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ESG Factors Are Increasingly Influencing Banks In Russia And Neighboring Countries

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Key Takeaways

- Banking regulation and the market environment in many countries are becoming increasingly demanding in terms of environmental, social, and governance (ESG) factors. In Russia, the Commonwealth of Independent States (CIS), Ukraine, and Georgia, ESG-related banking regulation will evolve in the next few years, providing business opportunities but also new regulatory requirements and additional costs for banks.
- The influence of ESG on banks in the region will increase. The most immediate impact will stem from governance factors, in our view, since they have historically constrained our ratings on several banks in the region.
- We also expect the impact of environmental factors on banks' asset quality to increase over time, given the high exposure of some regional economies to carbon-intensive sectors.
- Customer relations and workforce management, in our view, will increasingly affect banks' ability to build successful business models.

Regulatory And Market Environment For Banks Globally Is Becoming Increasingly Demanding In Terms Of ESG

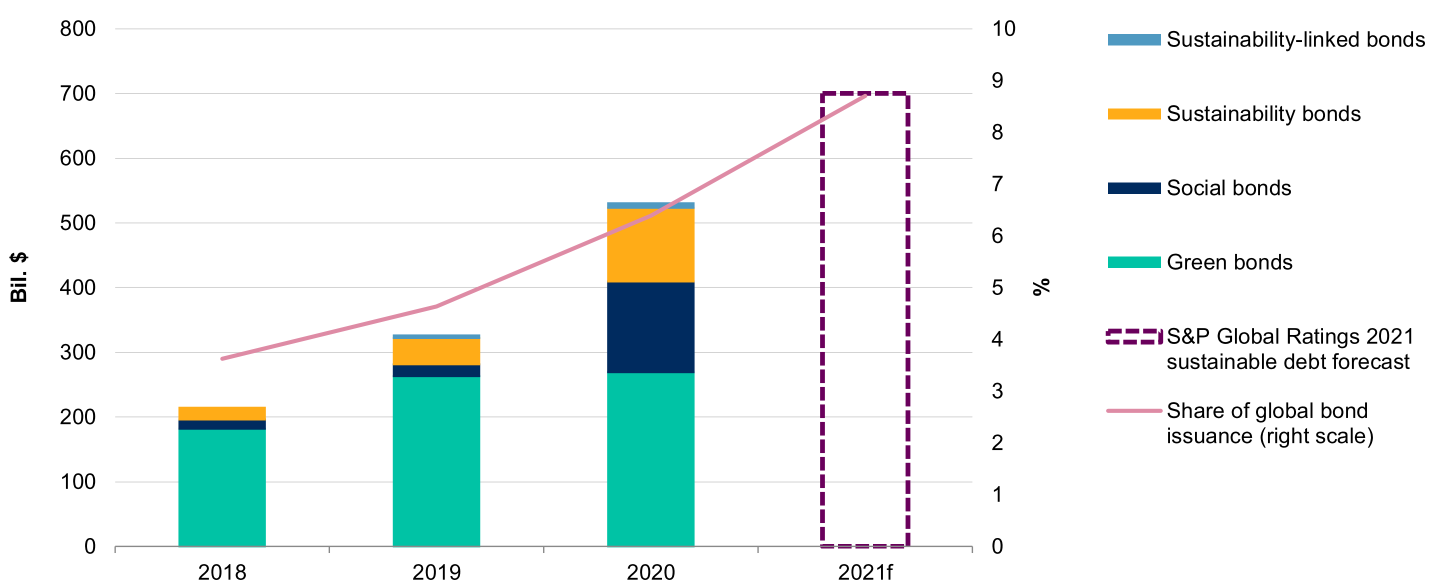
The importance of ESG factors for banks' strategies has been increasing over the past decade. Financial regulators in many countries are developing ESG-related regulations, recognizing banks' role as key providers of financial resources to the economy. The Network for Greening the Financial System (NGFS), which has 87 members worldwide, recommends that financial sector supervisors integrate climate change risks into the financial authorities' objectives, in order to ensure the resilience of the financial system.

The European Central Bank (ECB) is driving the efforts of banks based in the EU, a region that is among the leaders in its commitment to transition to a low carbon economy. The ECB expects banks to become more transparent about their exposure to climate and environmental risks, and it plans to incorporate ESG factors into its 2021 Supervisory Review and Evaluation Process (SREP). In addition, a number of central banks are considering initiatives aimed at adjusting banks' capital requirements based on their exposure to ESG risks, by introducing different risk weightings to more and less risky exposures from an ESG perspective. For instance, the Hungarian central bank introduced preferential prudential treatment for banks offering discounted interest rates on energy-efficient mortgages and financing of renewable energy production (as defined by the EU taxonomy) in 2020.

Over time, the growing investor requirements in terms of ESG may limit access to funding for banks that do not comply with these requirements. Many of the largest global investors have already integrated ESG into their investment policies. On the other hand, the surge in issuance of sustainable finance instruments will create additional business opportunities for banks in the areas of sustainable finance intermediation and advisory services. S&P Global Ratings expects the issuance of sustainable debt--including green, social, sustainable, and sustainability-linked bonds--will surpass $700 billion and reach about 9% of the overall global debt issuance in 2021, compared with 3.6% three years ago (see chart 1).

Chart 1

Sustainable Debt Issuance Will Surpass $700 Billion In 2021
Annual issuance in sustainable debt by instrument type



f--Forecast. Source: Environmental Finance and S&P Global Ratings.

ESG Regulation In Russia, CIS, Ukraine, And Georgia Will Evolve And Create Business Opportunities And New Regulatory Requirements

ESG banking regulation in Russia, CIS, Ukraine, and Georgia is just starting to develop. Historically, regulators focused on governance, in particular transparency and risk management practices, conflicts of interest, and business ethics. However, banking regulations have been less thorough with respect to environmental and social-related issues, such as customer relations and workforce management. We expect regulatory requirements on banks in these areas to increase in the next few years, given the growing awareness of ESG risks at the countries' government level and the banks' crucial role in facilitating the transition to a more sustainable economy. The discussions on potential new requirements in these fields have already started in these countries. Four banking regulators (in Russia, Ukraine, Armenia, and Georgia) have joined the NGFS network and committed to promoting the role of the financial sector in supporting sustainable development.

Many countries in the region are highly dependent on the oil, gas, and coal sectors and the carbon footprint of some countries (Kazakhstan, Russia, Belarus, and Ukraine) is higher than the global average of 4.7 tons of carbon dioxide per capita per year as of end 2019 (see table 1). That said, the countries have committed to transition to lower-carbon economies and are gradually working out measures to reduce greenhouse gas emissions, develop renewable energy sources, and raise energy efficiency. Massive investments will be needed to finance these initiatives. Therefore, the development of dedicated market tools--such as special ESG segments on domestic stock exchanges and requirements to the issuance of ESG instruments--could help in attracting this financing.

The regional market for ESG instruments is nascent, with a very small amount of outstanding sustainable debt. Most of it was placed in Russia--about $3.3 billion in total over 2018-2021, with the largest part ($2.2 billion) placed by the state corporation Russian Railways. Smaller amounts were issued in Armenia by Ameriabank ($50 million at the end of 2020) and Kazakhstan ($22.6 million issued through three bond issues by Asian Development Bank and state development institution DAMU over the past 12 months). We expect sustainable debt issuance to gain pace in these countries and gradually spread to other markets in the region in the next two years. For instance, the Ukrainian energy ministry is considering issuing green bonds, backed by state guarantees, of Ukrainian hryvnia (UAH) 24 billion (about $865 million). We understand that the Uzbek government is also looking to place green sukuk bonds in 2021 after amending its legislation to set the green bond framework.

An important step is the adoption of national green taxonomies that set the standards for green projects and allow the development of government subsidies for such projects. Ukraine already amended its legislation in 2020 to introduce local green taxonomy. Russia, Kazakhstan, and Georgia have started working on this, and plan to finalize the work in 2021. This may boost the development of local markets for green instruments, providing banks with business opportunities in sustainable debt intermediation. It remains to be seen, however, to what extent national taxonomies in the region will be aligned with the taxonomies adopted by the largest global financial markets, such as the EU. This will determine whether local projects will be attractive to a wider investor base and will receive investments from global markets.

Table 1

Russia, CIS Countries, Ukraine, And Georgia Gradually Develop Their ESG Infrastructure

	Carbon dioxide emissions per capita in 2019, tons per year	Paris Agreement signatories	National green taxonomy	Central bank membership in NGFS	Outstanding amount of sustainable bonds as of April 1, 2021 (mil. $)
Russia	16.9	Yes	In progress	No	3,300
Kazakhstan	11.5	Yes	In progress	Yes	23
Ukraine	6.6	Yes	Adopted	Yes	N/A
Belarus	5.1	Yes	N/A	No	N/A

Table 1

Russia, CIS Countries, Ukraine, And Georgia Gradually Develop Their ESG Infrastructure (cont.)

	Carbon dioxide emissions per capita in 2019, tons per year	Paris Agreement signatories	National green taxonomy	Central bank membership in NGFS	Outstanding amount of sustainable bonds as of April 1, 2021 (mil. $)
Uzbekistan	4.0	Yes	N/A	No	N/A
Azerbaijan	3.3	Yes	N/A	No	N/A
Georgia	2.6	Yes	In progress	Yes	N/A
Armenia	2.0	Yes	N/A	Yes	50

ESG--Environmental, social, and governance. CIS--Commonwealth of Independent States . NGFS--Network for Greening the Financial System. Source: Respective countries' official government websites, S&P Global Ratings.

The Influence Of ESG Factors On Russian, CIS, Ukrainian, And Georgian Banks Will Increase

Banks in the region are gradually becoming more aware of ESG issues, due to increasing demand from investors and the changing regulatory environment. Therefore, we believe that banks, especially larger players that have business relations with foreign counterparties, will incorporate ESG factors into their strategies faster in the next several years to preserve these relations and seize new business opportunities.

In our view, governance issues will continue to have the most immediate impact on the credit quality of banks in the region, as has been the case historically. That said, we consider that the relevance of environmental factors for the banks will gradually increase, reflecting the growing regulatory requirements and potential asset quality issues that could arise given the high exposure of these economies to carbon-intensive sectors. Furthermore, we consider that the importance of social factors, such as customer relations and workforce management, will gradually influence their business position.

The integration of ESG factors into banks' risk management policies, including loan underwriting, should support their asset quality. We have already seen examples of banks in the region that have introduced ESG factor-based due diligence on their lending portfolios. This could entail ESG-based financial terms for borrowers according to their ESG performance. In the longer term, borrowers that fail to adopt ESG practices compliant with banks' requirements will likely face a higher cost of funding. Consequently, extending loans to borrowers with ESG best practices will help banks to curb their problem loan portfolios in the longer term, since these borrowers will likely be in a better position to service their debt obligations.

Governance Factors Have Historically Negatively Influenced Ratings On Banks In The Region And We Expect They Will Remain Significant

Governance is--and has always been--an important component of our assessment of banks' creditworthiness in the region. Governance and risk management lapses have regularly occurred in the past decade, with the most notable deficiencies taking place in Russia, Kazakhstan, Azerbaijan, and Ukraine, which in turn negatively affected bank ratings.

Weak governance standards are a systemwide issue for the region, with the exception of Georgia (see table 2). We incorporate these systemwide considerations in our Banking Industry Country Risk Assessment (BICRA) analysis. We acknowledge that, in general, the level of disclosure has improved in the region over the past decade. For instance, banks now regularly publish financial statements according to International Financial Reporting Standards (IFRS), which in our view enhances transparency and comparability. However, it is still difficult to obtain timely and consistent IFRS reports for all banks in the systems for interim periods. Moreover, many cases of failed banks in the region raised questions about the quality of the banks' external audits and the reliability of these reports. The Georgian banking industry stands out from regional peers in terms of governance and transparency, in our view. We consider that Georgian banks' majority ownership by foreign investors, including the two largest banks (Bank of Georgia and TBC Bank, both listed on the London Stock Exchange) encourages higher standards of information disclosure and facilitates prudent corporate governance (in addition, Pillar III reports quarterly disclosure is enforced by the National Bank of Georgia).

Table 2

Selected Countries Where Governance And Transparency Issues Impact Overall Assessment Of Banking Sectors' Industry Risk

Countries	BICRA group	Industry risk score and trend	Assessment of quality of banking regulation and supervision	Regulatory track record	Governance and transparency
Russia	8	7/Stable	Intermediate	Weak	Weak
Georgia	8	7/Stable	Intermediate	Weak	Intermediate
Armenia	8	8/Stable	Weak	Intermediate	Weak
Uzbekistan	8	9/Stable	Weak	Weak	Weak
Azerbaijan	9	9/Stable	Weak	Weak	Weak
Kazakhstan	9	9/Stable	Weak	Weak	Weak
Ukraine	10	9/Stable	Intermediate	Weak	Weak
Belarus	10	10/Stable	Weak	Weak	Weak

BICRA--Banking Industry Country Risk Assessment. Source: S&P Global Ratings

Much remains to be done to improve governance and transparency in the region. Issues related to business ethics are highly material for the banking sector, given its role in financing the economy and in ensuring financial stability. We have identified some management and governance practices in Russia and other countries in the region that contributed to some bank failures. These include:

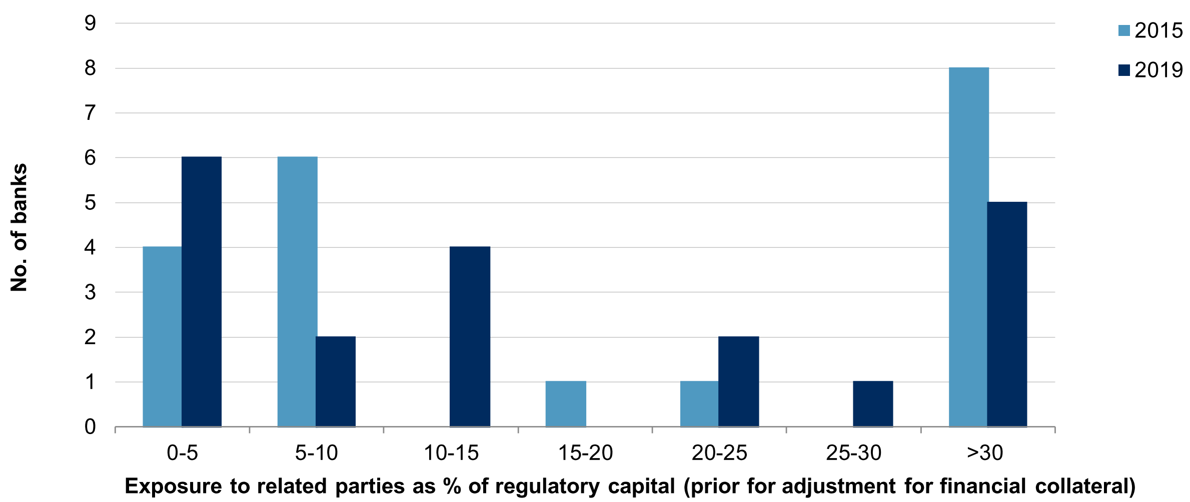
- Opaque ownership and weak governance structure;
- Extensive engagement in related-party lending;
- Inflated capital value through the use of various accounting techniques and late recognition of losses; and
- Business models that are over-reliant on new business at unsustainable margins.

In our view, the level of related-party lending for banks in the region will remain high compared with many developed countries. According to our estimates, based on disclosures under IFRS of the top 20 banks in Russia, as many as 17% of Russian banks had related-party exposure representing more than 30% of their capital at the end of 2019 (see chart 2), and some of them had well in excess of that level.

Chart 2

Russian Banks' Exposure To Related Parties Remains High, Although Somewhat Reduced In 2015-2019

As of year-end

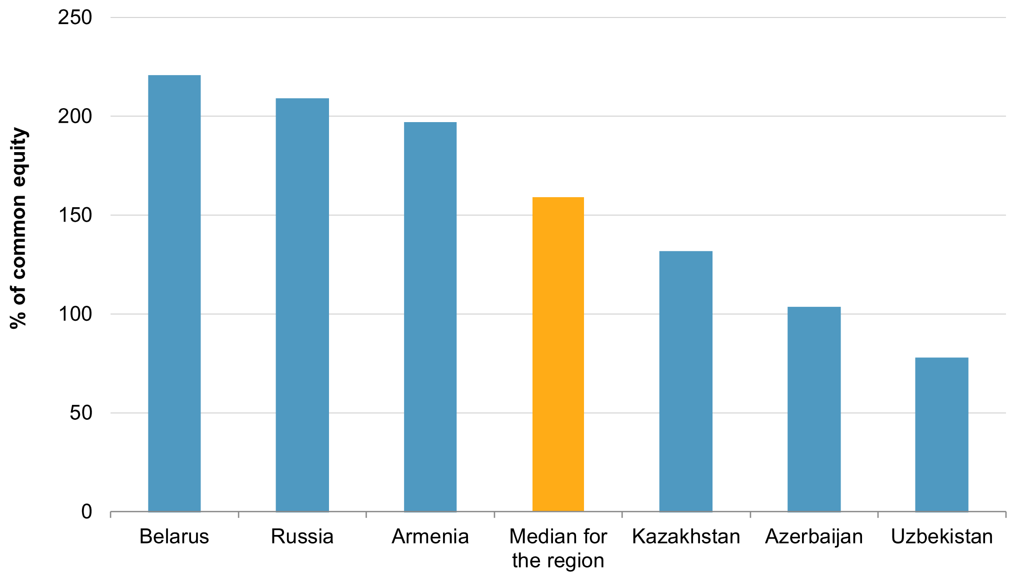


Source: S&P Global Ratings.

It is difficult to compare the level of related-party lending across countries, especially in emerging markets where intertwined relations between state and individuals, complex ownership structures, deficiencies in corporate governance, and poor disclosures sometimes disguise the true picture. We believe that Russia faces a similar situation as Kazakhstan, Uzbekistan, and Azerbaijan, where disclosure of ultimate beneficiaries of some midsize and small banks is typically muted. While we see fewer problems with the disclosure of ownership structures in Armenia, the problem of high lending concentrations (including those on related parties) remains high in that country as well. In Ukraine, Belarus, and Uzbekistan, we often note that banks, particularly the largest state-owned institutions, make some decisions based on government's broader economic and social objectives rather than purely commercial ones. In addition, we expect banks in the region to remain heavily concentrated on single-name exposures, which increases their vulnerability to adverse market conditions, and in turn is one of the main constraints on our ratings (see chart 3).

Chart 3

Largest Banks' Lending Concentrations To Their Top 20 Borrowers
As of 2020 year-end



Source: S&P Global Ratings, based on the banks' audited financial statements under IFRS.
Weighted-average indicators by gross customer loans of the largest banks in the respective countries.

Some banks in the region have been involved in controversies related to the failure of controls to identify and prevent money laundering, tax evasion, or other unlawful activities. We acknowledge the regulators' efforts to keep the systems under control and curb aggressive risk appetite of some banks, including license revocation. For instance, the number of banks operating in Russia reduced to fewer than 400 from about 1,000 in 2009, where up to 70% of license revocations were associated with the violation of anti-money-laundering legislation. The resulting financial and reputational damage of such events can be significant and spread over several years. At the same time, no material activity related to money laundering or tax evasion has been noted by regulatory bodies among the largest systemically important banks in the region in recent years.

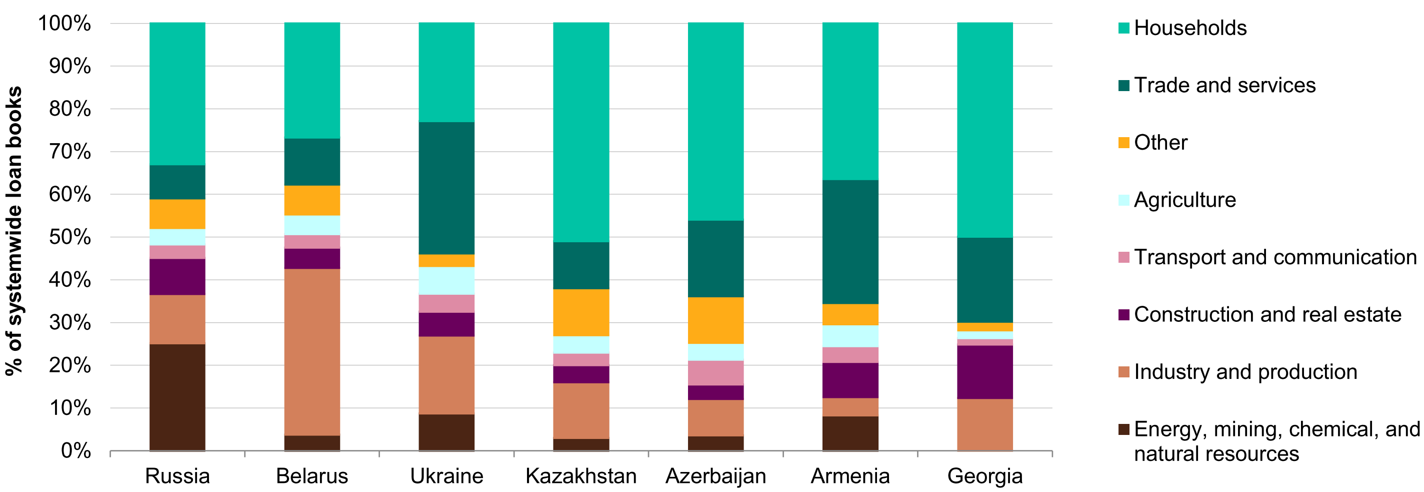
The Importance Of Environmental Factors For Banks Will Grow Over Time

We expect the impact of environmental risks on banks in Russia, CIS, Ukraine, and Georgia to increase over time. Banks are primarily exposed through their lending and securities portfolios. Evolving environmental regulations and customers' demand for green products and services have already started to influence banks' operations in some countries, especially in Europe. More and more banks around the world are committing to reduce, and in some cases stop, lending to the most carbon-intensive and environmentally damaging sectors (such as thermal coal, coal-fired power generation, arctic drilling, or tar sands).

Banks in the region are particularly exposed to credit risks related to environmental factors due to their exposure to brown sectors, with meaningful differences (see chart 4). Exposure to production and natural resources industries vary, from about 12%-13% in Georgia, Armenia, and Azerbaijan, to about 40% in Russia and Belarus. The systems most exposed to brown industries could face challenges related to the climate transition risk. Banks' borrowers are also subject to physical risks caused by extreme weather events, and transition risks related to the changing regulatory and market environment that could weaken their credit quality. We view the proposed EU carbon border adjustment mechanism (CBAM)--to be introduced as early as June 2021--as one of the most tangible near-term environmental risks for industrial companies in the region. While the exact mechanism is yet to be disclosed, the rationale is to apply the EU carbon pricing to imported goods in the same way as for emission-intensive goods produced in the EU. Estimates show that it may weigh significantly on exporters in the region, and may pressure their credit quality in the longer term if they do not perform actions to improve their carbon footprint.

Chart 4

Exposure To Production And Natural Resources Industries Varies
At end-2020



Source: Data from countries' central banks.

In addition, we believe that banks in the region will face increasing regulatory requirements. This could include enhanced disclosure of banks' environmental footprint or increased capital charges for carbon-intensive exposures in banks' prudential capital ratios. We note some first steps, including ESG recommendations for market participants and green bond standards issued by the Russian central bank and flexible conditions for banks to restructure green power producers' debts introduced by the National Bank of Ukraine. That said, the full-scale integration of environmental issues into banking regulation in the region is not expected in the near term.

Social Factors Will Increasingly Serve As A Source Of Competitive Advantage For Banks In The Region, Enhancing Revenue Growth And Profits

Some social factors have historically supported the creditworthiness of a number of banks in the region. Banks such as Sberbank in Russia and Halyk Bank in Kazakhstan have benefited from ensuring inclusive banking. Indeed, due to their history as national savings banks, they have fulfilled an important role in providing financial services in remote regions. This contributes to secure customer loyalty, a relatively stable and low cost of funding, and less volatile income for these banks, as they have been perceived as "safe harbors" over past economic cycles.

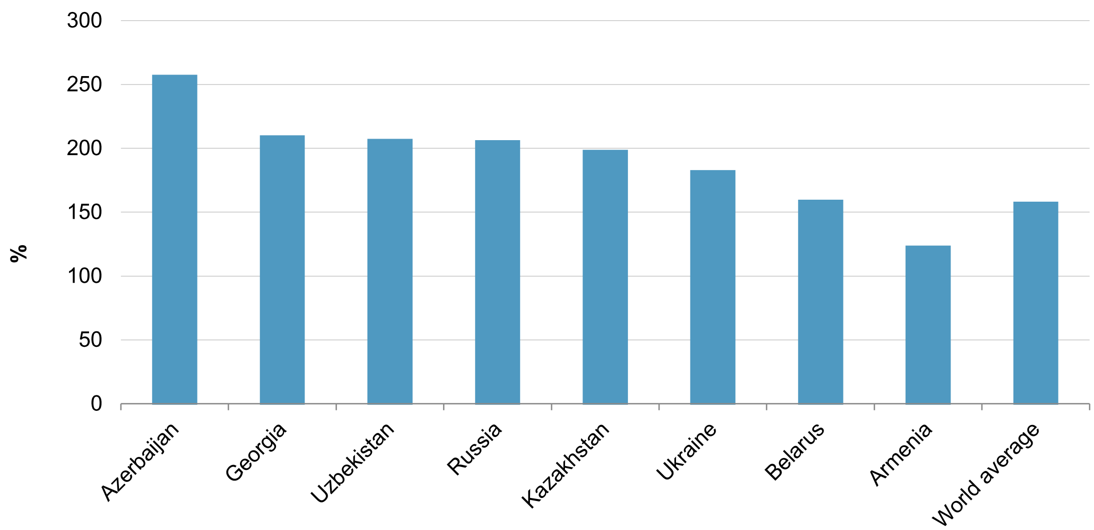
We believe that other social factors will increasingly provide competitive advantages to some banks and strengthen their business position. In particular, we think that good human capital management and customer relations will be crucial for banks to maintain successful business models.

Regional banks' competitive standing will also depend on their ability to retain and motivate highly qualified workforce, including IT programmers and cyber risk experts, as well as their ability to attract younger talents. The demand for a highly qualified workforce is demonstrated by the higher salaries offered by banks (see chart 5). An important factor for banks is their ability to establish a productive corporate culture and ensure attractive working conditions. The latter consists of effective motivation schemes that include not only attractive salaries but also noncash benefits, trainings to support professional development, inclusiveness, equality, and mental-health policies.

Chart 5

Average Salaries In The Banking Sector Significantly Exceed Average Salaries In The Overall Economy

Banking salaries as a percentage of the country average



Source: S&P Global Ratings.

Banks' business models also rely on banks' ability to offer attractive and innovative solutions to customers while safeguarding customers' interests. Several banks in the region--such as the Russian Sberbank and Kazakh Kaspi Bank--have been transforming their traditional banking operations into innovative and technologically advanced business models. In particular, they have been developing ecosystems with the aim of meeting various client needs, including processing daily customer purchases and managing personal finances, as well as offering easy-to-use payment, corporate finance, and marketing solutions to business partners.

Banks have been focusing on building strong technical capabilities to offer better customer solutions and enhance their credit risk analysis based on big data collection and artificial intelligence processing of a wider range and amount of client-related data. That said, the rapidly evolving technological trend exposes banks to higher data privacy and security risks and other related and unknown risks, a serious and common threat for banks. A number of large regional players (such as Sberbank, Halyk, and Kaspi) have accumulated extensive expertise in cyber-security that is generally on a par with global peers. But smaller players may find it more challenging to develop the necessary infrastructure to limit these risks.

Finally, we expect higher regulatory scrutiny to ensure that banks are treating customers fairly, avoiding potential discriminatory practices and fraudulent activities. While the related regulation is more stringent in developed markets, regional central banks have been gradually tightening their regulations as well. For example, they have requested banks to increase transparency of banking products terms and conditions to make them easier to grasp for customers, especially retail clients, to avoid mis-selling.

This report does not constitute a rating action.