European banks in Russia

Exceptional factors drive profit growth as regulators' call to speed up exits

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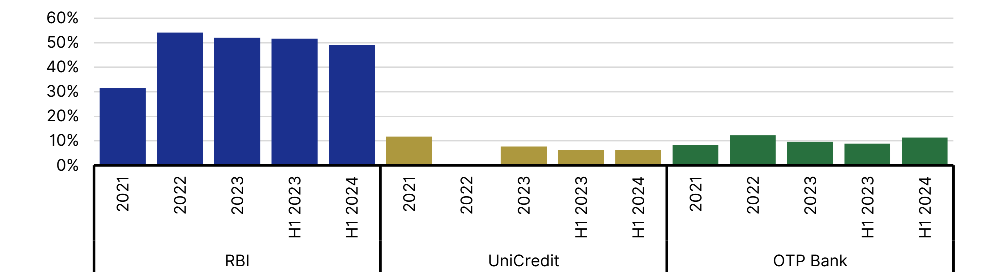
Raiffeisen Bank International, UniCredit, and OTP Bank, the European banks most exposed to Russia, reported a 9.1% increase in combined net profits in the first half of 2024 despite growing regulatory pressure to expedite exit plans.

While European banks remain in Russia and their subsidiaries continue to generate profits, the ability to repatriate these earnings remains constrained, however. The heightened reputational, legal and financial risks, including seizure of assets amid international sanctions, have prompted a cautious approach. This will persist, particularly given the risk of fines or the termination of correspondent banking relationships as a result of potential sanctions investigations by European or US financial authorities.

The deconsolidation process is challenging, given stringent local legislation and multi-stage approvals. We believe recently announced reduction plans are a constructive step although not entirely consistent with regulators' calls for an accelerated exit from Russia. Mainatining an open dialogue with regulators and financial authorities remains crucial for these banks, which are focused on an orderly exit from their Russian businesses.

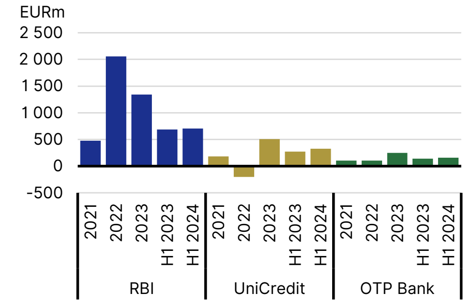
The impact of disorderly exits (such as the forced deconsolidation of Russian subsidiaries and write-downs of intra-group exposures) on the consolidated capital adequacy ratios of these banking groups is manageable for the groups, however.

Figure 1: Contribution of Russian subsidiaries to the groups' consolidated net profit



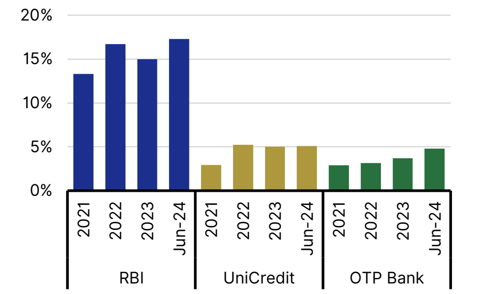
Source: banks' financial data, Scope Ratings

Figure 2: Net profit generated in Russia



Source: banks' financial data, Scope Ratings

Figure 3: Russia-related assets in total assets



Note: Risk-weighted assets of RBI and UniCredit, total assets of OTP Bank. Source: banks' financial data, Scope Rating

Rising local profits in Russia reflect exceptional circumstances

Profits continue to grow despite reduction plans

RBI, UniCredit, and OTP Bank saw their combined net profits in Russia grow by 9.1% YoY in H1 2024 to EUR 1.2bn (H1 2023: EUR 1.1bn). Full-year profits were comparable at EUR 2.2bn in 2023 and EUR 2bn in 2022 (Figure 2).

RBI's Russian unit remains its most profitable unit, accounting for around half of group net profits. Its net profit in Russia increased by 2.8% YoY in H1 2024 to EUR 705m, mainly due to the release of provisions. Operating profits fell by 17%.

UniCredit's net profit in Russia grew by 21.3% YoY in H1 2024 to EUR 329m, driven by revenue growth and lower operating expenses (which resulted in a 12.5% growth in operating profits) and by the release of provisions. The contribution to group profits was at around 6%, flat YoY.

OTP Bank's net profit in Russia jumped 11.5% YoY to HUF 57.2bn, while its share in the group's net profit rose to 11.3%. This was achieved by growing operating profit by 48% YoY, compensating for higher cost of risk and the tax burden on dividend payments.

Methods of generating profits in Russia are illustrative

Russian subsidiaries of foreign banks are in an exceptional position. They continue to make and even increase profits, taking advantage of the absence of sanctions to which most of their major Russian competitors are subject. The Russian units of RBI and UniCredit remain two of 12 systemically important Russian lenders. RBI was the fourth and UniCredit the eighth most profitable banks in 2023 among 319 banks operating in Russia as of July 2024.

In 2023, seven European banks (RBI, UniCredit, OTP Bank, ING, Deutsche Bank, Commerzbank, Intesa Sanpaolo) reported combined net profits of around EUR 2.4bn in Russia, a multiple of three times 2021 profits. However, we consider these profits unsustainable, as they primarily reflect non-recurring items or, at best, exceptional conditions that are unlikely to be available in the medium term. The ability for banks to upstream Russian profits to their European parents is limited.

While European banks have limited new lending activities since February 2022 in an effort to shrink their presence in Russia, they have seen a very large influx of deposits, boosting their liquidity. A significant amount of excess liquidity of Russian subsidiaries is placed with the Bank of Russia, the central bank. Profits are primarily driven by the spread between the interest rates paid to Russian depositors and the interest rate offered by the Bank of Russia. In other words, making profits is possible without expanding the customer base or even shrinking it.

Another reason is the release of significant loan-loss provisions as asset-quality trends have been stronger than the banks had anticipated since February 2022 when international sanctions were sharply escalated. The Russian subsidiaries of foreign banks are still connected to SWIFT, the global financial messaging system, so they play a crucial role in the transfer of money in and out of Russia. Commissions paid for transactions coupled with high customer demand have enhanced profits since February 2022. Cross-border payments are declining, however, or even have stopped in US dollars at the major banks.

Regulators have increased pressure on all euro area banks to exit Russia

Since 2022, euro area banks have been under pressure to examine all options regarding the future of their Russian subsidiaries, including a downsizing of activities and exit strategies. The ECB recently requested that all banks speed up their measures. However, pulling out of Russia quickly and completely is complicated by local regulations, legal procedures and approvals. Only a few foreign banks have been able to sell their business in Russia, and even then, with big losses. Société Générale and HSBC sold their Russian units; Intesa Sanpaolo has secured approvals to dispose of its assets in the country, but the deal has not yet completed.

RBI retains the highest exposure as of end-June 2024, with 17.2% of risk-weighted assets remaining in Russia, compared to 5.1% for UniCredit and 4.8% at OTP Bank (Figure 3).

RBI: significant downsizing through 2026

Possibility of staying for longer despite reduction plan

RBI is considering an exit from Russia, evidenced by reduced lending activity by around 60% since Q2 2022 to EUR 5.8bn, with customer loans accounting for approximately 5.7% of the group's total portfolio as of end-June 2024.

To accommodate increasing supervisory pressure from the ECB to accelerate its exit, RBI plans to reduce loans to customers in Russia by around 55% by 2026 (vs Q3 2023) along with a reduction in international payments originating from Russia. Lending and payments services are currently only offered to a pre-approved list of large and internationally active companies.

All local cash and excess liquidity are expected to be placed only with the Bank of Russia, and foreign currency placements with subsidiaries of Western parents. Only the latter are allowed to place deposits with RBI Russia. Further measures taken to further reduce customer deposits include eliminating fixed deposits and offering all current accounts at 0% with high maintenance fees. Since June 2024, RBI has stopped providing US dollar transfers out of the country. From July 2024, the bank temporarily suspended the opening of new brokerage accounts for retail investors.

Despite announced downsizing measures, loans and customer deposits increased in Q2 2024 by 1% QoQ, the number of customers by 1.9% QoQ to 3.3m, and risk-weighted assets by 13.9% QoQ (mainly because of higher placements with the Bank of Russia which carries a higher risk weight of around 100% compared to alternative assets). Management expects to accelerate the business-reduction and risk-mitigation strategy in coming months.

RBI is committed to achieving the deconsolidation of its Russian unit potentially through a sale or partial sale. The recent collapse of the STRABAG deal means that RBI would have to find another solution to repatriate capital from its subsidiary. This is becoming increasingly difficult and raising the possibility of deconsolidation at a lower price than anticipated. RBI's two-year continuity plan includes the option of staying in Russia for longer, despite regulatory pressure for a rapid exit for EU banks. Based on management's projections, the bank is most likely to sell 60% of its Russian business and retain 40% with the opportunity to receive dividends.

Even if RBI were to completely lose its Russian subsidiary, the group would still maintain a CET1 ratio of 14.7% as of end-June 2024 and would still meet regulatory capital requirements with a sufficient buffer. While the loss of the Russian subsidiary, one of its most profitable franchises, would weaken RBI's earnings capacity, the group believes it will continue to deliver double-digit return on equity at around 10% in 2024 even without the contribution of this unit. Given the group's resilient business model and strong market positions in Austria and in Central and Eastern Europe, we see this target as broadly achievable.

OTP Bank: limited risk to capital in worst-case scenario

Further business growth and dividend approval

OTP Bank has similarly been instructed by its local regulator, the Hungarian central bank, to reduce its business in Russia, to wind down its corporate loan book in Russia, keep its retail loan portfolio stable and reduce retail deposits. Loans in Russia accounted for around 4% of total customer loans as of end-June 2024. They showed the highest growth within the group in H1 2024, increasing by 18% YTD. While performing retail loans in Russia grew by 23% YTD, performing corporate loans declined by 14% and have fallen by 87% since end-2021. Retail deposits continue to grow in H1 2024 by 8% YTD.

Gross Russian bond exposures amounted to HUF 128bn equivalent at end-June 2024. The group's provisioning in Q2 2024 was significantly impacted by HUF 23.7bn booked on Russian bond exposures in line with supervisory approach (the provision coverage increased to 57%). OTP Bank has reduced its branch network in Russia by 39%, and the number of employees by 27% since Q1 2022.The bank has also significantly curtailed its international payments services involving Russia and has completely cancelled services related to customer transactions in US dollars.

According to OTP Bank estimates, a total loss of the Russian unit would have a very low impact on the group's CET1 ratio of -5bp as of end-March 2024. The Russian subsidiary approved RUB 13.5bn in dividends in 2023, and RUB 13.6bn was approved in H1 2024 for further dividend payment to the Hungarian parent.

UniCredit: accelerating withdrawal

Downsizing plan announced, but negotiations with ECB ongoing

UniCredit is also accelerating its withdrawal from the country despite a surge in profits in H1 2024. Exposure to Russia has decreased by 68% over the past two years, with Russian loans accounting for less than 1% of total customer loans as of end-June 2024. Risk-weighted assets increased in Q2 2024 by 5.7% QoQ, loans and customer deposits declined by 11% and 8% QoQ respectively. UniCredit received EUR 137m in dividends from its Russian unit in 2023.

The bank intends to continue its reduction plan by 2025, targeting an 85% decrease in net local loans to below EUR 1bn, a 75% decrease in local deposits to below EUR 2bn, and a 66% decrease in cross-border payments to below EUR 8.5bn from EUR 11.2bn at end-June 2024. Over the past two years, cross-border exposure to Russia has been reduced by 93% to EUR 300m and UniCredit intends to cut it to zero. According to UniCredit, a total loss of the Russian unit would have a manageable -51bp impact on the group's CET1 ratio of 16.2% as of end-June 2024.

While the bank's tapering plan appears constructive, it also stands in contrast to the ECB's call for a rapid divestment from Russia. UniCredit has applied to the European Court of Justice (ECJ) to review the ECB's request to reduce its business in Russia and to suspend the request pending proceedings. The bank confirmed in July that it had received sufficient clarity from the ECB such that some of the measures set had been satisfied. As a result, UniCredit has withdrawn part of its appeal and will drop the rest if further clarifications of the request allay its concerns.

Other European banks have negligible exposures in Russia

Already limited exposure and insignificant profits in other banks

The exposure of Deutsche Bank, ING, Commerzbank and Intesa Sanpaolo to Russia is limited, with less than 0.1% of customer loans and declining cross-border exposure. The share of net profits related to Russia at group level was also insignificant in 2023.

Deutsche Bank's exposure to Russia had reduced significantly to EUR 1.2bn by 2023 and consisted of loan exposure of EUR 500m, or 0.1% of the group's customer loans; EUR 26m of undrawn commitments and EUR 600m of deposits with the Bank of Russia. The Russian subsidiary delivered less than 1% of group's net profit in 2023. Since 2024, the group no longer discloses its exposure to Russia but states that it continues to monitor its risks related to the country.

Similarly, ING has no future plans for its business in Russia. At end-June 2024, it had credit exposure to Russian counterparties booked outside Russia of about EUR 1.2bn with Export Credit Agency (ECA) cover of around EUR 500m. The Russian unit contributed with less than 2% to group's net profit in 2023.

Intesa Sanpaolo reduced its net cross-border exposure to Russia by 87% since Q2 2022 to EUR 400m at end-June 2024. Remaining net customer loans amounted to EUR 100m or 0.1% of the group's customer loans. The Russian unit's share was around 1.4% of 2023 group net profit.

Commerzbank's exposure to Russia is negligible. By end-June 2024 exposure net of ECA and cash coverage decreased to EUR 153m, including net corporate loans of EUR 81m, less than 0.1% of the group's customer loans. The Russian unit held deposits of EUR 300m with the Bank of Russia and other Russian banks. Around 2% of the group's net profit in 2023 was from the Russian unit.

BNP Paribas, Crédit Agricole, BPCE, UBS and SEB still officially maintain very small subsidiaries in Russia but with no material Russian exposure. They have suspended Russian transactions and new financing activities.

Regulatory risks from sanctions compliance

Since 2022, banks have implemented substantial measures to mitigate the risks of their presence in Russia, including risks from sanctions compliance. We believe that compliance frameworks are well established, although the potential investigations initiated by regulators and US financial authorities may carry risks of fines or the termination of business relationships with correspondent banks. In 2023, RBI came under scrutiny from the Austrian Financial Market Authority (FMA) and the US Treasury's Office of Foreign Assets Control (OFAC).

Increasing risk of asset seizure in Russian units

At the same time, the risk of asset seizure in Russian units is increasing. Transactions that cannot be completed due to international sanctions put banks at greater risk of such rulings and weigh on provisions.

This was the case with recent Russian court decisions related to trade finance transactions that resulted in the seizure of assets of several EU banks including UniCredit, Deutsche Bank and Commerzbank. Even if the decisions were appealed, it will take several months for final decisions to be reached. All three banks have booked significant litigation provisions in relation to these cases.

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