NEWSLETTER

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Banking sector weighed down by legacy of state-led lending

Belarus' banking sector continues its recovery from the 2015-16 recession. Overall credit has again been growing since late 2017, with credit allocation shifting towards households and private enterprises. As the exchange rate stabilized and inflation has come down, local currency interest rates have markedly declined, encouraging a shift of deposits and lending into local currency. At the same time, it is still not clear that the sector is equipped to support further growth in the economy, and the long-overdue structural change towards private enterprises. In this regard, the legacy of delinquent loans of state-owned enterprises still needs to be resolved, and will require broader governance reform in the corporate sector. In this transition capital markets could become a more important source of funds.

The state retains a dominant stake in the banks

The Belarusian banking sector stands out in the emerging Europe region for an exceptionally high state ownership and concentration of assets in the three largest banks, which control over 60% of sector assets. Foreign ownership accounts for about a third of system assets, though concentrated in Russian banks.

There has been limited change in ownership in recent years, so it is encouraging that the state prepares the privatization of two mid-sized banks (Belinvestbank and Bank Dabrabyt), which are undergoing corporate governance reforms with support from the EBRD.

An even starker discrepancy to other financial systems in central Europe is apparent in terms of the very low share of bank credit directed to the private sector (23% of GDP in 2018). This reflects what remains a state-dominated economic structure in the country. The growth of several smaller and foreign owned banks which have established themselves in SME lending is encouraging in this regard.

Recent credit growth of 17% (April 2019) has been driven by consumer lending (there are no mortgages) and corporate credit is most dynamic in the private sector. Meanwhile, banks are running down the portfolio of subsidized lending programmes to state-owned enterprises and households in a number of sectors. Such loans, which still account for about 30% of the total credit stock, entail particularly high credit risks, and weak borrower discipline.

Soundness of the banking sector

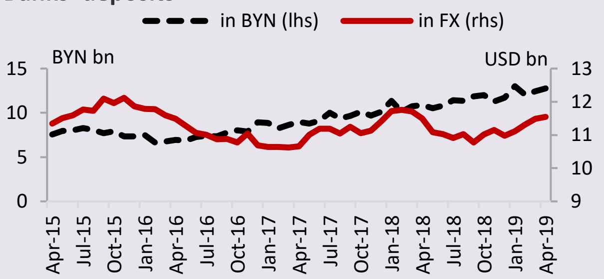
The previously mentioned aspects underline a defining vulnerability of the banking sector. Fully or partially state-owned enterprises account for 42% of GDP, and a similar share in bank loans. These enterprises have shown a markedly inferior financial performance to that of private enterprises, and benefit from extensive state guarantees, interest rate subsidies and recapitalisations. Some reforms in commercialisation and governance of state-owned enterprises are under way, though a recent costly rescue of three cement plants underlined that credit discipline is still weak. Banks have very limited scope to enforce security for such loans and essentially rely on state guarantees for this part of their portfolio.

Bank profitability and capital adequacy (at 18% of risk weighted assets) appear good according to official figures. Published figures on non-performing loans showed a sharp drop based on a new definition introduced in 2018. Bank exposures to the state sector are regularly subject to restructuring, and are now subject to higher reserve requirements. International standards for asset quality suggest that all assets that have been restructured within the last year, or where a guarantee will ultimately need to be exercised, should also be classified as non-performing.

A second vulnerability lies in the banking sector's exceptionally high share of foreign currency liabilities, largely in the form of USD household deposits. To avoid limits on open foreign currency position, these funds are largely recycled into foreign currency denominated government debt, further accentuating the banks' exposures to the state. Foreign currency loans to enterprises and households raise the vulnerability to future exchange rate variability. This undermines the central bank's ability to freely float the currency, as should be the case within an inflation-targeting regime.

As inflation has come down, the differential between BYN- and USD-denominated interest rates has decreased. Deposits and loans are therefore gradually shifting to local currency, and the National Bank has further supported this process through a number of prudential limits on bank's open FX positions, provisioning requirements on FX lending, and differentiated reserve requirements. Yet, the share of banks' foreign currency liabilities remains substantial at 54%.

Banks' deposits



Source: NBB

Recent initiatives in regulation

A recent decree by the National Bank also considerably distorts the functioning of the credit market. Loans that are priced at rates that exceed a certain benchmark (based on the seven largest banks) are subject to more onerous provisioning requirements and capital requirements. This measure was designed to restrict risky lending practices, though may in effect delay the much-needed reallocation of credit away from established large borrowers which benefit from state guarantees. Smaller private sector firms are increasingly seeking bank credit, though would require pricing of loans that is well above that for established state firms.

An important objective of the National Bank over the past two years has been the resolution of the backlog of non-performing loans. An asset management agency was established in 2016 and acquired BYN 769 m (about EUR 300) million in delinquent asset of agricultural enterprises. The transfer at face value in effect amounted to a recapitalization of banks, possibly further encouraging poor lending practices by banks and a lack of credit discipline on the side of state enterprises. The capacity of the asset management agency falls well behind that of other such entities elsewhere in Europe. The agency is limited to the foreclosure on delinquent assets, and it does not have authority to sell assets to other investors.

A decree of May 2018 significantly widened banks' capacity to restructure, including through debt-equity swaps, and by selling loans at a discount. A decree that is currently being drafted envisages a transaction platform for distressed loans, and a significant expansion of further transfer of state assets to the asset management company.

NPL resolution will require a strict enforcement of the new bank asset classification and of the related provisioning policy. This will provide incentives to banks to either restructure or divest of such assets. However, such a restructuring of bank assets will need to go hand-in-hand with broader structural change, including through credit discipline for loss-making state enterprises, if need be through foreclosure.

As bank corporate lending remains modest, the bond market has emerged as an alternative funding vehicle for enterprises. Corporate bonds outstanding in local currency amounted to USD 4 bn, or 6% of GDP. Including all bonds issued by state entities, domestic market capitalisation – in local and foreign currency – is about 25% of GDP, with around 280 issuing entities in total. This is similar to the ratio observed in EU countries in central Europe.

Government and National Bank support the capital market through the 2017 Financial Development Strategy, under which legislation for investment funds and securitization have already been adopted, and institutional investors and infrastructure are to be further strengthened.

Ultimately, the expansion of the local currency bond market should be led by BYN-denominated issuance by the state and state-owned enterprises, even though this may come at a cost. Pricing mechanisms, trading and rating assessments also need to become more transparent.

Outlook

The banking sector continues its gradual structural change, and credit allocation has begun to shift towards households, and private enterprises. The legacy of delinquent loans of state-owned enterprises still needs to be resolved, and will require broader governance reform in the corporate sector. In this transition capital markets could become a more important source of funds.

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A more detailed analysis will be provided in the forthcoming PB/04/2019 "Financial Sector Monitor Belarus 2019".

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