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Raiffeisen: Sevelda's struggle

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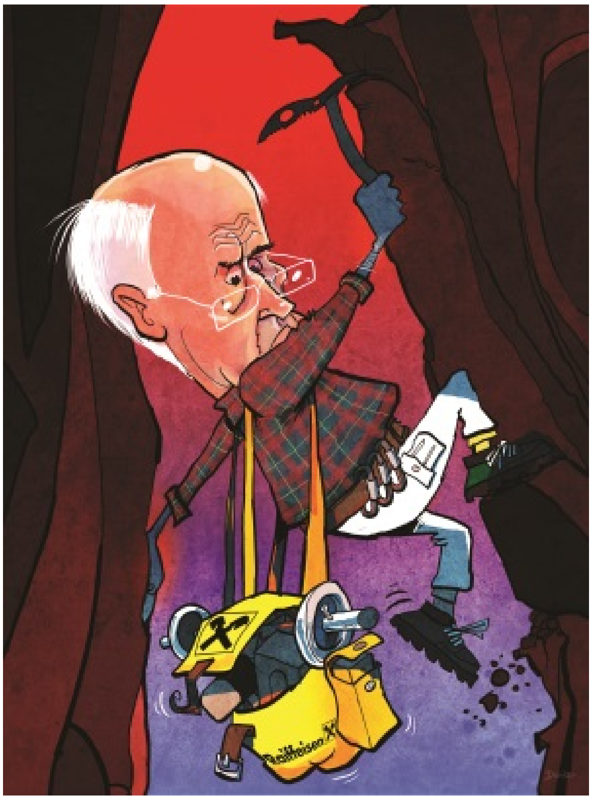
Raiffeisen insiders insist the bank's current woes stem from circumstances beyond its control. Outsiders say the business is now paying for the sins of the past. A new leadership is desperately trying to reposition a bank whose most important markets are in turmoil, and whose ownership structure leaves it with unique capital challenges. CEO Karl Sevelda has a mountain to climb.



Two years ago, Raiffeisen looked in good shape for a bank with most of its operations in central and eastern Europe. Under the charismatic leadership of Herbert Stepic, the man who transformed the bank from an Austrian also-ran into a regional giant with operations in 15 ex-communist countries, it had weathered the financial and eurozone crises without loss, was posting healthy profits and paying handsome dividends, and had just doubled its exposure to CEE's most promising market, Poland, by the acquisition of Polbank EFG.

Those days now seem very far away. Stepic has gone, replaced by his mild-mannered deputy Karl Sevelda, after being forced to resign in May 2013 over questions about property dealings in Asia. (Stepic has not left the building; he is still firmly ensconced in a magnificent top-floor office suite surrounded by his famous collection of African art.)

The banking empire Stepic built is also under threat. In February, at the same time as announcing Raiffeisen's first ever full-year loss, Sevelda also revealed plans to slash international exposure in a bid to boost the bank's eroding capital base. These include cutting exposure to the rapidly deteriorating Russian market, abandoning some of Raiffeisen's further-flung outposts in the US and Asia and, most importantly, the sale of all of the bank's newly merged operations in Poland.

So what went so badly wrong in the intervening two years? Sevelda, an urbane and well-connected veteran of Raiffeisen's Austrian operations, puts it down to bad luck. He says Raiffeisen was hit by "special events" in three of its biggest markets – Russia, Ukraine and Hungary, where the government last year added hefty compensation payments to foreign exchange borrowers to the many other charges levied on the banking sector – at a time when capital requirements are becoming increasingly onerous.

While agreeing that the Ukrainian conflict has been a big negative for Raiffeisen, external analysts are less convinced that luck has much to do with the bank's current difficulties.

"You could say they have been unlucky, but you could also say they had been overly optimistic," says Josef Christl, a former Austrian central banker and now head of Vienna-based Macro-Consult. "The rationale for the expansion into CEE – to support the Austrian corporate sector and gain access to markets with higher growth than Raiffeisen's home market – was fundamentally sound. But the pace of expansion was clearly too fast, the risks of these new markets were underestimated, and not enough attention was paid to the need to strengthen the capital base."

Too far, too fast

The first of these charges, that Raiffeisen went too far and too fast into emerging Europe, particularly in the run-up to the financial crisis when acquisition mania gripped banks in the region and led to eye-watering prices being paid for lenders in markets as far afield as Kazakhstan, is vehemently rejected by Stepic.

"We were never growth fetishists," says the famously bonhomous and combative former CEO, with a flourish of an enormous cigar. "We never chased new markets, we followed market demand as far as we were able – which was not always possible given the strength of demand for reliable and high-quality banking services that emerged in CEE after 1989 as a result of the overnight transition to a free-market economy."

Stepic notes that, for the first 10 years after the fall of the Berlin Wall, Raiffeisen only worked on greenfield operations. "We didn't make any acquisitions at all because I didn't want any old communist thinking in our banks," he says. "We had a huge and very important role to play in the region, and to judge that from today's perspective, where the situation has shifted through 180 degrees, is unrealistic and unfair."

The suggestion that Stepic might have underestimated the risks of the Ukrainian market, where Raiffeisen acquired Bank Aval in 2005, prompts him into an even more vigorous response and more emphatic cigar-waving: "When I decided to open a bank in Slovakia in 1991, everyone in western Europe said: 'You must be crazy.' There was uncertainty, there were no rules, there was no banking structure, there was nothing. When we moved into Albania, my friends said: 'You must be crazy.' When I went anywhere I was told I was crazy – so was moving into Ukraine crazier than moving into Slovakia? In 1992 we had gunmen coming round the corner at us when we repossessed a sawmill in Slovakia. That is just how it is when you are operating in emerging markets."

Stepic is equally dismissive of suggestions that Raiffeisen should have become so dependent on Russia, which accounts for nearly 12% of the balance sheet of the bank's international arm and in 2013 provided nearly three-quarters of group profits. While putting the blame for the Ukrainian crisis firmly on "a totally misguided geopolitical policy on the part of Europe and the US", he insists that the current situation "is not something that any investor or analyst could have forecast".

He says: "I have no regrets about the decisions we took with regards to expanding into CEE when I was still responsible for leading RBI, including Russia and Ukraine. In the same situation with the same opportunities I would do the same again."

Even Stepic, however, admits that more attention could have been paid in the boom years to Raiffeisen's less than ample capitalization – an issue that, Christl notes, was raised by Austrian regulators well before the collapse of Lehman Brothers.

If Raiffeisen's capital ratio was double what it is today then they would be well positioned to ride out the current problems in some of their key markets

Josef Christl, Macro-Consult

Herbert Stepic, the man who transformed the bank from an Austrian also-ran into a regional giant

"Clearly if we had built stronger capital buffers pre-crisis it would have been better," says Stepic. Here again, though, he seems more inclined to shift the blame away from Raiffeisen and on to the regulators. "I believe we had sufficient capital for the prevailing situation," he adds. "The massive increase in capital requirements since the financial crisis has put pressure on everyone, particularly due to the speed at which the changes have been introduced."

This sentiment is echoed by Sevelda, who served under Stepic for three years before his unexpected elevation to the top job – and whose management style, like his office, is said to be rather more in the austere Austrian tradition than that of his predecessor. "In the present environment, with all the economic and political threats we are facing, we want to increase our core equity tier-1 capital," he says. "Before the global financial crisis, however, when RBI was an extremely profitable bank and in the top league in Europe, a lower capital ratio was acceptable – not to mention that the legal requirements were much lower."

Sevelda is also keen to stress that Raiffeisen's current capitalization – the bank's CET1 ratio is 10.0% fully loaded for Basel III and 10.9% CET1 on a transitional basis – is in line with its main competitors. "That means we are in quite a comfortable position," he says.

Analysts, however, say such comparisons are misleading. For one thing, Raiffeisen's risk profile is very different to that of other leading eurozone banks, few of which have more than 20% of assets in emerging markets. At UniCredit, Raiffeisen's main rival in CEE, regional exposure accounts for less than 30% of group risk-weighted assets (RWA), while Russia represents just 3.8% of the total. By contrast, nearly half of the total assets of the Raiffeisen group are in CEE – of which its operations in Russia, Ukraine and Belarus together make up 24%.

As one senior bank analyst in Vienna puts it: "Raiffeisen's capitalization has always been in the middle or at the low end of the range of eurozone banks. That may have been fine from a regulatory perspective but it didn't match its risk profile, which is that of an emerging market bank – especially since 2008, with the increasing dependency on Russia."

The analyst suggests that a CET1 ratio of 13% to 14% fully loaded would therefore be more appropriate for Raiffeisen than the 12% target set by Sevelda for the end of 2017, and which the new strategy is designed to achieve. Sevelda says the 12% level was "voluntarily" set by Raiffeisen –

outsiders speculate that the bank may have been encouraged to do so by its new regulator, the European Central Bank.

'Inherent' limitation

The real issue though is not Raiffeisen's current capital ratio but its inability to raise new capital – a limitation that analysts say is inherent in Raiffeisen's group structure. Raiffeisen Bank International (RBI), the group's non-Austrian arm, is listed on the Vienna Stock Exchange – following an IPO in 2005 – but is still **majority-owned by Raiffeisen Zentralbank Osterreich (RZB)**. RZB is 90% owned by the eight Austrian regional Landesbanks, which in turn are owned by 473 independent local Raiffeisen cooperative banks.

This three-tier structure means that raising capital from within the group for RBI is nigh-on impossible – particularly as the network banks are rumoured to be fairly low on capital themselves. At the same time, secondary offerings in 2007 and 2014 have diluted RZB's holding in RBI to 60.7%. Any further share sale would therefore involve RZB losing its majority stake – an option the group has said it is not willing to consider.

All of this means that when things go wrong for RBI, as they did last year, the only way for the bank to rebuild its capital base is to make cuts to its network. Hence the new strategy, announced on February 9 – which, says Sevelda confidently, will slice €26 billion off the group's risk-weighted assets by the end of 2017, an amount equivalent to one-third of the total at the start of October.

Key measures will include cutting exposure to Russia and Ukraine by 20% and 30% respectively, restructuring in Hungary, rescaling and potentially exiting its small operations in the US and Asia, and selling the bank's Slovenian subsidiary and Zuno, its Czech and Slovak online bank.

The most dramatic step, though, is the proposed exit from Poland. Sevelda says the "very difficult" decision to sell was mainly prompted by the bank's lack of scale in the country, even after its €470 million purchase of Polbank EFG in 2011. "Our bank is at best number eight in a market that is very mature and competitive," he says. "In order to become competitive there we would need to invest a lot more and potentially even make another acquisition – and we simply don't have the resources for that. So for us the choice was grow or go."

Healthy bank valuations in the Polish market helped to make the latter option more appealing. "We can expect to achieve a comparably good price for the bank," he adds.

Profits from Russia have been offsetting losses elsewhere for some time now

Eleni Papoula, Berenberg Bank

Yet exiting Poland may not turn out to be as easy – or as profitable – as Raiffeisen had hoped. **The fly in the ointment is Poland's notoriously fierce bank regulator, KNF**, which announced in February that it would hold Raiffeisen to its commitment – made at the time of the Polbank acquisition – to float 15% of the merged entity on the Warsaw Stock Exchange by mid-2016. KNF also made it clear that it would not approve a sale until the listing had been completed.

Analysts say this could severely hamper Raiffeisen's ability to find a buyer for its Polish operation. "If they are forced to list a minority stake in Polbank prior to selling it on to a third party it could cause delays and also be negative for valuation of the business," says Eleni Papoula, an equity research analyst at Berenberg Bank. "A potential buyer may not be willing to pay as much for an entity with a listed minority stake."

Sevelda, who visited Warsaw in late March to talk to KNF, says there are "misunderstandings" but insists that the problem is only temporary. "The discussion here is rather about timing than about a difference in principles," he says cheerfully. "We think it would make more sense to do an IPO when the new majority owner is already known to the market – and any buyer would in any case be required to do a listing. I'm sure we will come to an agreement."

The requirement to list, however, is unlikely to be the only regulatory hurdle. On past form, the KNF will also baulk at a sale to a bank with a lower rating than Raiffeisen – a condition that will become less onerous if other rating agencies follow Moody's in downgrading the bank to triple-B status – or one with a large existing presence in Poland. Indeed, KNF head Andrzej Jakubiak has said he would prefer Polbank to go to a new entrant to the market.

Again, however, Sevelda is adamant that this will not prevent a successful sale. "We have seen expressions of interest by a number of parties that are in line with the preferences that were publicly communicated by KNF," he says. "I have no doubt that the bidding process will be competitive."

The disposal of Raiffeisen's much smaller Slovenian operation is expected to be less challenging. Negotiations were started well before the current crisis and reports suggest that a buyer could be announced within weeks. Online bank Zuno has also attracted a clutch of bidders, Sevelda notes, adding that talks are underway with the European Bank of Reconstruction and Development regarding potential cooperation in Ukraine – a statement the market has taken to mean that the bank is hoping to persuade the EBRD to take a stake in Bank Aval.

Cutting exposure

In Russia, meanwhile, Raiffeisen is set to close operations in six far eastern regions and 15 smaller cities across the country, as well as pull back from the auto loan market. Sevelda says the bank will also take steps to improve the quality of its loan portfolio in Russia, including strengthening collateral requirements, shortening tenors, reducing exposure to "certain cyclical industries" and taking a more conservative approach to foreign exchange lending.

Sevelda describes this new strategy for Russia as "ambitious" – but others are less impressed.

One senior bank analyst in Vienna dismisses the measures announced so far as "cosmetic", noting that Raiffeisen's far-east operations "were more about goodwill and showing the flag than profitability" and that most of the targeted 20% reduction in risk-weighted assets in euro terms will be accounted for by **the depreciation of the rouble**.

The analyst argues that, given the extent of the tail risk in Russia revealed over the past 18 months, Raiffeisen should have been much bolder in cutting its exposure to the country and reducing its weighting in the group. "No one would blame them for announcing plans for a 40% reduction in Russia," he says. "What is more, it's a fast-moving market where maturities are short and adjustments can be made fairly quickly, so they could easily upscale again quickly if the situation improves."

As to why Raiffeisen has been reluctant to cut back harder in Russia, several theories are doing the rounds in Vienna. Locals report that the Russian operation's dynamic CEO, Sergei Monin, wields considerable clout within the group – unlike the management of under-performing Polbank – and has convinced Raiffeisen's supervisory board that his bank can generate profits even in a deteriorating environment. There are also suggestions that the softly spoken Sevelda is still making his presence felt among the subsidiary bank heads, nearly all of whom were appointed on Stepic's watch.

Sevelda is certainly full of praise for the Russian management team. "They are doing a great job and we are fully aligned with them," he says. Ultimately, however, the decision to back Russia may have more to do with simple economics than internal politics. This year, for the first time since the creation of RBI, the bank will not pay a dividend to its Raiffeisen group shareholders – and analysts doubt they can manage without it.

Karl Sevelda notes: 'Our majority shareholder has always expected us to pay dividends'

Pressure on

Financial data on the Raiffeisen network in Austria is scant, but profitability is presumed to be fairly low for both the Landesbanks and the cooperatives, given the overbanked nature of the Austrian market and the cost of maintaining an extensive physical network of small banks. The Landesbanks also compete directly with their own cooperative banks in some segments – and, for a country the size of Austria, there are a lot of them. One Vienna analyst notes: “Germany has five Landesbanks for a population of 80 million, we have eight for a population of 8 million.”

For nearly 30 years, however, any holes in the Austrian network have been plugged by a steady flow of profits from RBI – which also helps to explain why earnings were not retained in the good years to build the capital base, even when the regulatory wind shifted after the financial crisis. As Sevelda notes: “Our majority shareholder has always expected us to pay dividends.”

The pressure is thus clearly on RBI to resume dividend payments – but for the past five years, the only part of the group that has been consistently and impressively profitable has been Russia. Even in 2014, the Russian operation posted a pre-tax return of €436 million and a return on equity of 28.8%, easily outstripping the rest of the group. “Profits from Russia have been offsetting losses elsewhere for some time now,” says Papoula. “Without that the group’s profitability would be very low, which suggests that the current group structure doesn’t quite work.”

As yet, there has been no sign that Raiffeisen executives envisage the need for, or the possibility of, any large restructuring – but analysts say it cannot be ruled out if, as seems more than likely, the strategic plan fails to deliver the promised capital boost. Sevelda himself admits that its growth assumptions – of at least 3% to 5% in several of its key markets – are “ambitious” given that demand for new lending remains very weak across CEE.

Meanwhile, Papoula suggests that Raiffeisen’s estimate of the cost of cutting exposure to other markets, €500 million – or 2% of the assets in question – looks very low. Similar recent loan-book rundowns by UniCredit and RBS have cost closer to 20% of assets. Even allowing for a successful sale of Polbank and minimal rundown losses, Papoula estimates that Raiffeisen will fall at least 1.2 percentage points short of its 12% CET1 target at end 2017.

In that case, Raiffeisen may find itself forced to take more drastic action by the regulators, who are reported to be keeping a very close eye on the bank. That would mean either a public capital raise, or, if RZB insists on keeping a majority stake in RBI, the sale of more successful subsidiaries such as Czech Republic and Slovakia.

For RBI’s minority shareholders, the former would likely be the preferred solution, according to analysts – particularly if that meant bringing in new management from outside the very closed world of Austrian banking. (Of the 14 members of Raiffeisen’s management and supervisory boards, only two have worked for any length of time outside Vienna, and of those one came from WestLB. The majority, including Sevelda, have spent most of their careers within the Raiffeisen network.)

Some external shareholders, indeed, are said to have pushed Raiffeisen to look beyond Austria for a new CEO after Stepic’s sudden departure. “They should have gone for an outsider who could restructure the bank,” says one banking source in Vienna. “It’s not the Austrian way – but if they want to be an international bank then they should play by international standards.”

Mismatch

The question, however, is just how much RBI’s owners do want it to be an international bank. It has been reported for some time that many in Raiffeisen’s local network are uncomfortable about the mismatch between a free-wheeling emerging market business and the ultra-conservative rural Austrian base. These CEE sceptics are said to have been glad to see the back of the uber-internationalist Stepic – indeed, rumour suggests that, if not actually instrumental in his departure, they may have encouraged it.

There are hints that Sevelda, who spent 12 years at RZB headquarters before taking up the deputy CEO position at RBI, may be more in tune with the Austrian base. While he insists that further disposals or cuts are “not on the agenda”, he is also keen to stress that Raiffeisen has drastically revised down its expectations for international growth.

“If you have growth of 20% to 30% over a 10- to 15-year cycle you get spoiled but you know it can’t go on for ever,” he says. “The benefit of the financial crisis is that it has shown us that there are limits for growth – and we are clear that we know our limits.”

Nevertheless, Sevelda insists that the business case for being in CEE remains valid. “In the mid- to long-term it is clear that our region will show higher growth rates than western Europe,” he says. “Even the most developed countries in CEE have per capita incomes less than half that of Austria, so there is still ample room for growth.”

Christl agrees. “When Europe recovers, these markets may well be able to maintain growth of one percentage point or so above the European average and offer concomitantly higher banking returns,” he says. He is less convinced, however, that by that time Raiffeisen will still be in a position to take full advantage of that pick up. “I could certainly envisage a situation in which they would have had to sell out of major markets,” he says.

That would be a sad end to Stepic’s pioneering CEE empire – and a cautionary tale of the value of maintaining a strong capital base. As Christl notes: “If Raiffeisen’s capital ratio was double what it is today then they would be well positioned to ride out the current problems in some of their key markets.”

Another senior analyst in Vienna is more forthright. “There was simply no excuse for Raiffeisen’s low capitalization,” he says. “With big exposures in high-risk emerging markets such as Russia and Ukraine you have to run strong capital buffers, otherwise you’re nothing but a badly managed macro hedge fund.”

In taking on Stepic’s empire, Sevelda has stepped into some very big shoes – and at the same time has been set a very rocky road to climb. Only time will tell whether he has the steady hand necessary to lift Raiffeisen back to growth and stability. Raiffeisen in 10 years’ time could look very different from Raiffeisen today.