Still Hobbling Along: An Update on the Russian Banking System

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In the aftermath of Russia's August 1998 financial crisis, many observers had hoped that genuine reform and restructuring would occur in the Russian banking sector. Unfortunately, almost two years after the crisis, the sector hobbles along with only a few half steps taken towards effective restructuring. Some banks have been closed, but consolidation into a few strong and competitive banking institutions has not occurred. Instead of the emergence of only a few hundred strong and competitive banks, there are still 1,338 banks in Russia as of April 2000 (from 1,700 banks at the beginning of 1998). Authorities have revoked the licenses of approximately 200 banks, but subsequently and arbitrarily reinstated some. Major bankers have also been guilty of asset stripping, and have transferred assets from bankrupt entities to new banks or "bridge banks." None of these bankers have been called into account for actions that essentially defrauded depositors. Finally, while improved profitability and liquidity, the absence of an exchange rate crash, and growth of approximately 3% in the Russian economy in 1999 create a positive environment for Russian banks going forward, the sector as a whole will remain shaky and risky unless government authorities take more focused and effective steps toward effective reform.

The Functions of Russian Banks

The Russian banking sector is highly underdeveloped. Loans to the private sector and to non-financial public enterprises in Russia totaled approximately 14% of GDP as of early 2000. The figure for Poland is 20%, while it is 80-120% for West European countries. The sector is also small in terms of assets and capitalization. As of August 1999, the Central Bank of Russia (CBR) reported that total assets for Russia's top 30 banks--representing as much as 60% of the country's total banking assets--amounted to only R979 billion or approximately $37.7 billion. The sector's total capital (minus Sberbank) as of January 2000 was reported at R111 billion or approximately $4.0 billion (this is 85-90% of the sector's pre-August 1998 capital level). To put this in perspective, the amount of capital in Russia's banking sector is roughly equivalent to 7.3% of the year-end 1999 total equity of the financial firm Citigroup in the United States. The Russian government also continues to dominate the banking system, with the CBR owning 58% of Sberbank (which controls 80% of the retail deposit market), 96% of Vneshtorgbank (Sberbank and

Vneshtorgbank together control 30% of the sector's assets), 50% of Mezhgosudarstvenny Bank, 45% of Roseximbank, and 20% of Vneshekonombank.

Unlike in most developed economies, where banks' central role is that of financial intermediation (i.e., mobilizing savings and directing them to the highest-value uses--for example, loans to industrial enterprises or to individual entrepreneurs), Russian banks do minimal retail business. Except for Sberbank, Russian banks take very few deposits and make few loans. The role that Russian banks do play covers six areas. First, banks act as the financial arm of large enterprises or groups of enterprises. They settle payments for these "clients," provide banking services to managers and employees, and engage in investment activities on behalf of their enterprise-owners. A good example would be Gazprombank, the financial arm of gas behemoth Gazprom. Second, Russian banks manage Russia's "quasi-money" system, issuing veksels or promissory notes to help companies and government agencies manage intricate operations of barter, credit, and taxes. Third, until August 1998, banks were lenders of last resort to the central government in Moscow and were chief purchasers of the government's treasury bills or GKOs. In fact, some banks held as much as 70% of their capital in government paper and were the first to go under after the government defaulted in August 1998. Fourth, Russian banks fulfill a treasury function for the central government. If they meet minimum asset requirements or compete successfully in the bidding process, they could qualify as repositories and/or transfer agents for state funds--including customs revenues, budget subsidies, state wages, tax payments, and reconstruction funds (e.g., for Chechnya after the 1994-1996 war). This function will wane as the government moves more fully into a treasury system. Fifth, Russian banks provide short-term credit for the Russian economy, especially in the import-export sector. Finally, banks, using foreign or offshore accounts, have been (and are) central facilitators of Russian capital flight.

Outstanding Issues

Reform in Russia's banking system will be critical to the country's long-term economic health. Without a banking system that provides financial intermediation, efficient capital accumulation is highly unlikely to happen in Russia's financial system. Without capital accumulation, real investment in the economy will continue to decline or be sluggish at best. With a more professional and trustworthy banking system, one can imagine the mobilization of an estimated $30 billion in savings currently under Russian "mattresses," and the deployment of these resources towards genuine value-creation in the economy.

At least four issues are paramount in reforming the Russian banking system: mismanagement and corruption, government-led financial restructuring, strategic foreign investment, and accounting reform.

- *Mismanagement and Corruption*

After the financial disaster of August 1998, some of Russia's largest banks stripped assets from their institutions, transferred them to bridge entities or new banks, and refused to fulfill their obligations to domestic and international creditors. Some examples of this practice are Uneximbank, which transferred assets and businesses to Rosbank; Menatep to Menatep St. Petersburg; SBS-Agro to First Mutual Credit Society; and Rossisky Kredit to Impexbank. Managers and major shareholders were able to benefit from transferred assets partly with help from Russian authorities, who announced a 90-day moratorium on external debt payments in August 1998. After August, government authorities also continued pumping money into bankrupt but subjectively defined "socially important" banks (e.g., SBS-Agro). There has been no accounting as to how these government resources were used. Indeed, the unwise largesse of the authorities served only to postpone the day of reckoning for Russian banks and to deepen the culture of mismanagement and corruption that was already widespread in the sector. Corruption continues in the sector; for example, in early 2000, the temporary administrator for bankrupt bank Menatep complained that the bank's assets were not being locked down but sold off. Instead of an immediate response to stop the siphoning off of assets, the Moscow Arbitration Court responded by postponing hearings on the allegations. Clearly, Russian authorities will have to be more serious about cleaning up the banking system if they want it to become a useful component of economic rehabilitation.

- *Government-Led Financial Restructuring*

The Russian government created ARKO, the Agency for Restructuring of Credit Organizations, after August 1998. ARKO began operations in March 1999, using a capital base of R10 billion and armed with a mandate to coordinate the liquidation of insolvent Russian banks, restore the solvency of specific institutions, and provide a network for timely and accurate settlement of payments. ARKO's mandate, however, has proven too tall given the agency's resources and weak political clout. Experts estimate that ARKO needs R50-100 billion to fulfill its mandate, but the 2000 federal budget sets aside direct funds of only R1 billion for the agency, with another R4 billion in bonds to be guaranteed by the government. The agency also works at odds with the CBR, which is officially the lead institution for bank supervision. For example, in June 1999, just hours after ARKO announced that it was making a $128 million loan to Promstroibank, the CBR declared that it was revoking the bank's license. Success in restructuring the banking sector will depend not only on more capital and stronger political authority for ARKO, but also on the development and implementation of a host of legal and regulatory measures on bank bankruptcies, market transparency, protection of shareholder and depositors' rights, and deposit insurance. The prospect of all these measures moving forward simultaneously is bleak.

- *Strategic Foreign Investment*

The share of foreign capital in Russia's banking system as of March 2000 was 10.7%. In April 2000, CBR officials announced that the 12% limit for foreign capital in the banking system had been removed (mainly through a reinterpretation of existing law). In theory, the removal of protectionist ceilings on foreign capital should facilitate a much-needed inflow of strategic foreign investment in the Russian banking sector. As the experience of Poland and Hungary suggest, foreign capital--coupled with the introduction of western strategic approaches to banking--could greatly enhance growth, efficiency, and competitiveness among banks. But the experience of Poland and Hungary is unlikely to be repeated in Russia. At the moment, 21 banks in Russia have 100% foreign ownership, while 32 banks report over 50% foreign ownership. More than 150 other banks have some percentage of foreign capital, but in general, foreign banks have not rushed to expand their Russian presence and operations. To the contrary, banks like the Republic Bank of New York have dramatically scaled back their Russian operations. In a more welcome development, some foreign banks have shifted their activities from the Russian financial markets to more regular commercial banking (e.g., new individual and commercial accounts, transfers, Letters of Credit, currency operations, trade finance, and documentary operations). These banks, however, have limited scope for distribution (i.e., it is difficult for them to open branches throughout the country) and are hampered by political and legal risks that are difficult to hedge. These realities will continue to hamper the development of foreign strategic investment in the Russian banking sector in the next few years. Unless the Russian government takes steps to convince the foreign banking community that the business environment is becoming more fair, stable, and transparent, few foreign banks will take the opportunity to significantly expand their capital and operations in Russia.

- *Accounting Reform*

The accounting practices of many Russian banks are shoddy, and few institutions subscribe to International Accounting Standards (IAS). It is often extremely difficult for western analysts and other interested parties to get reliable financial statements. Window dressing of accounts is prevalent, as are "qualified" auditors' opinions (i.e., auditors are unable to obtain sufficient or verifiable evidence in support of all the numbers reported by a specific entity). In January 2000, Central Bank chair Viktor Gerashchenko reported that violations of Russian bookkeeping standards and incorrect financial reports were found in 70% of Russian banks. After the financial collapse of August 1998, the Central Bank itself was guilty of approving changes in Russian Accounting Standards (RAS) that allowed banks to defer 1997 losses and offset them against 1998 gains on government securities of the same series--hence allowing banks to pad their 1997 earnings. Official complicity with and encouragement of poor accounting practices must stop.

Vladimir Putin and Banking Sector Reform

New Russian President Vladimir Putin has several times indicated his desire to reform the banking sector. But though his rhetoric sounds right, at least two of his early acts in the sector undermine confidence in his desire and ability to undertake the right reform measures. First, Putin asked the CBR to stop bankruptcy proceedings against Promstroibank in February 2000. The bank no longer had a license but Putin declared that the bank should be restructured by ARKO. According to a Thompson BankWatch analyst, this step puts Promstroibank among the "living dead"--i.e., banks that are no longer viable but will be kept temporarily liquid because of their political connections. Putin's decision on Promstroibank sets a negative precedent for a systematic, law-based overhaul of the banking system. It also appears inappropriate given that Putin holds his largest savings account in the bank and owns 23 shares in Promstroibank's St. Petersburg branch. Second, Putin signed a resolution to establish Rosselkhozbank, a new bank for the agricultural sector. The resolution enumerated the bank's activities even though the bank did not yet possess a license. This act appears counter to the systematic functioning of law and procedure, and smacks of corruption. It has been reported, for example, that Rosselkhozbank will be run by the same corrupt and inept management that ran the now-defunct SBS-Agro and will operate in SBS-Agro's former premises.

Policy Recommendations

During his early April 2000 visit to Moscow, IMF (International Monetary Fund) acting managing director Stanley Fischer noted that banking reform should be one of six key elements of Russian economic restructuring under Vladimir Putin. Fischer's emphasis on banking reform is in line with efforts by multilateral institutions such as the IMF, The World Bank, the European Union (EU), and the European Bank for Reconstruction and Development (EBRD) to assist Russian banking reform in the aftermath of August 1998. These efforts should continue and intensify, particularly if Putin and his cabinet prove serious in their intent to address problems in the sector. A few specific policy recommendations for western actors follow:

- *Strengthening the Credit Culture*

Western assistance should be directed at bolstering Russia's credit culture. In particular, training programs to improve credit analysis, loan analysis, and approval procedures in Russian banks should be supported. Assistance and investments should also be targeted toward banks that have put in place or are trying to put in place robust credit practices. In other words, outsiders should reward professionalism and integrity in the banking sector. Multilateral institutions should also work with Russian authorities to improve reporting requirements: onerous and unnecessary reporting details should be removed and key disclosure requirements such as Non-Performing Loans and capital adequacy ratios added.

- *Legislation*

There is a consensus in the new Duma on passing legislation to facilitate the role of banks as financial intermediators and to promote lending to non-financial enterprises. Where outside technical assistance can be useful, it should be offered to develop legislation on tax incentives to banks that lend to the real sector, on government deposit insurance, and on measures to stem capital flight. On the latter issue, for example, the Duma is considering several draft laws. Two of these--intended as amendments to Russia's hard currency regulation and Civil Code--will allow banks to suspend "suspect" operations for five days and report them to the appropriate law enforcement agencies. An official investigation could then ensue for as long as 30 days. But criteria for "suspect" versus legitimate deals are murky, and the draft laws could lead to a bureaucratic nightmare for legitimate financial transactions. In this case, outside input on best practices from stable and transparent banking systems might add value to Russian legislators' efforts to codify rules and standards to prevent capital flight.

- *Currency Stabilization and Increasing Public Trust*

There is very little public trust in Russian banking institutions, for good reason. This lack of trust is reflected in an overall decrease in deposits by corporate and private Russian depositors in 1999. However, trust must be revived if Russia is to have a stronger banking system. Currency stabilization will help cultivate public trust, and should be a focus of external assistance as long as Russian policymakers exhibit the will to act appropriately and effectively in this area. In an environment where inflation is still high (36.5% in 1999), it is difficult for depositors and bankers to think in the long term. In fact, in Russia, bank resources and deposits with maturities longer than a year amount to only 8.5%-13% of bank liabilities as of January 2000. At the same time, long-term lending (more than one year) is only 39% of Russian bank loans to enterprises and individuals (in Germany, this figure is 86%). Besides assistance toward currency stabilization, external resources might also be offered to help compensate small depositors who lost money after August 1998 (ARKO already offers some compensation, but its funds are meager). However, this should be made strictly conditional on Russian authorities' will and ability to implement the law on bankruptcy of financial institutions, to liquidate the assets of bankrupt banks and use them to compensate depositors, and to bring to account bankers who have defrauded the public.

Conclusion

1999 proved to be a much better year for Russian banks than many had originally anticipated. Liquidity in the sector increased due to rising commodity prices (especially oil) and growing government coffers. The Central Bank reported in late 1999 that the majority of Russian banks were operating profitably and that the sector as a whole was overcoming its state of crisis. However, the Russian banking sector has experienced only a temporary respite rather than a definitive turn away from crisis in the next five years. When commodity prices dip, as they will inevitably do, Russian banks will once again experience low liquidity. In addition, banks have yet to settle numerous forward contracts (amounting to billions of dollars) with domestic and foreign counterparties, and liquidity and profitability could tighten as such liabilities come due. In the words of Richard Thomas of Standard and Poor's: "The issues of personality, politics, and brinkmanship that govern the Russian financial system continue to … [underline] the questionable banking and legal practices in Russia and [point] to the weak and arbitrary nature of the country's credit culture." Russian failure to implement measures to change this assessment will mean that the banking sector, at best, will hobble along in the foreseeable future. Limping alongside it will be the larger economy and lost hopes for a better life for most Russians.