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The credit crunch and the Russian banking system

Russia's current credit crunch has its origins in the sub-prime mortgage market in the United States and in the markets used by private equity companies and other corporate acquirers to raise finance. Russia is not a major player in these markets so any effects that the credit crunch has had on the country's banks are therefore incidental – a kind of collateral damage.

How do these developments affect the fund?

There is no sign that our corporate borrowing customers are experiencing any serious adverse side effects of the liquidity problems in the banking system. Instead, we are now being offered substantial amounts of very attractive assets by lenders that are suffering from the liquidity squeeze but don't want to damage long-term client relationships. This is an important positive opportunity for the fund, which we are looking to use to increase our gross yield. We are confident that the current liquidity problems of the banking system will not be allowed to develop into a significant macroeconomic setback. Therefore, we expect Russia's economic growth to continue, setting the backdrop for the success of the fund.

The Backdrop

Probably the biggest impact has been on those commercial banks that derive a substantial part of their financing from bond issues. Primary issuance dried up with the result that credit spreads widened and yields rose in September. In recent days there's been a reduction in spreads and issuers are announcing their intention to proceed with new sales of bonds. Even during the period of rising spreads and domestic overnight borrowing rates, Russian commercial banks continued to be active trader of securities on Micex, which shows that market liquidity did not dry up entirely.

The most prominent problems have been with the fast growing consumer lending banks, such as Russian Standard, which have depended very heavily on bond issues to finance their business. Russian Standard has since cut back on its lending quite sharply, and other banks may have done likewise. However, some banks with stronger liquidity, such as VTB, have been buying consumer loan portfolios, thus helping to ease liquidity problems in the market as a whole. More generally, interest rates charged to borrowers have risen. The net effect is likely to be some slowdown in consumer demand.

However, Russian banks are not likely to face a generalised liquidity crisis in the near future. It is true that money market rates are currently relatively high by the standards of the past year or so, though not by the standards of the past seven years (see chart). The tightness of money market rates in late September suggests that the demand to borrow is strong, but it is thought that the incidence of seasonal tax payments was the main reason. Since peaking on September 28 they have begun easing and are likely to continue falling over the next week or so. Meanwhile, some $2.5 billion of international and domestic bonds were redeemed in September, and total maturities between now and the end of the year are just under $1 billion. The big question is not about liquidity but about longer-term sustainability – ie about the ability of bond-financed banks to continue to grow profitably in a period of higher bond yields.

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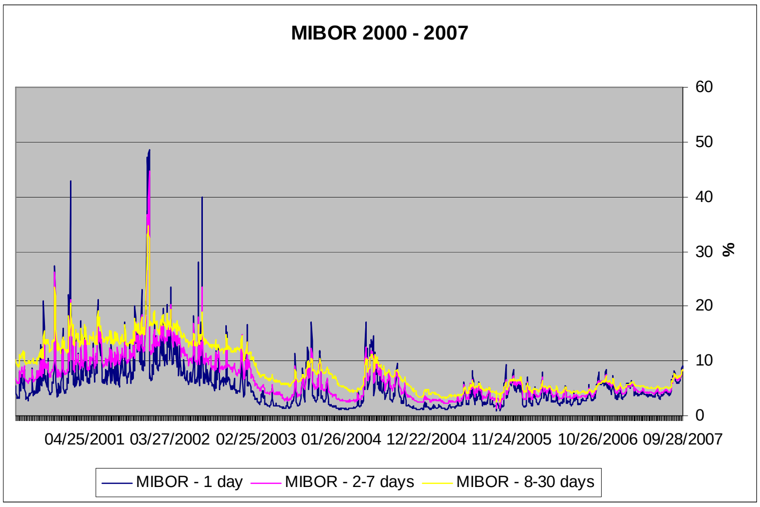

Some banks have come under pressure in the new tougher environment for wholesale borrowing. The Central Bank of Russia is clearly alert to the situation: it has said that it will widen the range of collateral that it accepts against loans, and that it will widen the range of assets that it is willing to accept as collateral by accepting B+ rated paper as from October 6th. This can be expected to cause market liquidity to improve substantially. Clearly, the central bank wants to put itself in a strong position to manage liquidity problems if they arise at any stage. The central bank has enormous foreign exchange holdings, exceeding $400 billion.

It should not be assumed that the central bank will not allow any Russian bank to fail. The central bank may well think that a few failures among small banks would help reinforce discipline in the banking industry. However, President Putin has made it clear that the central bank can be counted on to prevent a systemic crisis in the Russian banking system – ie a crisis that would have serious macroeconomic effects. It is an objective for Russia to become regarded as a financially serious country, and for the non-energy part of the economy to continue to grow and prosper. Neither of these objectives would be served if major problems were allowed to develop in the banking industry.

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