FitchRatings

10 Sep 2020 | Rating Changed Outlook to Stable

Fitch Revises Sovcombank's Outlook to Stable; Affirms IDR at 'BB+'

Fitch Ratings-Moscow-10 September 2020:

Fitch Ratings has revised Russian-based Sovcombank's (SCB) Outlook to Stable from Negative, while affirming the bank's Long-Term Issuer Default Ratings (IDRs) at 'BB+' . A full list of rating actions is provided below.

The Outlook revision reflects reduced pressure on SCB's credit profile from the pandemic, lower oil prices and the resulting economic contraction in Russia. Pre-impairment profitability has remained robust, which supports the loss absorption capacity of the bank, notwithstanding its moderate capitalisation, and in Fitch's view would be sufficient to provide for further credit losses even in a longer and more severe downturn than currently anticipated. Asset quality erosion has also been limited to date.

Key Rating Drivers

The ratings of SCB are driven by its intrinsic credit strength and continue to capture a record of strong performance and resilient asset quality to date, as well as a reasonable funding and liquidity profile. These strengths are balanced by moderate capitalisation, significant market risk and the operational model's significant volatility due to rapid growth, acquisitions and an evolving business focus.

SCB's Stage 3 loans were a low 2.9% of gross loans at end-1H20 (a 10bp reduction from 2019's) and were 145% covered by total loan loss allowances (LLAs). Stage 2 loans increased to 3.7% at end-1H20 from 1.6% at end-2019, and restructured Stage 1 loans added a further 1.4%. We view corporate loan quality at SCB as reasonable but a bit weaker than higher-rated Russian peers'. SCB's retail loan quality is supported by a high share of secured retail lending (60% of retail loans), while unsecured products have smaller average monthly installments than at peers, which we view as credit-positive.

Overall asset quality at SCB benefits from a material share of non-loan exposures, which at end-1H20 exceeded 55% of total assets. Most of these relate to SCB's sizeable bond portfolio (5.7x CET1 capital at end-2Q20, although management expects to gradually reduce this to 3x-4x), which is of generally reasonable credit quality. However, SCB's exposure to 'B'-rated and unrated bonds (47% and 41%, respectively, of CET1 capital at end-2Q20) is higher than at most peers, which may pose additional risks to asset quality.

The large bond portfolio is also a source of elevated market risk. Most of SCB's bonds are measured at fair-value in IFRS accounts, and in 1Q20 SCB lost 10% of its IFRS equity on negative bond revaluation, losses which were largely reversed in 2Q20 along with a gradual recovery of bond prices. The bond portfolio is mainly funded with short-term liabilities (direct repos and customer deposits), giving rise to interest-rate risks.

In 1H20 SCB's annualised pre-impairment profit was equal to a high 7.4% of average gross loans, providing SCB with a strong loss absorption capacity. SCB's loan impairment charges (LICs) amounted to 3.5% of loans (annualized) allowing the bank to post a 15% return on equity (ROE) in 1H20. We expect moderate deterioration of SCB's loan-quality ratios, but pre-impairment performance should be sufficient to cover additional impairment losses in 2H20 and 2021.

SCB's CET1 capital ratio (based on IFRS accounts) was an adequate 8.8% at end-1H20 for the bank's strong pre-impairment profit and high risk-weighted asset (RWA) density. At end-1H20, RWAs were equal to a high 95% of total assets, which Fitch views as conservative for SCB's asset structure. The asset structure also contributes to SCB's flexibility in capital management, as the bank may sell some of the bond portfolio to ease capital pressure in case of need.

The regulatory CET1 ratio was a higher 10.5% at end-1H20 (providing 350bp headroom over the statutory minimum, including the fully-loaded capital conservation buffer), due to lower risk-weights on some corporate exposures and regulatory forbearance for the inflation of foreign-currency assets following a15% devaluation of the Russian rouble in 1H20.

At end-2Q20, customer funding comprised 60% of SCB's total liabilities. Direct repos, which SCB uses to fund some of its bonds, accounted for another 25%, although the bank intends to gradually replace this funding with deposits. SCB's liquidity is strong, as expressed by a low 83% gross loans-to-deposits.

SUPPORT RATING AND SUPPORT RATING FLOOR (SRF)

SCB's SRF of 'No Floor' captures the bank's limited systemic importance and the lack of official D-SIB (domestic systemically important bank) status. If SCB is designated as a D-SIB, then Fitch would likely raise its SRF to the 'B' category.

DEBT RATINGS

SCB's senior unsecured debt rating of 'BB+' is aligned with the bank's IDRs.

SCB's subordinated debt, placed through SovCom Capital DAC and rated 'BB-', is notched down twice from the IDRs, reflecting higher loss severity than senior unsecured obligations.

SCB's perpetual debt issued through SovCom Capital DAC and rated 'B', is notched down four times from the bank's VR, reflecting its deep subordination and fully discretionary coupon payments.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrades:

SCB's ratings could be downgraded, if the impaired loan ratio increases significantly above our expectations, resulting in considerable net losses and capital pressure.

Factors that could, individually or collectively, lead to positive rating action/upgrades:

Positive rating actions are unlikely in the near term given the bank's still moderate franchise. In the longer term, meaningful franchise expansion, lower appetite for market risk, a more stable business model and stronger capitalisation would be credit-positive.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

SovCom Capital DAC
----subordinated; Long Term Rating; Affirmed; B
----subordinated; Long Term Rating; Affirmed; BB-
PJSC Sovcombank; Long Term Issuer Default Rating; Affirmed; BB+; RO:Sta
; Short Term Issuer Default Rating; Affirmed; B
; Local Currency Long Term Issuer Default Rating; Affirmed; BB+; RO:Sta
; Viability Rating; Affirmed; bb+
; Support Rating; Affirmed; 5
; Support Rating Floor; Affirmed; NF
----senior unsecured; Long Term Rating; Affirmed; BB+

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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Endorsement Status

Endorsement Policy

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