Credit Europe Bank N.V.: Challenges Amid Fast-Changing Market Conditions

Rapid growth in Russian consumer lending, ongoing losses in Romania and subdued growth in Western Europe are weakening the credit profile of Netherlands-based Credit Europe Bank N.V. In 2012, losses in Romania diluted more than two-thirds of the group’s non-Russian profits. Following its rapid expansion into the buoyant but volatile consumer loan market, the Russian unit has contributed most of the group’s profits. However, given the ongoing deterioration in the Russian economy and, in particular, in the consumer-lending segment, we expect the earnings contributions from Russia to weaken. Growing reliance on the Russian operations’ performance is converging Credit Europe Bank N.V.’s credit profile (CEB-NV; Ba2 negative; D-/ba2 negative) towards its lower-rated Russian subsidiary Credit Europe Russia Ltd. (CEB-Ltd; Ba3 negative; D-/ba3 negative).

CEB-NV has significantly reduced its cross-border funding operations that supported growth in emerging markets with deposits raised in West Europe, and so achieved a more sustainable degree of self-sufficient local funding and lending. This development is credit positive, as it reduces earnings volatility and risk from foreign currency fluctuations and interest-rate misalignment, but it renders CEB-NV’s liquidity and profitability more vulnerable to refinancing risks domestically. CEB-NV’s increasing exposure to local market funding sensitivities further require a strengthening of its liquidity resources that have become more constrained over time.

CEB-NV’s strong capital and adequate profits mitigate the deterioration of its credit profile. As at end-June 2013 the group reported a total capital ratio of 13.8%, Tier 1 ratio of 9.1% and a return on average risk-weighted assets (RWA) of 1.1%. Despite our expectation of pressure on their solid profit generation due to rising loan-loss provisions from Russia and the gradual weakening in core capital levels as well as a growing portion of a Tier 2 component in their capital structure, CEB-NV displays sufficient loss-absorption capacity under our scenario analysis.

1 Russian Consumer Finance Banks: Rising Credit Risks Accelerate Asset Quality Weaknesses
Credit Europe N.V. (CEB-NV) is an internationally oriented bank with small market shares in regions it has a presence in (mainly Russia, Romania, Turkey, the Netherlands, Germany). In Russia, the bank has stronger presence in auto and instant-cash loans, and a market share of about 5%. CEB-NV’s loan book is almost equally split between commercial and retail. CEB-NV is 70% funded by deposits where 71% is retail deposits, and is a member of the Dutch savings-deposit insurance scheme.

CEB-NV is owned by FIBA Holding A.S. (a financial investment portfolio holding of the ultimate owner Mr. Husnu Ozyegin, who also own FINA Holding A.S. – the non-financial investment portfolio holding; unrated). Both holding companies are based in Turkey.

In December 2012, CEB-NV spun off its Turkey-based subsidiary (Fibabanka A.S.), acquired in 2010, to its ultimate parent, FIBA Holding A.S. Prior to spin off, the subsidiary formed 13% of CEB-NV’s consolidated balance sheet (data as of Q3 2012) and provided a modest earnings contribution.

Rapid growth in Russian consumer lending, ongoing losses in Romania and subdued growth in Western Europe are converging CEB-NV’s overall credit profile towards its lower-rated Russian subsidiary

Earnings diversification cushioned weaknesses in West Europe and Romania, but reliance on Russian operations exposes the group to volatility in the local market

In 2012, losses in Romania diluted more than two-thirds of CEB-NV’s non-Russian profits (see Exhibit 1).

EXHIBIT 1
Losses in Romania diluted 70% of all non-Russian profits in 2012
Geographical distribution of CEB NV’s consolidated net profit

Note: Turkey* – Turkish subsidiary Fibabanka A.S. ( unrated) was bought in 2010 and sold to the parent holding company in 2012
Source: Moody’s Investors Service, Credit Europe Bank N.V. Financial Statements

The Russian unit contributed 80% of the bank’s net profit in 2012, or EUR65 million, despite a share in total assets of around 30% (see Exhibit 2). This compares with a net profit contribution of 75% in 2011 and 63% in 2010. Profits from operations outside Russia have fared less well in comparison. Positively, Western Europe contributed EUR36 million in 2012, a threefold increase from EUR12 million reported in 2011. After a period of poor performance, the West European retail segment finally returned to profit in 2012 as a result of tightened loan origination standards, cost cutting and lower loan-loss provisioning needs. Wholesale lending (primarily corporate trade finance) has also gained momentum as a result of rising international demand.
However, the strengthened performance in Western Europe was largely offset by deterioration in the Romanian operations (primarily Credit Europe Romania SA; unrated), which recorded a loss of EUR32 million. The other regions contributed EUR11 million, resulting in lower earnings diversification compared to previous years (see Exhibit 1).

The weak performance of Romanian lending operations primarily reflects the delayed effect on asset quality of earlier economic weakness in 2009 and 2010, when GDP contracted by -6.6% and -1.1% respectively and only recovered gradually. As a result of the weak environment, CEB-NV scaled down Romanian operations by one third since 2008. With economic conditions now somewhat improving (GDP forecast: +1.8% in 2013, +2.0% in 2014), the group expects its Romanian operations to return to profit in 2014.

Overall, the growing dependence on the performance of the Russian unit weakens CEB-NV’s earnings diversification and renders it more vulnerable to potential economic headwinds from this region. The group expects to compensate for the deteriorating operating environment in Russia and the associated asset quality and profitability pressures, by returning to profit in Romania and by further expanding its trade finance activities which, however, remain challenged by the fragile economic conditions in its core Western European countries (see Exhibit 3).
We expect rising credit risks in the Russian consumer lending segment to accelerate asset quality weaknesses and to pressure profits

Russia’s retail lending market expanded rapidly in the aftermath of 2008-09 crisis, driven by low customer indebtedness, post-crisis economic recovery, healthy consumer appetite and disposable income growth. Benefitting from robust margins and moderate credit losses in consumer loans, Russian lenders expanded their consumer-lending operations, targeting sound profits as unsecured consumer lending was delivering the highest returns in the sector.

Supported by its established branch network and retail lending franchise in Russia, the bank’s Russian unit, CEB-Ltd, expanded its Russian retail loan book by an average of 47% a year between 2010-12. Because of this rapid growth, the share of retail loans in the Russian bank’s loan book increased to 78% as of H1 2013 from 51% at year-end 2009 (see Exhibit 4).

Source: Moody’s Investors Service

Source: Credit Europe Bank Ltd, Financial Statements
This strategy enabled CEB Ltd to increase its profits to support the rising funding costs in 2011-12 and tightening competition in Russia’s corporate segment. The Russian unit’s growth in the segment of unsecured loans has been particularly rapid in recent quarters, exhibiting annualised growth of 51% in H1 2013.

However, as addressed in our recent special comment, we expect the quality of the Russian retail portfolio to weaken in the next 12-18 months leading to rising credit costs and lower profitability. The bank’s cost of credit risk (loan loss provisions as a percentage of average gross loans) already increased to 3.66% (annualised) in H1 2013. While still a moderate level for a Russian bank with a high share of consumer lending operations, we expect asset quality to continue to deteriorate and to exert downward pressure on the bank’s profits. Moderated risk appetite and strict origination standards at CEB-Ltd. partly mitigate the ongoing rapid growth of the retail loan book and, until recently, enabled the bank to operate with much lower credit costs than other Russian lenders despite the rapid growth in the risky retail lending segment.

Overall, we believe that the growing reliance on the Russian unit’s performance converges CEB-NV’s credit profile towards its intrinsically weaker and lower-rated Russian subsidiary CEB-Ltd. This is reflected in the negative outlook on CEB-NV’s ratings.

**CEB-NV has improved the alignment of its cross-border, intragroup funding sources and uses, thereby reducing potential earnings volatility, a credit positive**

CEB-NV has increased local funding and reduced cross-border dependencies...

The geographic misalignment between Eastern European assets and West European liabilities has improved in the past years. Previously, CEB-NV took advantage of lower-cost deposits raised in its West European franchises to fund asset growth in higher-yielding emerging markets. The improved geographic alignment of using locally raised funding for local lending activities better shields CEB-NV’s operations against foreign-currency shocks and interest-rate movements and it dampens potential earnings volatility. Since the global financial crisis, national regulators in Europe also tended to view the use of West European deposits to fund growth in emerging markets with some concern. Such cross-border funding fell to 10% of total assets in H1 2013 (2010: 15% 2008: 25%) (see Exhibit 6).

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2 Russian Consumer Finance Banks: Rising Credit Risks Accelerate Asset Quality Weaknesses
The Romanian operations continue to be primarily funded by intragroup funds as the Romanian subsidiary lacks a sufficiently large local funding franchise. In Russia, strong lending growth has recently been increasingly funded via domestically raised wholesale funds.

…but higher reliance on market funds raises liquidity needs

The higher reliance primarily on the Russian wholesale funding market renders the Russian subsidiary and the group as a whole more vulnerable to local refinancing and re-pricing risk, while rising reliance on confidence-sensitive market funding requires a liquidity profile that is able to cope with short-term market disruptions. Although we consider the group’s overall liquidity position to be satisfactory, the evolution in the group’s funding profile over recent years has led to a tightening of the liquidity cushion. As of H1 2013, the bank’s loan to deposits ratio increased to 100% from 73% in 2010 (see Exhibit 7).

As of H1 2013, the bank’s liquid assets (cash and balances at central banks, funds due from other financial institutions or in securities) declined to 28% of total assets, down from 33% in 2011 (see Exhibit 8). The bank has also increased its holdings of more risky emerging-market securities. Although these securities are freely traded repo-eligible instruments (with their own central banks) we...
consider these to be less liquid in the market in a stressed scenario. As of H1 2013, emerging market bonds accounted for 59% of the group’s securities portfolio, up from 42% in 2010 (see Exhibit 6).

EXHIBIT 8
CEB NV is becoming more reliant on wholesale funds and its declining share of liquid assets are increasingly invested in emerging market securities

Geographic Composition of Liquid Assets and Funding

Source: Credit Europe Bank N.V. financial statements

The primarily short-term nature of the group’s lending activities, specialised in trade finance and consumer lending, affords a degree of additional flexibility in managing liquidity requirements. We note, however, that the tenor of the bank’s loans are getting longer. Furthermore, the liquidity gap (maturing assets – liabilities) in the up-to three and 12 months buckets is widening; which, according to our estimates equates to a short position of 7% and 23% of the total balance sheet respectively (from short 2% and 9% respectively) (see Exhibit 9).

EXHIBIT 9
The liquidity gap between assets and liabilities is widening on the back of longer assets and shorter funding maturities

Maturity Profile of Assets and Liabilities and the Net Position

Source: Credit Europe Bank N.V. Financial Statements
CEB-NV’s weakening credit profile is mitigated by still healthy profitability...

CEB-NV’s profitability, while recently under pressure, still remains solid. Return on average risk-weighted assets was 1.1% in H1 2013, down from 1.5% in 2010. The net interest margin rose to 4.6% in H1 2013 from 3.3% in 2010 resulting in pre-provision income lifting to 4.2% of average risk-weighted assets (RWA) from 3.4% in 2010 (see Exhibit 7). The widening of pre-provision margins reflects the growing share of high-yielding emerging market loans, but the overall rising cost of more localized funding, higher credit costs and limited profits outside Russia are expected to impact bottom-line profitability.

... and adequate capital buffers

As of H1 2013, the group reported a sound total capital adequacy ratio of 13.8%. This level provides solid loss-absorption capacity against the potentially more volatile developing economies (see Exhibit 10). While we note a decline in the Tier 1 capital ratio to 9.1%, down from 11.4% in 2010, the group should nonetheless be able to easily comply with the increased capital rigors of Basel III.

Nevertheless, capital quality has weakened as the group increasingly resorted to using Tier 2 capital to improve its regulatory capital in order to support further balance sheet growth. The higher cost of capital of subordinated debt partly constrains CEB-NV’s earnings retention capacity, thereby limiting future (capital) growth. We believe that the bank’s internal capital generation will be key in keeping pace with continued strong growth.

CEB NV has paid no dividends to its shareholders since inception (except for a one-off payment upon the spin-off of Fibabanka A.S. in 2012) and we don’t expect this dividend policy to change in the foreseeable future. We expect the bank to receive sizeable shareholder capital injections if and when needed, in order to support further franchise growth and therefore expect Tier 1 capital ratio to remain at current levels. ³

³ The bank is planning to achieve full Basel III-compliance of the $126 million (2% of RWA) Tier 1 perpetual loan obtained from Turkish parent FIBA Group, by end of February 2014
Moody’s Related Research

Special Comments:
» 2013 Survey of Russian and CIS Banks’ Single-Client and Related-Party Concentrations, November 2013 (159972)
» Russia’s Higher Deposit Insurance Premiums Will Be Credit Positive for Consumer Lenders, September 2013 (158309)
» Russian Consumer Finance Banks: Rising Credit Risks Accelerate Asset Quality Weaknesses, September 2013 (157644)

Credit Opinions:
» Credit Europe Bank N.V.
» Credit Europe Bank Ltd.

Rating Methodology:
» Global Banks, May 2013 (154225)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
Appendix:

Regulatory framework governing CEB-NV’s consolidated balance sheet composition

As a Netherland based bank the CEB-NV is governed by Dutch Banking and Supervision Regulatory body (DNB) and will report in IFRS under the Basel III framework which was adopted in the European Union’s as of 1 January 2014 (CRD IV / CRK). Individual subsidiaries follow the local regulatory requirements, as well as, DNB’s, who at times performs on site visits of subsidiaries.

With the current regulatory framework and internal guidance of the board, the geographic exposure of the CEB-NV is governed primarily by the following:

1. Max 25% of regulatory consolidated capital cannot be lent to any group including individual subsidiary under Basel III
2. DNB’s policy rule⁴ on the treatment of concentration risk under emerging (geographic) market risk - dependent on the exposure duration, credit protection (where applicable), type of lending (trade finance vs. otherwise) – Pillar II
3. Max 25% of the individual subsidiary’s total assets could be funded per recommendation by Dutch regulatory guidance
4. Internal risk management’s thresholds 100% as a percentage of regulatory capital for each geographic asset exposure

Amongst other, under Pillar II, as articulated in point 2 above, DNB has the authority to require additional regulatory capital depending on its emerging market risk guidance and could also request banks to limit size of the funds provided to its subsidiary as a percentage of subsidiaries size. Over all, these main features not only aims to contain the concentration risks at consolidated level but also encourage limited dependence of subsidiaries to parents to encourage a sustainable growth strategy. At the same time may constrain growth opportunities of subsidiaries, mainly Russian operations and overall profitability indicators as they increasingly have to transition from being a captive to higher self reliant operations from funding and liquidity management perspective.

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4 Section 3:17 of the Wet op het financieel toezicht or Wft; and Sections 23, 24a and 25a of the Besluit prudentiële regels Wft;
Ratings History

Credit Europe Bank N.V.

Credit Europe Bank Ltd