01 SEP 2021

Fitch Affirms Sovcombank at 'BB+'; Outlook Stable

Fitch Ratings - Moscow - 01 Sep 2021: Fitch Ratings has affirmed Russian-based PJSC Sovcombank's (SCB) Long-Term Issuer Default Ratings (IDRs) at 'BB+'. The Outlook is Stable. A full list of rating actions is provided below.

Key Rating Drivers

The affirmation of the ratings reflects limited changes to SCB's credit profile since the last rating action in September 2020. The ratings of SCB are driven by its intrinsic credit profile, as measured by its 'bb+' Viability Rating (VR). The VR continues to capture SCB's strong financial profile, as expressed by its sound profitability, consistently low impaired loan ratios, and a reasonable funding and liquidity profile. These strengths are balanced with occasional shifts in SCB's business model in the past, only moderate capital ratios, and somewhat higher risk appetite than domestic peers'.

In Fitch's view, although most of SCB's financial metrics are consistent with a higher rating, fast loan growth (including through regular bank acquisitions) and certain franchise limitations constrain the ratings to the sub-investment grade range.

At end-2Q21, SCB's impaired loans (defined as Stage 3 loans under IFRS 9) equaled to a low 2.3% of gross loans and were 1.6x covered by reserves. Loan impairment charges (LICs) moderated to 1.4% (annualised) of gross loans in 2Q21 from 3% in 2020, and we believe that LICs are likely to remain below 2% in 2021. The quality of SCB's largest corporate loans is reasonable, in Fitch's view, but a bit weaker than at higher-rated Russian peer banks. In retail, secured lending prevails and down-payments on average are reasonable, reducing risk, while SCB's exposure to unsecured consumer finance lending is only a modest 1x common equity Tier 1 (CET1) capital.

At end-2Q21, net loans made up around half of SCB's assets, while most non-loan exposures reside in SCB's sizeable bond portfolio, equal to 3.2x CET1 capital at end-2Q21. A significant treasury business gives rise to market risks, despite interest-rate risks on these bonds being hedged. Most of the bonds are booked at fair value, which may cause considerable volatility of earnings, as was the case in 1Q20, for example. Credit quality of the bonds is generally reasonable, but SCB's exposure to 'B'-rated and unrated bonds (21% and 19%, respectively, of CET1 capital at end-2Q21) is more significant than at most peers.

Another sign of SCB's higher risk appetite is the bank's rapid loan expansion. In 1H21, SCB's gross retail and corporate loans grew 41% and 32%, respectively, well above sector averages. This increase is due to fast organic growth and the consolidation of Orient Express Bank (OEB) - a distressed Russian retail bank purchased by SCB in April, which is likely to merge into SCB by year-end. We view this acquisition as neutral for the ratings. SCB has an impressive record of smooth bank mergers and OEB's loan book was deeply provisioned pre-acquisition. Any residual risks from legacy asset-quality problems should be limited relative to SCB's equity and pre-impairment profit.

Robust profitability is SCB's key rating strength. SCB has a long record of consistently stronger profitability than the sector average. Pre-impairment profit is supported by wide margins (6.5% in 2Q21, which was 220bp above the sector average) and equals to a high 8% of gross loans, providing SCB with a strong loss-absorption capacity. Annualised return on equity (ROE) was a strong 27% in 2Q21, which Fitch views as a sustainable target for the medium term.

SCB's Basel III CET1 capital ratio was a moderate 10.3% at end-2Q21. Fitch believes that despite its strong internal capital generation capacity, SCB will continue to operate under moderate capital buffers due to fast organic growth and/or M&A activities. We expect SCB's CET1 capital ratio to remain below 11% in the medium term. At end-2Q21, headroom of SCB's regulatory capital ratios over the statutory minimum (including buffers) were in the 50bp-100bp range, which is thin, in Fitch's view.

SCB is primarily deposit-funded (76% of end-2Q21 liabilities) and its liquidity position is strong, as expressed by a low 83% gross loans-to-deposits ratio.

SUPPORT RATING AND SUPPORT RATING FLOOR (SRF)

SCB's SRF of 'B+' and Support Rating of '4' reflect Fitch's view of a limited probability of state support from the Russian authorities, in case of need. This view is based on the record of state support to privately-owned banks in Russia, as evident by the bail-out of senior unsecured creditors at only three medium-sized Russian private banks that failed in 2017, and the absence of any current plans to introduce comprehensive senior creditor bail-in provisions into Russian legislation.

However, the wide gap between SCB's 'B+' SRF and Russia's 'BBB' sovereign rating captures SCB's private ownership and only moderate systemic importance, as reflected by the bank's low 1.6% share in sector assets at end-2Q21.

DEBT RATINGS

SCB's senior unsecured debt is rated 'BB+' and aligned with SCB's IDR.

SCB's subordinated debt is rated 'BB-' and notched down twice from the VR, reflecting higher loss severity than senior unsecured obligations.

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

All the above debt is issued through SovCom Capital DAC.

RATING SENSITIVITIES

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

A positive rating action would require (i) higher capital ratios, with the CET1 ratio being sustainably above 13%, which is a threshold for a 'bbb' category capital score under our Bank Rating Criteria; (ii) further franchise expansion; and (iii) a record of lower risk appetite. The latter could be manifested in lower asset growth, moderation of risks in SCB's treasury business and a more limited appetite for bank acquisitions.

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

SCB's ratings could be downgraded if LICs increase sharply, resulting in negative or close to negative net income for several consecutive quarterly reporting periods.

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

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

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
SovCom Capital DAC					
• subordinated	LT	BB-	Affirmed		BB-
• subordinated	LT	B	Affirmed		B
• senior unsecured	LT	BB+	Affirmed		BB+
PJSC Sovcombank	LT IDR	BB+	Affirmed		BB+
	ST IDR	B	Affirmed		B
	LC LT IDR	BB+	Affirmed		BB+

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	Viability	bb+	Affirmed		bb+
	Support	4	Affirmed		4
	Support Floor	B+	Affirmed		B+

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING	⊙	◆
STABLE	◘	

Applicable Criteria

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

Additional Disclosures

Solicitation Status

Endorsement Status

PJSC Sovcombank	UK Issued, EU Endorsed
SovCom Capital DAC	UK Issued, EU Endorsed

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