Financial Sector Monitor Belarus 2019

Alexander Lehmann

German Economic Team Belarus

Berlin/Minsk, June 2019

Outline

I. The financial sector in Belarus

II. Macroeconomic context and access to finance

III. Bank soundness

IV. Recent regulatory initiatives

V. Conclusions and policy challenges
   - Reducing dollarization
   - Tackling NPLs
   - Stimulating risk capital, in particular venture capital

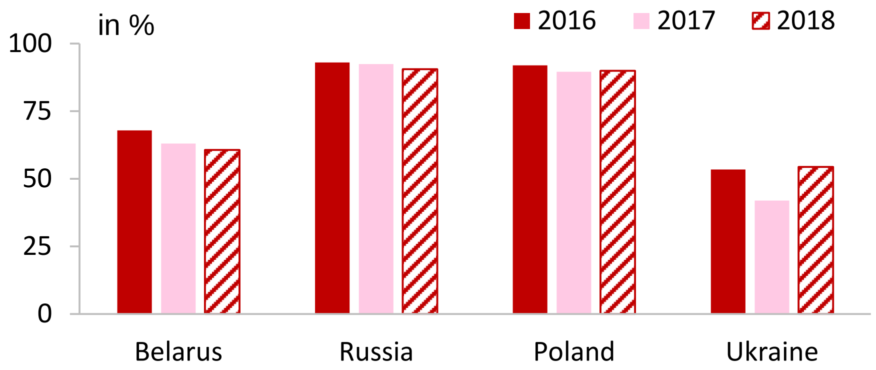
Key banking sector indicators

Contacts

I. The financial sector in Belarus

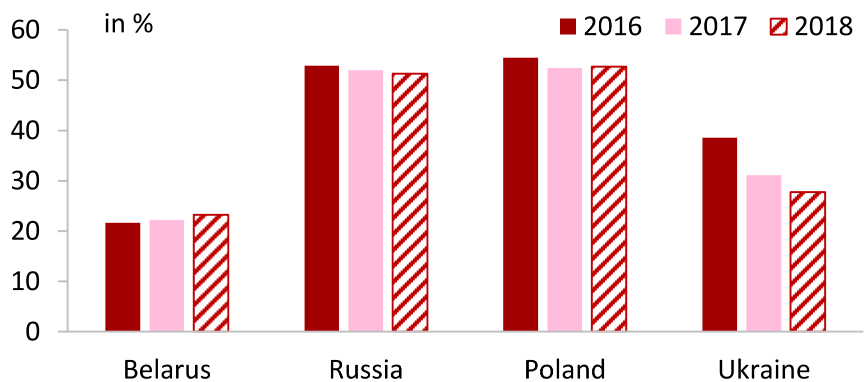
The financial sector in a regional context

Bank assets to GDP



Source: Own calculations based on data of central banks and national statistical committees

Ratio of credit to private sector to GDP



Source: Own calculation based on IMF data (WEO for GDP, IFS for credit to private sector and FSI for bank assets)

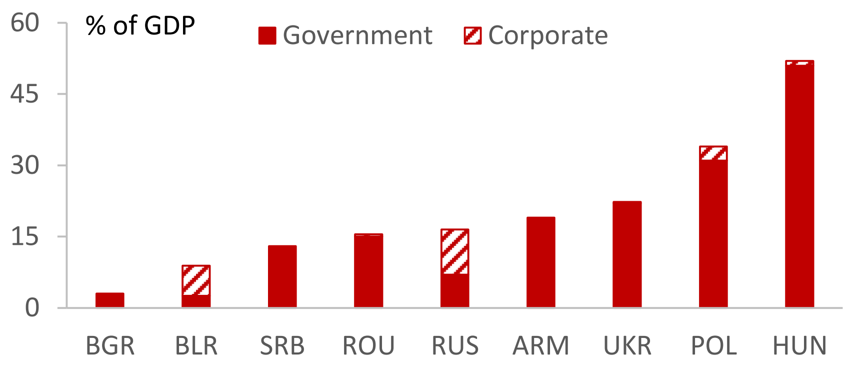
- The size of the banking sector in Belarus in 2018 was 61% of GDP, much smaller than in Russia or Poland
- Share of loans to private companies and households in GDP one of the lowest in CEE region
- Significant part of bank assets in gov. FX bonds

➢ In terms of a bank asset ratio, Belarus is not out of line with comparable countries

➢ But bank assets reflect the state-dominated economic model

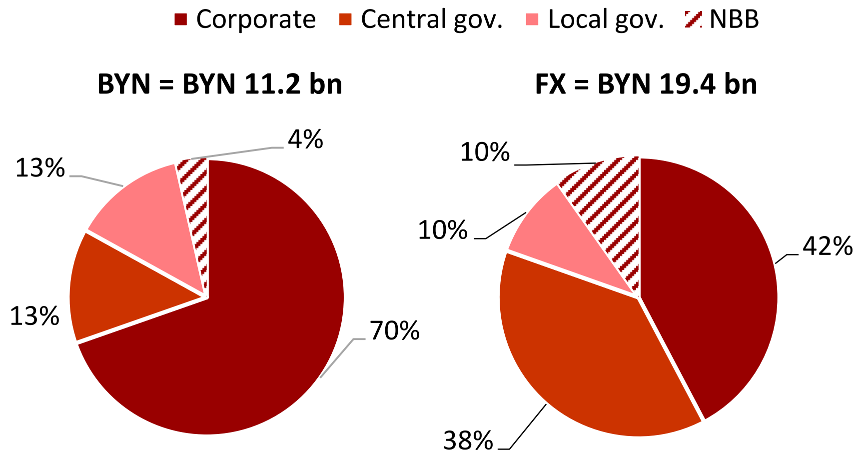
Capital markets as alternative source of corporate finance

Outstanding local currency debt securities



Source: IMF, own estimates; data as of 1 January 2019

Structure of outstanding local bonds by currency



Source: NBB; data as of 1 January 2019

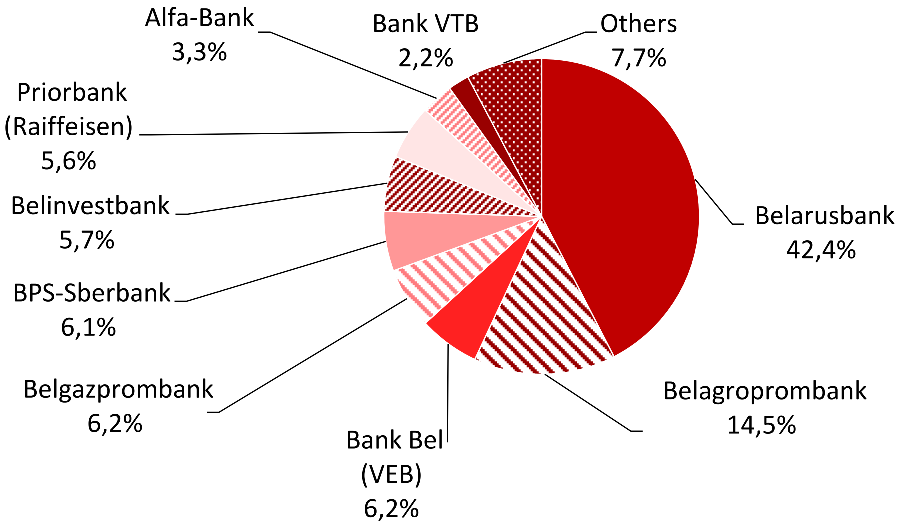
- Capital markets are poorly developed in comparison to neighbouring countries
- Capitalisation of domestic corporate bond market in BYN is significant: outstanding amount of USD 4 bn or 6% GDP
- Total domestic bond market capitalisation (BYN and FX) of 25% of GDP or USD 15 bn, issued by about 280 entities

Significant bond issues in 2018

- Belarusian Railway made 5 issues for total USD 200 m at 5-7% for 3-7 years
- A-100 Development (one of the largest developers of residential and commercial real estate in Belarus) made 48 issues of interest-free housing bonds for total BYN 178 m for up to 2 years
- Local banks and some individuals were the principal investors

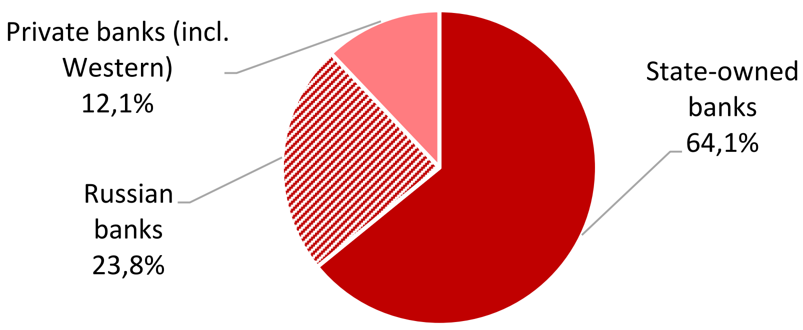
Bank market shares

Banking sector assets



Source: NBB, own calculations, data as of 1 January 2019

Market share by ownership



Source: NBB, own calculations, data as of 1 January 2019

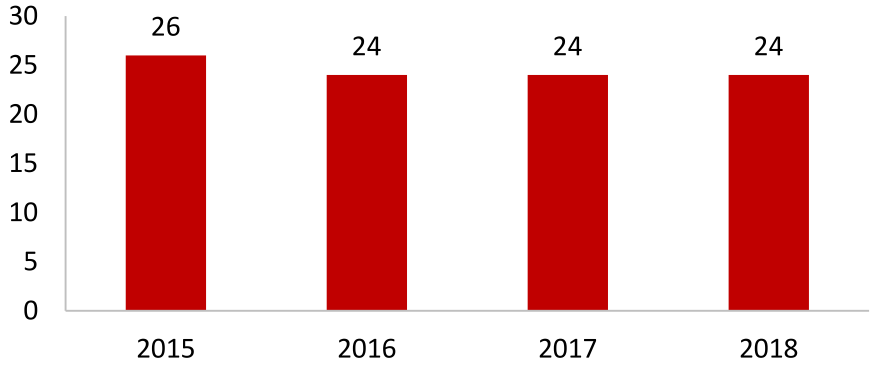
- The sector remains state-dominated and heavily concentrated: the combined market share of state-owned Belarusbank, Belagroprombank, and Belinvestbank remains at over 60%
- Russian-owned Bel-VEB is the largest foreign bank with 6.2% of market share on the third position, with Austrian Priorbank with 5.6% market share at rank 7

➢ Continued high state share

➢ Foreign stakes in the sector dominated by Russia

Market concentration, exit and entry

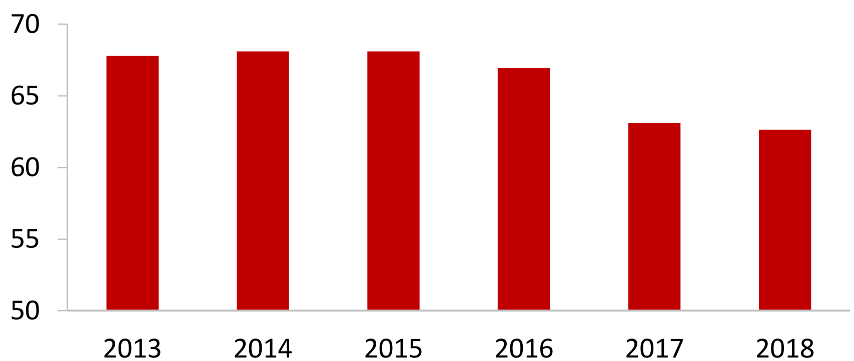
Number of banks



Source: NBB; excluding the Development Bank

Share of Top-3 banks

% of total bank assets



Source: NBB, own calculations, data as of 1 January 2019

- The number of banks remained at 24 in 2018, following the exit of several smaller banks in 2014-16
- Two smaller state-owned banks currently receive pre-privatization support, including corporate governance reforms
- The state indicated willingness to divest of its stake in Priorbank

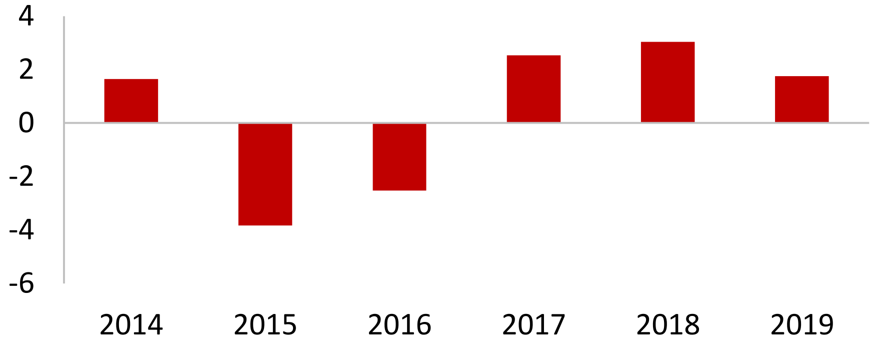
➢ High concentration in a small and closed financial market is not unusual and not necessarily inefficient

➢ Market dominance of the three largest banks poses problems of moral hazard, due to implicit state guarantee

II. Macroeconomic context and access to finance

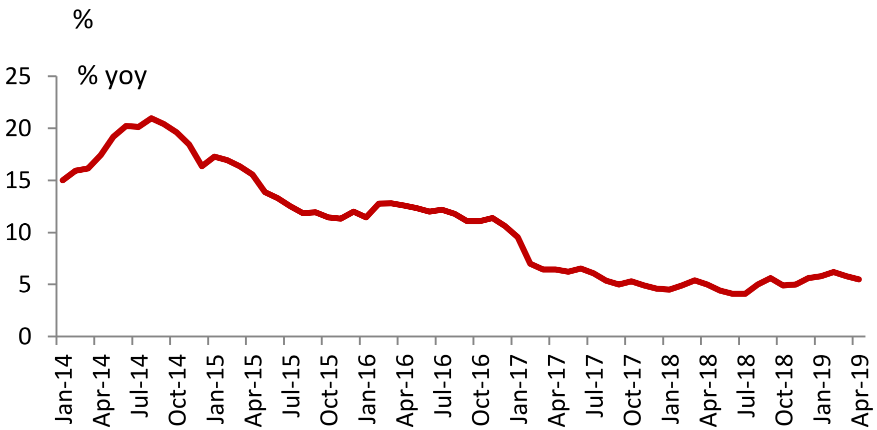
Economic growth and inflation

GDP growth



Source: IMF WEO

Inflation rate



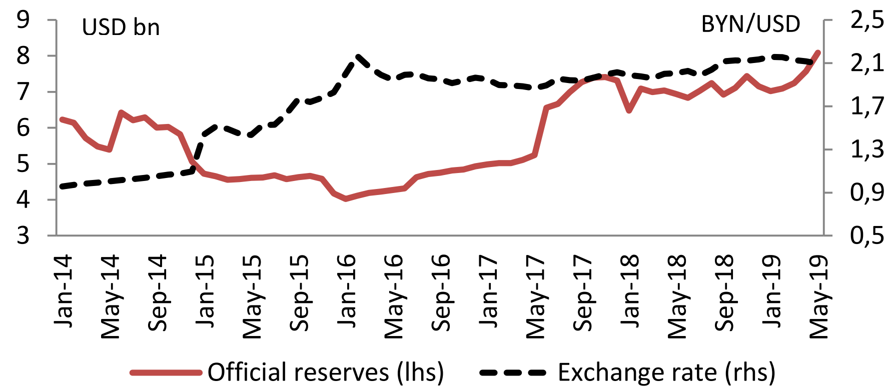
Source: NBB

- Belarus recovered from the economic crisis in 2017
  - Real GDP growth 2018: 3.0%
  - 2019: 1.8% (IMF forecast)
- Growth is expected to continue, but remains limited at around 2% p.a. without major economic reforms
- Based on a new monetary framework, inflation has declined and remains under control
  - 2018: 5.0% (annual average)
  - 2019: 5.0% (IMF forecast)

Outlook: growth is expected to remain positive but limited; inflation will continue to remain under control

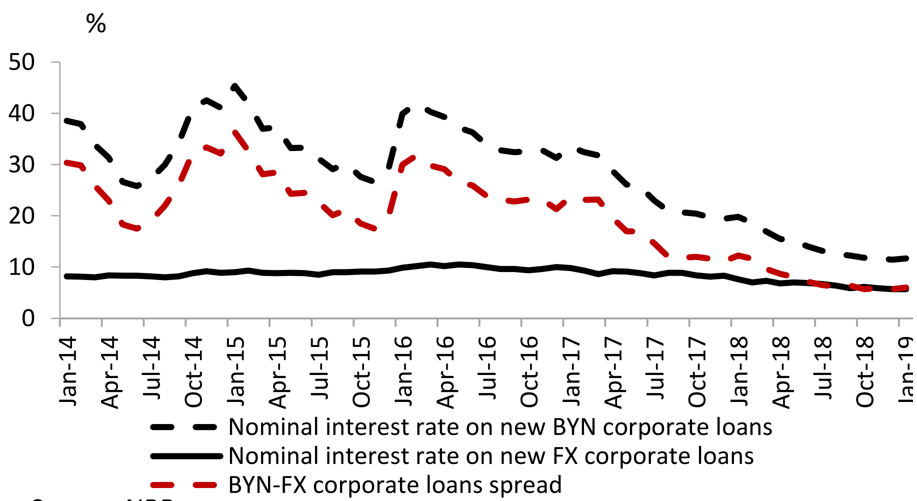
Exchange rate developments and interest rates

Exchange rate and FX reserves



Source: NBB

Interest rates on corporate loans



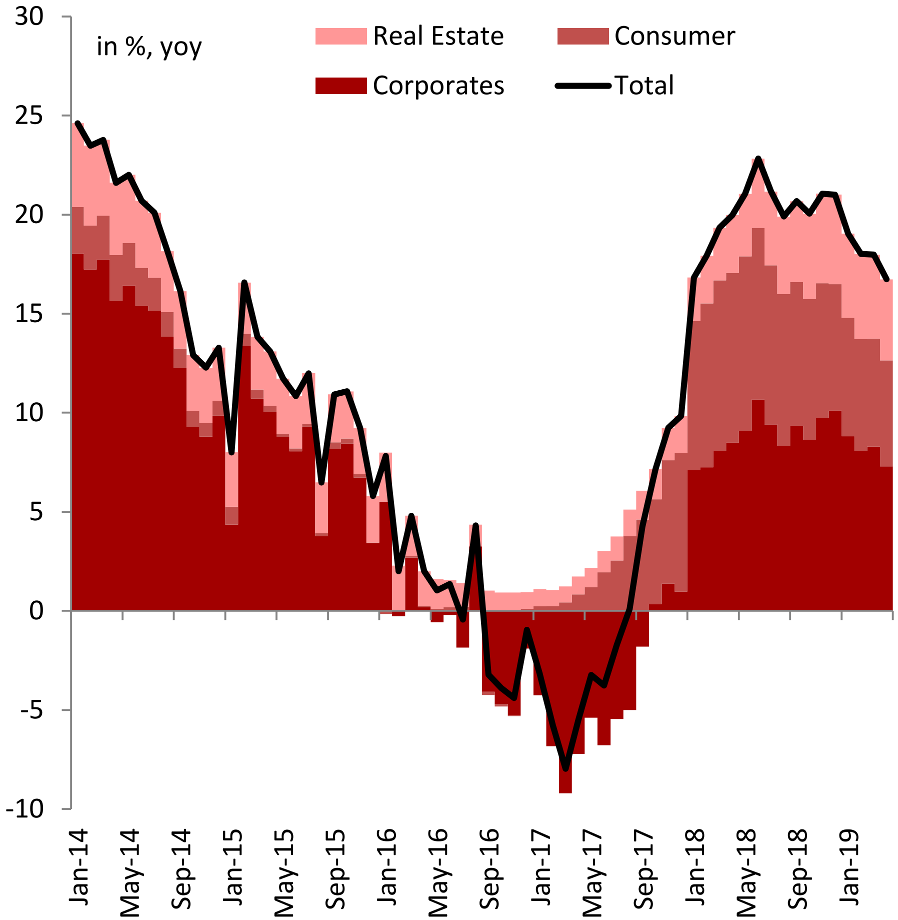
Source: NBB

- Stable development of the exchange rate in a relatively flexible system
- Reserve assets remain stable, with a positive development recently
  - May 2019: USD 8.1 bn
- Together with the decline in inflation and stabilization of economic situation, BYN and FX corporate loan rates converged

➢ The 2015 recession underlined risks from the large exposure to Russia, and from the widespread use of the USD in the banking system

Loan growth

Contribution to credit growth

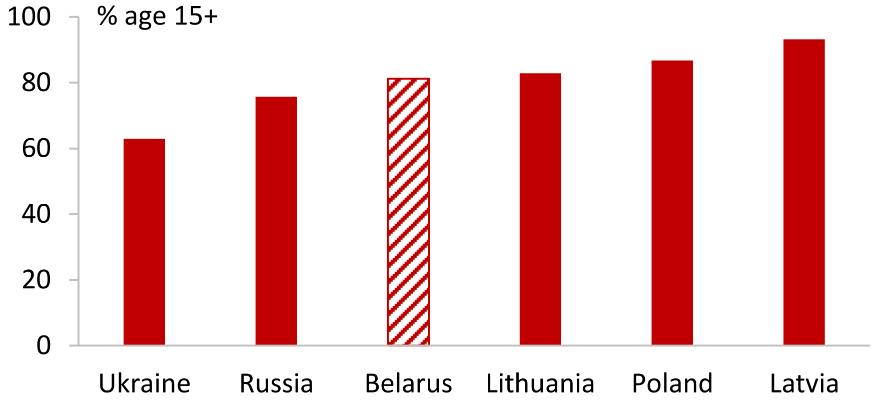


Source: NBB, own calculations; constant exchange rates

- After almost two years of contraction, loan growth turned positive in late 2017
- Retail credit has been the most dynamic (cars, housing and consumer loans)
- Corporate credit to private firms has been more dynamic than to state firms. FX share in corporate lending only slightly reduced at 57%
- Some niche players expand SME programmes
- Credit directed under state programs is gradually declining in importance

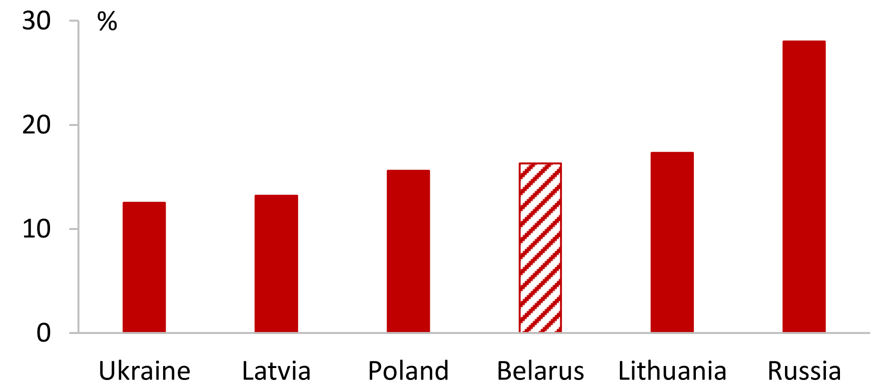
Financial access and credit constraints in a regional comparison

Account at a formal financial institution



Source: World Bank; data for 2017

Firms identifying access to finance as a major constraint



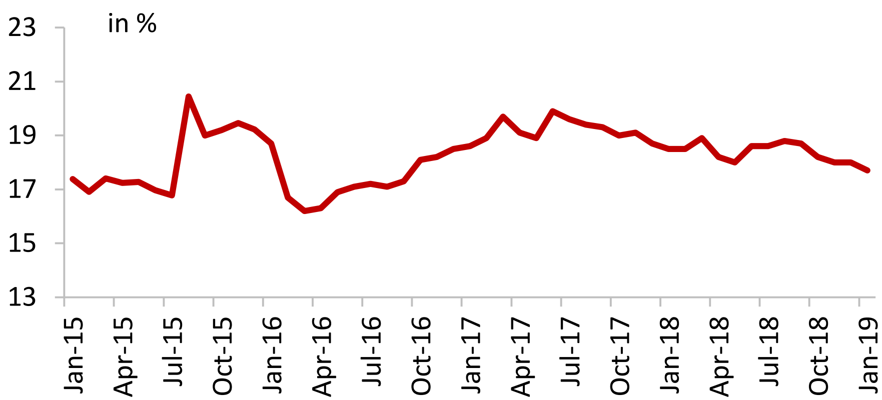
Source: World Bank; latest available data of 2013.

- Overall, access to financial services for households seems well developed, e.g. looking at the share of the population with a formal account
- Firms reporting constraints on obtaining credit also in line with that what is observed elsewhere in the region, though the banks' capacity for SME lending poorly is developed
- The credit information system is well developed, with broad coverage of the credit registry and good depth of information

III. Bank soundness

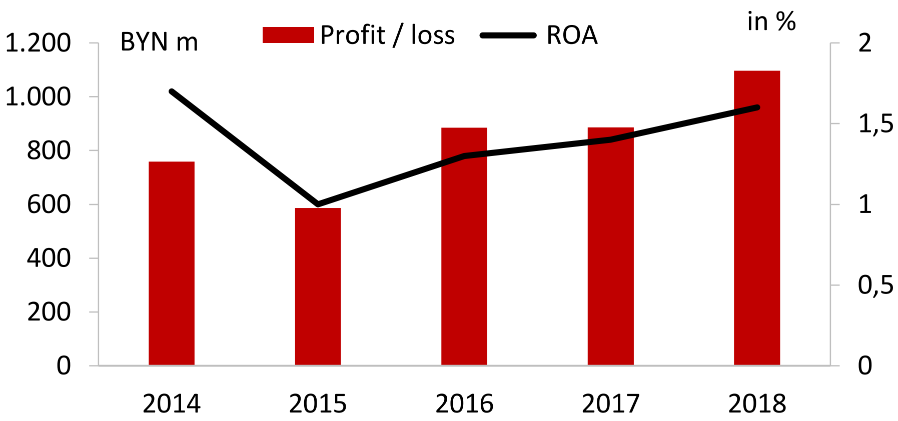
Earnings and capital coverage

Capital adequacy ratio



Source: NBB

Banking sector profit



Source: NBB

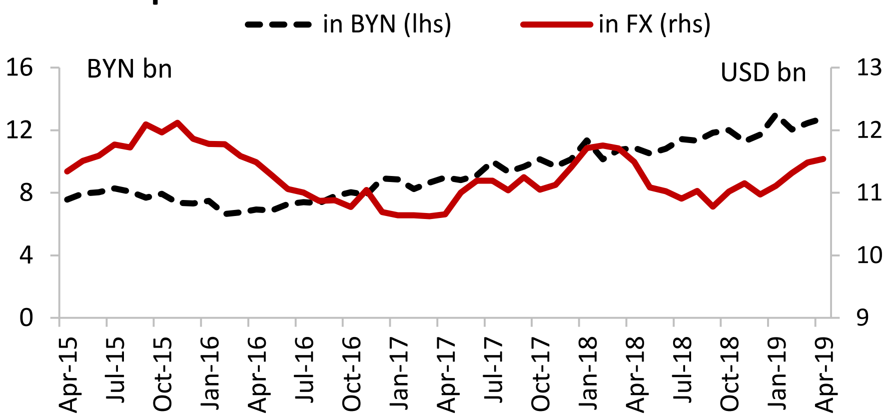
- Bank profitability and capital coverage have improved since the 2015 recession
- Capital coverage is well above regulatory benchmarks
- Current loan growth and reduced funding costs will continue to underpin profitability

➢ State owned enterprises account for 32% of GDP (but a much larger share in loans)

➢ Forbearance on SoE loans (continual restructuring) and delay of credit losses remain key concerns

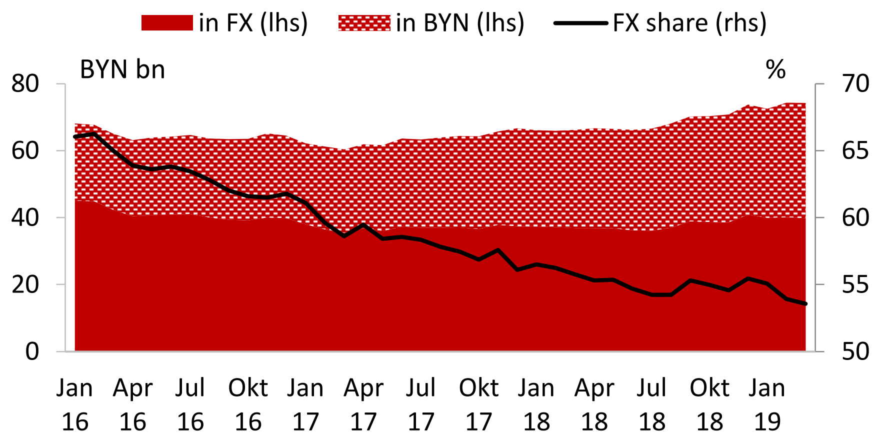
Liquidity and bank funding

Banks' deposits



Source: NBB

Banks' liabilities



Source: NBB

- Higher BYN real interest rates explain expanding share of local currency deposits
- Share of FX in total household deposits still about 66%
- FX deposits have decreased since the 2015 recession when exchange rate uncertainty was at a peak
- Overall foreign currency liabilities remain substantial at 54%

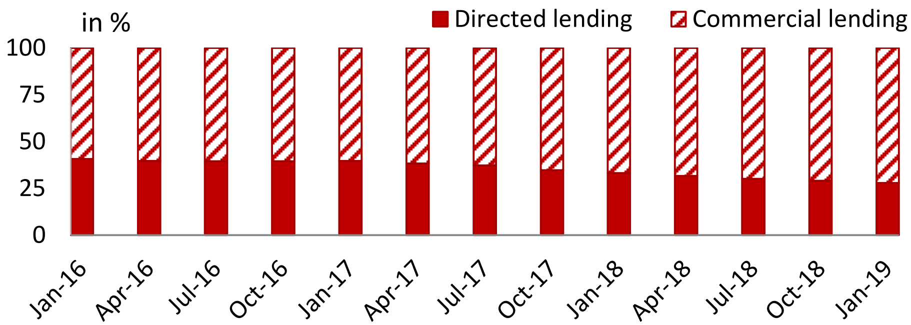
➢ Stable exchange rate and lower inflation make BYN deposits more attractive

➢ Banks' FX liquidity (access to liquid assets) remains a concern, also in light of limited FX reserves

IV. Recent regulatory initiatives

Directed lending and interest rate regulation

Structure of banks loans



Source: NBB; excluding Development Bank

- Stock of loans from the directed lending to SoEs and households has continued to decline by roughly 2 pp of GDP in past two years
- As direct lending still accounts for a substantial share of bank loans this still undermines portfolio quality

Measure on ‘estimated values of standard risk’ of March 2019

- Objective is to limit systemic risks generated by high-risk business models
- If BYN rate for new loans exceeds benchmark based on 7 top lenders, additional provisions and a higher risk weight for required capital calculation apply
- Similarly, higher reserve requirements apply for deposit attracted at above average rates

➢ Smaller institutions unlikely to be a source of systemic risks

➢ Measure will distort credit allocation, discourage lending to riskier SMEs

➢ NBRB could instead focus on ’risk appetite’ within banks and on credit approval procedures

Resolution of non-performing loans (NPLs)

- NBB conducted asset quality reviews in 2016 and 2017
- The Asset Management Agency (AMA) was founded in July 2016, and acquired certain non-performing agricultural assets of 356 agricultural organizations (BYN 766.8 m) at face value
- Decree No. 200 of May 2018 now provides for debt-equity swaps and tax neutral debt write-offs, and allows for loan sales at a discount
- The 2018 asset quality definition led to a sharp downward revision of NPL ratios. Restructured loans are not counted as NPLs, though now subject to higher reserve requirements

Planned decree

- NPLs to be sold through an electronic auction at the currency and stock exchange
- The tasks and assets of the existing asset management agency (AMA) are to be considerably expanded

➢ Engagement of private investors and restructuring uncertain, and AMA currently not resourced to engage in restructuring

Systemic ('macroprudential') regulation

The key risk is in Belarus arises from high dollarization, which is one of the highest in the CEE region: foreign currency accounts for 57% of corporate loans (though is now negligible for household loans), and 54% for bank liabilities

- Vulnerabilities arise from liquidity risk in banks, and credit risk among borrowers; monetary policy becomes less effective ('fear of floating')
- FX deposits of banks are recycled into FX sovereign debt, which results in bank vulnerability to government credit quality

Measures to stem **risks from FX loans/de-dollarization**:

- Differentiated reserve requirements;
- Regulation of corporate FX lending, and higher provisioning ratios;
- Limits on banks' open FX positions.

There are also limits on household debt (debt service to income and loan-to-value ratios), though at present there is no risk of credit overheating

Capital market development

The 2017 Financial Development Strategy is gradually being implemented

- A range of about 50 measures aimed at capital market development:
  - Legal basis of investment funds and securitization created in 2017
  - Futures and derivatives
  - Development of institutional investors such as pension and investment funds, mortgage savings accounts envisaged; draft decree on insurance market issued
- An update of the Financial Development Strategy is planned for the second half of 2019

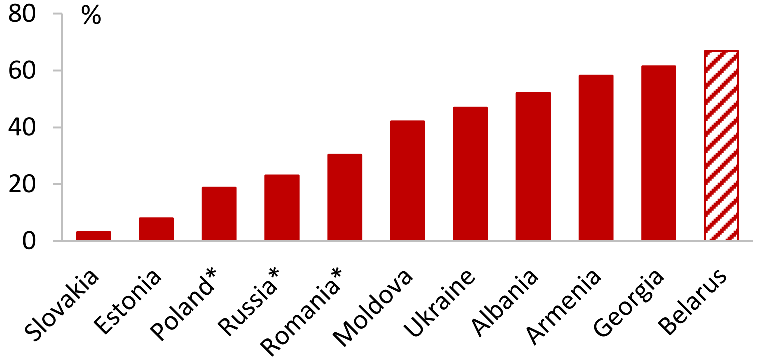
V. Conclusions and policy challenges

Conclusions

- ✓ A key challenge remains the commercialization of state banks. Preparation of privatisation of two banks and winding down of directed credit programme are welcome news in this regard
- ✓ The state recapitalisation and guarantees of SoEs (e.g. in a rescue of three cement plants in May at a substantial cost) undermines credit discipline and banks' capacity to enforce on delinquent loans
- ✓ Capital adequacy and earnings seem sound. There needs to be greater transparency on bank asset quality, and credibility that new provisioning requirements are strictly enforced, as repeated restructuring of loans is still widespread. The implicit state guarantee is essential for bank soundness
- ✓ Recent limitations on interest rates charges distort the allocation of credit, raising costs, and possibly undermining access, for smaller private enterprises
- ✓ Dollarization of liabilities remains very high, and forces banks into large sovereign exposures. Sovereign BYN debt issuance could stimulate more local currency funding
- ✓ Private bond issuance is a significant source of funds, though the market infrastructure, liquidity and pricing mechanisms need strengthening

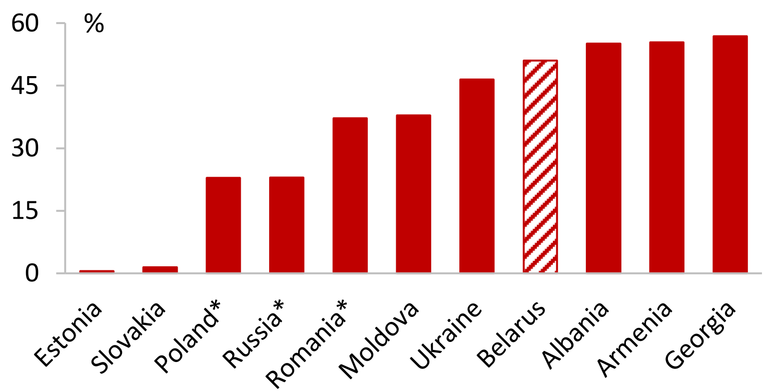
Further measures on de-dollarization

Share of FX in banks' liabilities



*Source: IMF FSI statistics; data for 2018; *data for 2017*

Share of FX in banks' loans



*Source: IMF FSI statistics; data for 2018; *data for 2017*

- The monetary framework in effect since 2015 has stabilized inflation. Experience in other CEE countries suggests that this is the key precondition for reducing dollarization
- Further measures to reduce dollarization could be:
  - Development of the local BYN market, which needs to be more liquid along the yield curve of all maturities, e.g. through longer term issue by the government and SoEs
  - Strengthening the legal foundations for the local market (eg derivatives legislation)
  - Tightening of prudential requirements on unhedged fx lending, though without setting hard limits

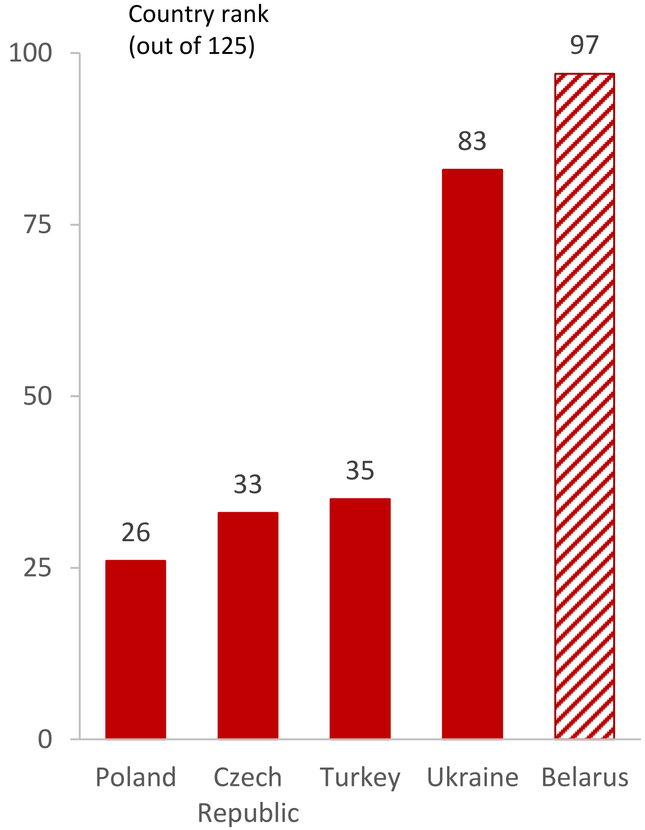
Tackling NPLs

The large state sector, and its close linkages to state banks, pose an ongoing risk of forbearance for bank asset quality

- The definition of non-performing loans should comply as closely as possible to international standards (e.g. Basel Committee), and cover:
  - Exposures defaulted, impaired, or more than 90 days past due
  - Restructured loans, unless they have met contractual loan terms for at least a year
  - Loans where exercising the collateral or guarantee is expected
- Loan sales at discount could be an instrument to relieve banks of NPLs, though investors will require full transparency on loans, and need to be in a position to restructure or foreclose
- The Asset Management Agency could assist in the process of NPL resolution, but would need substantial powers and capacity to engage in restructuring
- Further transfers of distressed loans need to happen at discounts that reflect value to investors. Otherwise this amounts to a recapitalisation, and encourages further risky lending
- Delays in loan restructuring diminish value and prospects for recovery

Stimulating risk capital, in particular venture capital

Attractiveness of PE and VC framework conditions



Source: 2018 VC and PE country attractiveness index

- A strong start-up sector in Belarus is currently largely funded informally and through "business angels", but requires more formal funding and expertise from venture capital funds
- Funding options for the entire life cycle of an enterprise need to be defined. Private equity is held back by poor corporate governance practices and inadequate rights for minority shareholders
- Private bond issuance could grow but would need to be based on a full sovereign yield curve

➢ Both venture capital and private equity could be developed through a law on investment funds. Much potential from foreign funds

➢ The 2017 capital market development strategy should be supported through BYN issuance by the government, development of capital market infrastructure, and preparing large enterprises for equity and bond issuance

Annex: Bank sector statistics (excluding Development Bank)

Balance sheet data	2014	2015	2016	2017	2018
Total assets (BYN m)	48,153.08	63,046.33	64,467.00	66,679.60	73,706.40
in % of GDP	61.86	72.49	67.90	63.06	60.63
Total loans (BYN m)	31,398.86	37,777.12	35,851.00	38,762.50	44,061.00
in % of GDP	40.30	43.40	38.01	36.66	36.24
Loans to private enterprises (BYN m)	10,334.20	13,198.06	11,860.20	12,613.90	13,901.50
in % of GDP	12.30	15.20	12.57	11.93	11.44
Loans to households (BYN m)	6,293.61	6,878.84	7,155.40	9,031.90	11,596.40
in % of GDP	8.09	7.90	7.59	8.54	9.54
Loans in foreign currency (BYN m)	15,969.46	21,593.86	20,089.10	19,684.80	21,337.80
in % of GDP	20.50	24.80	21.30	18.61	17.55
Loans in foreign currency (% of total loans)	50.86	57.20	56.03	50.78	48.43
Total deposits (BYN m)	21,378.36	29,520.66	29,946.00	34,795.50	37,469.80
in % of GDP	26.53	32.83	31.54	32.90	30.82
Deposits from households (BYN m)	13,433.30	19,272.04	19,074.20	20,103.11	22,173.92
in % of GDP	17.30	22.20	20.22	19.01	18.24
Total loans (% of total deposits)	146.87	127.97	119.72	111.40	117.59
Structural information					
Number of banks	31	26	24	24	24
Market share of state-owned banks (% of total assets)	63.40	63.80	66.65	64.45	64.13
Market share of foreign-owned banks (% of total assets)	33.23	33.75	30.78	32.43	32.90
Profitability and efficiency					
Return on Assets (RoA)	1.7	1	1.3	1.4	1.6
Return on Equity (RoE)	13.1	8.4	10.8	9.6	10.7
Capital adequacy (% of risk weighted assets)	17.4	18.7	18.6	18.5	17.7
NPLs (% of assets subject to credit risk)	4.37	6.80	12.80	12.90	5,00*

*Source: NBB, Belstat, own calculations Note: *-new methodology*

Contacts

Dr Alexander Lehmann

lehmann@berlin-economics.com

Dmitry Chervyakov

chervyakov@berlin-economics.com

German Economic Team Belarus
c/o BE Berlin Economics GmbH
Schillerstraße 59, D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
www.get-belarus.de
Twitter: @BerlinEconomics
Facebook: @BE.Berlin.Economics