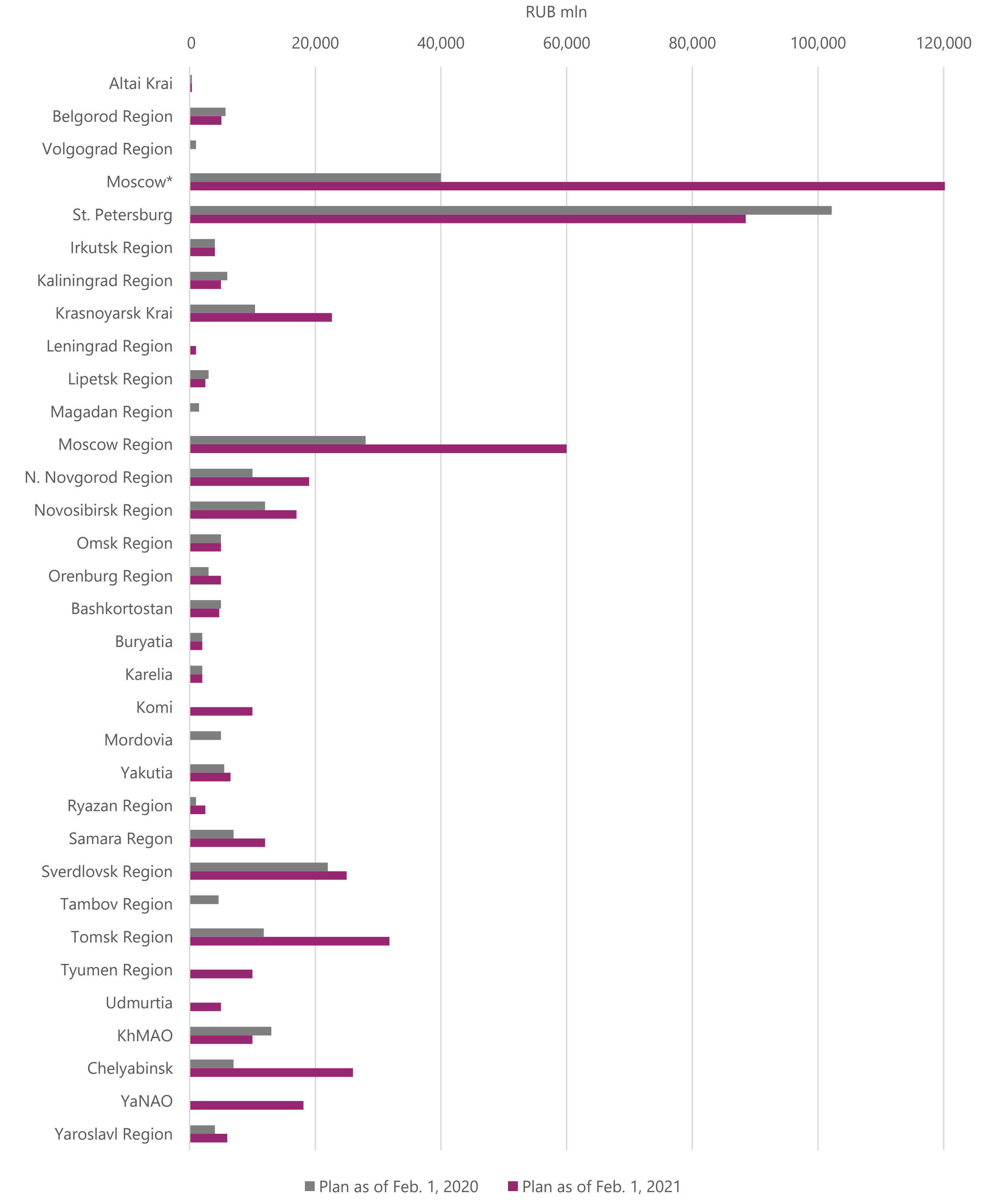
As of February 1, 2021, 29 regions (including Moscow) had plans to enter the bond market this year; a year earlier, there were 28. The expected volume of offerings, excluding Moscow, was RUB 406 bln, while on February 1, 2020, this volume amounted to RUB 282 bln (excluding Moscow). The Leningrad Region is among the regions that have not entered the bond market for a long time, but have planned bond offerings for 2021. Others include the Republic of Komi and the Yamalo-Nenets Autonomous Okrug, which have not placed bonds for several years.

Taking into account low interest rates, ACRA expects the number of offerings to reach its maximum in 2021. This will resolve the debt refinancing problem and, in some cases, improve the credit quality of regions, since it is important to prevent refinancing risks when the volume of debt increases.

In drawing up their debt policies, regions should be focused on long-term market instruments with a smooth repayment schedule, otherwise they will continue to depend on the largest lender, and the inefficiency of procurement will persist. In addition, a large volume of one-off repayments (note that regions have no other sources of debt repayment other than refinancing) will destabilize the credit quality of many regions that do not pay due attention to the problem of short-term debt.

A possible way out of the debt refinancing situation could be further long-term restructuring of loans issued to regions in December 2020. However, ACRA does not have any information on such initiatives.

Figure 5. Volume of bond offerings planned by regions



* Moscow is expected to borrow RUB 396 bln
Sources: Federal Treasury Department, ACRA

The Analytical Credit Rating Agency (ACRA) was founded in 2015, with its 27 shareholders representing major Russian corporate and financial institutions and its authorized capital exceeding RUB 3 bln. ACRA's main objective is to provide the Russian financial market with high-quality rating products. Methodologies and internal documents of ACRA are developed in compliance with Russian legislation and with regard to global rating industry best practices.

ACRA credit ratings reflect ACRA's opinion about the ability of a rated entity to meet its financial obligations or about the credit risk of individual financial obligations and instruments of a rated entity at the time of publication of the relevant Information.

Non-credit ratings reflect ACRA's opinion about certain non-credit risks assumed by interested parties interacting with a rated entity.

The assigned credit and non-credit ratings reflect all material information pertaining to a rated entity and known by ACRA (including the information received from third parties), the quality and reliability of which ACRA considers appropriate. ACRA shall not be responsible for the accuracy of information provided by clients or relevant third parties. ACRA does not audit or otherwise verify the provided data and shall not be held responsible for their accuracy and completeness. ACRA conducts rating analysis of information provided by customers using its own methodologies, with the texts thereof available on ACRA's website – www.acra-ratings.com/criteria.

The only source that reflects the latest Information, including the one about credit and non-credit ratings assigned by ACRA, is ACRA's official website – www.acra-ratings.com. Information is provided on an "as is" basis.

Information shall be considered by users exclusively as ACRA's statement of opinion and must not be regarded as advice, recommendation or suggestion to buy, hold or sell securities or other financial instruments of any kind, nor shall it be viewed as an offer or advertisement.

Neither ACRA, nor its employees and persons affiliated with ACRA (further referred to as the ACRA Parties) provide any direct or implied guarantee expressed in any form or by any means regarding the accuracy, timeliness, completeness or applicability of Information for making investment and other decisions. ACRA does not act as a fiduciary, auditor, investment or financial advisor. Information must be regarded solely as one of the factors affecting an investment decision or any other business decision made by any person who uses ACRA's information. It is essential that each of such persons conduct their own research and evaluation of a financial market participant, as well as an issuer and its debt obligations that may be regarded as an object of purchase, sale or possession. Users of Information shall make decisions on their own, involving their own independent advisors, if they deem it necessary.

ACRA Parties shall not be responsible for any action taken by users based on Information provided by ACRA. ACRA Parties shall under no circumstances be responsible for any direct, indirect or consequential damages or losses resulting from interpretations, conclusions, recommendations and other actions taken by third parties and directly or indirectly connected with such information.

Information provided by ACRA is valid only as of the date of preparation and publication of materials and may be amended by ACRA in the future. ACRA shall not be obliged to update, modify or supplement Information or inform anyone about such actions, unless the latter was recorded separately in a written agreement or is required by legislation of the Russian Federation.

ACRA does not provide advisory services. ACRA may provide additional services, if this does not create a conflict of interest with rating activities.

ACRA and its employees take all reasonable measures to protect all confidential and/or material non-public information in their possession from fraud, theft, unlawful use or inadvertent disclosure. ACRA provides protection of confidential information obtained in the course of its business activities as required by legislation of the Russian Federation.