Improvement of prudential measures of The Bank of Russia under new conditions

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1 Introduction

The main objective of the Bank of Russia is to maintain the banking system stability, and therefore, eliminate deficiencies in banking regulation and banking supervision in order to suppress attempts to unjustifiably increase assets, protect consumer rights in the financial market, increase the financial stability of credit organizations, and exclude unfair players from the market

Recently many changes have taken place in the banking sector of the Russian Federation. The most significant change is the division of banks into 2 categories depending on the license type: banks with a universal license and banks with a basic license. Each category of banks has to meet different requirements, including regulatory requirements, prudential provisioning, and permitted transactions.

Research objectives are to evaluate the efficiency of the regulator's innovations in terms of developing the banking services market and protecting consumer rights in this market, as well as increasing the banking system stability.

2 Research methods

Since 2019, improvement of the banking sector regulation has been ongoing, and new rules have been introduced to create reserves for possible losses from loans, new rules of lending to individuals, and much more, which we will dwell on in more detail.

Changes in banking legislation can be divided into two groups: innovations aimed at increasing the banking sector financial stability and measures aimed at developing the banking services market and protecting consumer rights in this market (Table 1,2,3).

Table 1. Regulator’s measures to increase the banking sector financial stability

Changes in banking regulation	Meaning	Results, consequences
LCR increase for systematically important banks since January 1, 2019 in accordance with the schedule of “Basel III” phased implementation adopted in late 2015	Minimum acceptable liquidity coverage ratio (LCR) is increased from 90% to 100%: highly liquid assets/ net expected cash outflows within 30 calendar days (in case of a stress situation)	“Basel III” implementation has been completed [5]. Ensuring short term sufficient liquidity
Schedule has been set for increasing capital adequacy	Starting from January 1, 2019 the increase was 1,875%, from	The increase should cover bank losses during financially

ratio in accordance with “Basel III”. Capital adequacy ratio (applies to all banks with universal license) is increased according to the schedule approved by the Central Bank	April 1, 2019 — 2%, from July 1, 2019 — 2,125%, from October 1, 2019 — 2,25%, since January 1, 2020 — 2,5%. It is calculated in percent of risk-weighted assets	unstable periods. Banks that do not meet increased capital adequacy requirements are limited in their rights to distribute profits and pay non-fixed reward to management
Systemically important banks begin to calculate the maximum single customer concentration risk or group of related customers concentration risk	All credit requirements to a single borrower (group of borrowers) without risk-weighting / fixed capital.	Supervisory requirements to limit major risks according to “Basel III” [5]
The risk coefficient for mortgage loans with down payment of 10% to 20% increases, therefore, the capital adequacy ratio of banks with such loans in the portfolio will drop (Fig. 1)	Risk ratio increases from 150% to 200% for loans granted since January 1, 2019. The rule will be valid only for a period until the ratio of loan debt to collateral value exceeds 80%.	1) Decrease of bank risk on mortgage loans. Decreased default risk for mortgage clients 2) Banks are less interested in such borrowers

The main indicator of the banking sector stability is the capital adequacy ratio (H1). Taking this ratio in consideration, the Bank of Russia can revoke a license or reorganize a bank. In Russia CAR is 8%, and Russia’s banks easily fit this norm at the moment, although there has been a slight drop in H1 due to the tightening of requirements for calculating risk-weighted assets. Table 2 shows the capital adequacy ratio of the banking system before and after the introduction of the measures presented in table 1.

Table 2. Capital adequacy ratio of Russia’s banks

Value of H1.0	1.01.18		1.02.20	
	Number of credit organizations	Share in banking share assets, %	Number of credit organizations	Share in banking sector assets, %
Lower than 8%	20	6.8	10	2.4
From 8% to 10%	9	1.5	4	0.4
From 10% to 12%	36	21.5	22	17.5
From 12% to 14%	64	18.1	46	53.5
14% and higher	420	52.1	344	22.4
Profitable CO	421	-	319	-
Unprofitable CO	140	-	108	-

In general, as of 02.20.2020, the capital adequacy ratio in the banking system was 12.5% with the norm of 8% (compared with 12.1% of 01.01.2018). It means that measures to ease prudential supervision in terms of regulations did not lead to deterioration of the result.

Short-term liquidity ratios H26, H27, which are calculated as the ratio of highly liquid assets to expected cash outflows within 30 days as of 01.01.2019, were observed by all banks. The norm was 90% in 2018, and increased to 100% in 2019. Systemically important banks exceeded this ratio, as of 01.01.2019. It amounted to 130.5% (in the range from 98.6% to 177.7%) [2]. What does the LCR coefficient signify? This ratio forces banks to

have sufficient unencumbered high-quality liquid assets in case an outflow of funds occurs within 30 days as a result of a stress scenario:

- outflow of retail deposits;
- outflow from derivatives (market valuation);
- unsecured financing by non-financial institutions.

The formula for calculating LCR is as follows:

$$LCR = \frac{\text{High quality liquid assets}}{\text{Net outflow within 30 days}} \geq 100\% \quad (1)$$

Table 3. Regulator’s measures to develop the banking services market and protect consumer rights in this market

Changes in banking regulation	Meaning	Results, consequences
Deposit insurance system applies to funds of small enterprises in rubles and foreign currency placed in banks of the Russian Federation	Insurance indemnity is 100% of the amount of funds in the accounts (deposits), but not more than 1.4 million rubles in total in each bank.	Protecting SMEs from risks
Loans to developers as part of shared construction development have been recorded in escrow bank accounts since July 2019.	Escrow account is a bank account that is opened for depositing interest holders’ money until the construction is finished	1) Significant risk reduction for interest holders 2) Development of project financing in banks
SME loans on standard terms increase from 5 to 10 million rubles, financial situation being “average”	Loans up to 10 million rubles can now be included in a portfolio of homogeneous loans with standard terms of granting	A standardized approach to assessing the risks of SMEs with a larger contract amount. A loan becomes more affordable even if a borrower’s financial situation is “average”
Reduced asset risk ratio (75%) is applied to SMEs when calculating capital adequacy	The maximum amount per single borrower rises from 60 million to 70 million, the risk ratio is reduced from 100% to 75%	Ratio H1 allows to increase lending to SMEs
While assessing the creditworthiness of SMEs, it is not necessary now to analyze a company’s operation	Financial situation without operational analysis can be recognized as “good”	The volume of reserves for possible losses from loans decreases. This results in better loan affordability for SMEs and fewer bank denials.
Requirements for risk assessment of restructured and refinanced loans to SMEs are reduced	Debt service of restructured and refinanced loans is recognized as “good”	The volume of reserves for possible losses from loans decreases and affordability of loans to SMEs increases.
SME Corporation guarantees are taken into account when assessing the risks of lending to SMEs	SME Corporation guaranteed loans	Improving affordability of loans to SMEs and reducing the number of bank denials.

Some liberalization of risk management in lending to small and medium-sized businesses is worth special attention. What can this lead to? Let us look into fundamental indicators that caused liberalization of banking supervision in credit risks of SMEs.

First of all, it is necessary to refer to the statistics on overdue debts and creation of reserves for possible losses from loans to SMEs [2]:

Fig. 1. Debt on loans to small and medium-sized businesses, including loan arrears, million rubles - scale on the left, share of overdue debt in the portfolio (scale on the right)

The regulator's decision to ease the risk assessment policy for SMEs is quite reasonable: the share of delinquency in this segment is falling: it was 13.2% in early 2019 and 12.3% in late 2019. Only some regions demonstrate an aggravation of the solvency situation of small and medium-sized borrowers (North-Caucasian Federal District and Far Eastern Federal District), which is associated with regional features.

As for mortgages, we can see some tightening of requirements for assessing these assets risks, in particular loans with a down payment of <20%. The share of overdue mortgage loans decreased from 1.3% to 0.9 % starting from early 2018 to early 2019. However, the amount of granted mortgage loans increased from 1.9 to 2.3 million rubles [3]. In addition, mortgages with a low down payment are one and a half times more likely to default [4]. Although mortgage lending remains the most high-quality segment of lending at the moment, mortgage borrowers are too debt-ridden and besides mortgage borrowers have to repay other loans as well. From the point of view of borrowers and the mortgage market development, there exists a negative effect. Banks are less interested in these borrowers, as it is necessary to create larger reserves for them now.

In 2019, the regulator took new measures to protect interest holders' property. Since July 2019, developers have to use escrow accounts. Now they will be able to develop construction projects not with interest holders' money, but with their own or credit funds. Holders' money is kept in escrow accounts until they become real estate owners. An

interest holder, who was a developer's "creditor", is not able to assess the developer's creditworthiness, and the bank responsibility is providing loans and professional assessing of borrowers. The source of the loan is the escrow account itself. Money can be transferred to the account only after the registration of the share agreement in Rosreestr (Federal Service for State Registration, Cadaster and Cartography). The developer can receive payment from the escrow account only after the building is put into operation.

3 Conclusions

Changes in banking supervision adopted in 2018-2019 protect the rights of banking services consumers, and also aim at improving the banking sector stability and increasing economic growth.

The following factors support that conclusion:

- Growth of the banking sector liquidity in stress situations (tightening LCR coefficient).
- Reducing default risks on mortgage lending.
- Small and medium-sized businesses development because of greater access to bank loans, as well as the protection of their money in commercial banks.
- Protection of interest holders' rights.

However, with regard to LCR, the introduction of this indicator poses some problems that require further consideration:

- The desire of banks to use liquid securities more actively though this asset has a lower return level
- Reduction of bank securities in banks return.

These problems, in turn, reduce the bank's interest margin, and as a result can lead to an increase in lending rates.

References

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