European banks’ not so hidden risks – pt 2

See pt 1: European banks’ not so hidden risks

Take the Ukraine operations of Austrian bank **Raiffeisen Bank International** (WBAG:RBI). Ukraine is an often-corrupt, always-difficult place for foreigners to do business. I once met a successful investor who said he would never invest a cent in Ukrainian stocks, ‘some markets just don't let foreigners make money, too rigged’. Considering this investor had put together a superb long-term track record running a fund entirely focused on *Russia*—of all places—his words held weight.

Raiffeisen’s Ukraine operations elicit concern for several reasons. Firstly, at year end 2012, a whopping 34.7% of the subsidiary’s loans were ‘non-performing’ (usually defined as a borrower being at least 90 days overdue on scheduled payments).

Secondly the Ukraine subsidiary, which at the end of 2012 accounted for about 3.6% of the bank’s total assets, employed 23% of the bank’s entire headcount. Although the subsidiary has been in something of a run-down (and write-off) mode—Ukraine was more than 7% of total bank assets in 2008—the headcount was so bloated the only comforting explanation would be if Raiffeisen was doing back office processing for all its operations out of the country.

That turns out not to be the case—‘all Ukraine staff are domestic-focused, not central office functions’, investor relations told us mid-last year. We pressed the point, and got a fanciful answer about the UEFA Euro 2012 being held in Ukraine. We muffled the laughs and pressed again, and heard about ‘concierges, bloated back office’ from the boom time, a lot of fat. Getting somewhere. We pressed further, to hear about an ‘intense workout team, working to clean out the loan book’. Undeterred, we steered the conversation towards corruption—‘we don’t get that information’.

So Ukraine is clearly a tough place to do business, but the focus of this post is the currency mismatch between the bank’s assets and liabilities.

At the end of 2012, Raiffeisen’s loan book in Ukraine was 52% denominated in Euros or Swiss franc. That was down from 70% in 2008 (one of only a few markets where the balance had improved markedly over the past five years, mainly because the bank is running the business down in Ukraine as it has been a financial disaster).

More than half its Ukrainian borrowers (by loan weight) will experience significant hardship should the Ukraine hryvnia depreciate markedly against the Euro or Swiss franc. Depending on the severity of any depreciation, many will be unable to repay in full and on time (even more than the 34.7% currently struggling to repay).

In case you haven’t noticed, political strife is brewing in Ukraine today. The protestors want the country to face towards Europe. The government, perhaps being held hostage by Putin, have sharply turned back towards Russia.

So far, the currency markets have let out an almost inaudible sigh of indifference, as the hryvnia has only softened a little against the Euro and franc. But what if the protestors violently ransack government? What if the government ‘does a Tianenmen’ on the protestors? What if, for any other reason, the currency markets get skittish? What if the political activism spreads to nearby countries?

Raiffeisen has needed to raise capital for some time. It must soon repay a substantial and cheap loan extended by the Austrian government during the financial crisis, and it needs to buffer its equity ratio in line with the newer thinking on capital adequacy requirements.

The bank had been stalling on the raising, we'd speculate because its major shareholder didn’t have enough money to take up its pro-rata share but also didn’t want to be diluted.

Last week, the bank raised €2.8bn in fresh equity at fairly decent prices. Kudos to them (needless to say, the International Fund didn’t participate). They have enough capital to survive current conditions. The major shareholder kicked in what it could afford, and copped some dilution in the process.

Given the bank’s previous reluctance to rush to market for capital, we couldn’t help but wonder if the troubles in Ukraine helped move the bank to action. Or perhaps it's the recent skittishness in other emerging markets currency like the Brazilian Real (down more than 20% versus the Euro since mid-2013), South African Rand (down >20%) or the too-close-to-home Turkish lira (down 25% since May 2013 and more than 10% in the past month).

Eastern Europe also relies on foreign capital. What if investors decide to pull their cash from here too? Should Ukraine and perhaps a few other Eastern European subsidiaries ever hit the skids at once, €2.8bn won’t be enough—not even close.