Fitch Upgrades Sovcombank and Rosevrobank to 'BB'; Outlooks Stable

Fitch Ratings-Moscow/London-24 August 2018: Fitch Ratings has upgraded Russia-based PJSC Sovcombank's (SCB) and its subsidiary Rosevrobank's (REB) Long-Term Issuer-Default Ratings (IDRs) to 'BB' from 'BB-'. The Outlooks are Stable. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
SOVCOMBANK
The upgrade of SCB's ratings reflects the completion of the acquisition of REB without a significant weakening of SCB's regulatory capital position or realisation of any contingent risks. This is in line with Fitch's expectation in March 2018, when we revised the Outlook on the bank's ratings to Positive. More generally, the upgrade reflects the bank's extended track record of sound financial metrics, and the more balanced business mix and improved funding profile resulting from the acquisition of REB.

At the same time, the ratings remain constrained by SCB's exposure to the difficult Russian operating environment, its high appetite for non-organic growth and exposure to interest rate risk stemming from the bank's sizable securities portfolio.

SCB completed the acquisition of REB in April 2018 and currently owns 100% of its ordinary shares. Some of REB's founders exchanged their REB shares into those of SCB. SCB is planning to legally merge with REB in 4Q18, after which the latter will cease to exist as a separate legal entity. SCB aims to integrate REB's well-performing corporate business (including management team) with its own operations, mainly focused on retail lending and treasury/investment banking.

Fitch views SCB's asset quality as a relative rating strength. This reflects its low credit impairment levels compared with peers, confirmed by recent IFRS9 disclosures, which indicated a Stage 3 (S3) ratio of 2.4% at end-1H18, one of the lowest among larger Russian banks. S3 loans at SCB comprise NPLs rather than impaired restructured or other risky exposures, and were 166% covered by loan loss allowances at end-1H18. Impairment charges have also been relatively low, at 2% of average loans in 2017-2016, despite a sizable share of consumer lending. All figures at end-1H18 are based on SCB's financial statements consolidating REB.

As a result of the REB acquisition, SCB's Fitch Core Capital (FCC) fell to 12.2% of Basel I risk-weighted assets (RWAs) at end-1H18 from 14% at end-2017. This is still commensurate with the 'bb' rating category, especially considering the bank's good asset quality and strong performance. SCB's regulatory capital ratios based on non-consolidated accounts were tighter (core Tier 1 of 8.5% at end-7M18, adjusted for unaudited profits, compared with regulatory minimum of 4.5% plus 1.875% capital buffers), mostly due to the deduction of the equity investment in REB, higher loan loss allowances in regulatory accounts and the non-recognised capital surplus from the bank's investments into Express-Volga Bank. The bank's regulatory Tier 1 (9.6%, minimum 6% + 1.875% buffers) and total (12.7%, minimum 8% + 1.875% buffers) capital ratios are supported by a number of subordinated instruments, including the recently placed USD100 million Tier 1 eligible perpetual subordinated bonds and USD150 million Tier 2 eligible subordinated bonds.

The bank's capital ratios should have increased by at least 40bp-50bp in August after a consortium of sovereign investment funds (led by the Russia-China Investment Fund) made an equity injection. Following the legal merger with REB, SCB's regulatory capital ratios should further improve by about 1pp.

SCB's consolidated profitability slightly deteriorated in 1H18 due to a one-off securities loss recognised by the bank in April 2018 following market volatility shortly after the imposition of US sanctions on some Russian individuals and corporates. However, net of this loss the bank's core operating profitability remained strong, with an adjusted operating profit to equity ratio of over 25%. The bottom line in 1H18 was additionally supported by one-off negative goodwill from the acquisition of REB.

SCB's funding has improved since the last review, following the acquisition of REB with its granular and cheap funding base. SCB's consolidated cost of funding decreased by almost 1pp in 2Q18 compared with 1Q18, while the share of current accounts rose to 16% of total liabilities. Liquidity is supported by a sizable liquidity cushion, consisting of cash and unpledged securities (covering 47% of end-1H18 total liabilities) and part of the loan book (5% of liabilities), which could be pledged to raise funding from the Central Bank of Russia.

SCB's senior unsecured debt rating is aligned with the bank's Long-Term Local-Currency IDR, reflecting Fitch's view of average recovery prospects, in case of default.

The '5' Support Rating and 'No Floor' Support Rating Floor (SRF) reflect Fitch's view that support from either the bank's shareholders or the Russian authorities, although possible, could not be relied upon, in all circumstances.

ROSEVROBANK
The upgrade of REB's Long-Term IDRs to 'BB' and Support Rating to '3' reflects potential support from SCB given the latter's majority ownership, significant operational integration and the plans to legally merge the banks in 4Q18.

The upgrade of REB's Viability Rating to 'bb' reflects the now reduced risks from the acquisition by SCB and the fact that REB's credit profile is becoming more aligned with that of SCB as they move to a full merger.

REB's credit profile remains robust, as reflected by an extended record of good performance (a ROA of over 3% in 1H18 and 2017) supported by relatively low funding costs and strong asset quality (S3 ratio of 1.5% at end-1H18), a solid capital buffer (FCC ratio at 18%) and ample liquidity sufficient to cover 43% of its standalone liabilities at end-1H18.

The withdrawal of REB's SRF reflects the fact that institutional (shareholder) support has now become the primary source of potential support for the bank, in Fitch's view.

RATING SENSITIVITIES
An upgrade of SCB's ratings would require further improvement of the merged bank's franchise based on more balanced growth and without a weakening of underwriting/asset quality, a longer track record of good performance, stronger capital position and a reduced appetite for market risk.

A downgrade could result from a sharp deterioration in asset quality or aggressive growth above our expectations leading to material capital erosion, or mismanagement of liquidity and market risks arising from the bank's trading activities.

If SCB becomes designated as a domestic systemically important bank (D-SIB), we could revise its SRF to 'B', similar to the other two privately-owned D-SIBs, Alfa-Bank (BB+/Stable) and Credit Bank of Moscow (BB-/Stable).

REB's ratings are likely to move in tandem with those of SCB until they are merged and REB ceases to exist as a separate legal entity. At that time we will withdraw its ratings.

The rating actions are as follows:

PJSC Sovcombank
Long-Term Foreign- and Local-Currency IDRs: upgraded to 'BB' from 'BB-'; Outlooks Stable
Short-Term Foreign-Currency IDR: affirmed at 'B'
Viability Rating: upgraded to 'bb' from 'bb-'

Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured debt: upgraded to 'BB' from 'BB-'

Rosevrobank
Long-Term Foreign- and Local-Currency IDRs: upgraded to 'BB' from 'BB-'; Outlooks Stable
Short-Term Foreign-Currency IDR: affirmed at 'B'
Viability Rating: upgraded to 'bb' from 'bb-'
Support Rating: upgraded to '3' from '5'; removed from Rating Watch Positive
Support Rating Floor: affirmed at 'No Floor'; withdrawn

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Applicable Criteria

Bank Rating Criteria (pub. 22 Jun 2018) (https://www.fitchratings.com/site/re/10034713)

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