Distorted Incentives Fading? The Evolution of the Russian Banking Sector since Perestroika

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The present study attempts to trace and analyze the development of the Russian banking sector since the final years of Soviet rule. It deals with legal foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs, the role of foreign credit institutions and FDI. For many years prevailing conditions and incentives have favored speculative and short-term activities, but have not allowed banks to carry out effective financial intermediation in Russia. After the financial collapse of August 1998 sluggish post-crisis restructuring ensued. The banking sector only recovered on the back of the general economic recovery, buoyed by the ruble devaluation, the oil price boom, political stability and some first fruits of structural reforms. A credit boom unfolded, giving rise to new risks. Most recently, the authorities have undertaken impressive efforts to intensify reforms. If implementation follows up, Russia will have put itself on the catching-up lane with other transition countries that are further advanced in banking reforms.

1 Introduction

The banking sector is certainly one of the branches of the Russian economy that has exhibited considerable susceptibility to distorted incentives. Banking development in Russia has been fraught with structural problems, a great deal of which are rooted in the Soviet past. In contending with the challenging and quickly changing environment, banks have often proved to be very flexible, even ingenious. However, this versatility has not always been reflected in increased value added in a market economy sense. This study attempts in a chronological approach to trace and analyze the development of the Russian banking sector since the final years of Soviet rule. The study deals with legal foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs, the role of foreign banks and FDI. Particular emphasis is put on highlighting salient features of the everyday business environment in which credit institutions[2] have found themselves and on incentives to which they have been exposed.

Chapter 2 sets the initial stage, describing the banking system of the late period of Soviet rule. Chapter 3 deals with the early years of transition and the many sources of speculative earnings that emerged. A turnaround was brought about by the tightening of economic policy and the ensuing interbank loan crisis in the mid-1990s, subject of chapter 4. Soon thereafter, new sources of enrichment emerged: shares-for-loans deals, short-term treasury bills (GKOs) and monetary surrogates, related in chapter 5. This trend contributed to an increasing differentiation of the sector, to growing risks and structural imbalances, dealt with in chapter 6. Chapter 7 focuses on the Russian financial collapse of August 1998 and its immediate repercussions, while chapters 8 and 9 analyze the sluggish post-crisis restructuring and the following recovery of the banking sector, buoyed by effects of the recent oil and raw materials price boom. In connection with this boom, credit institutions have taken on new risks.

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[2] *In this paper, the terms "bank" and "credit institution" are treated as synonyms.*

The evolving banking structure, the most recent reform measures and the current situation (2003–2004) are explained in chapters 10 and 11. Chapter 12 intends to draw conclusions and to come up with some suggestions.

2 The Latter Soviet Years (1985 to 1991)

The first steps that prepared the establishment of a market-oriented banking sector in the former Soviet Union were taken as elements of perestroika policies of the second half of the 1980s. Before that, the single-tier banking system, dominated by Gosbank (Gosudarstvenny bank/State Bank) in the Soviet state-owned and centrally planned economy, essentially played a passive role. The banks carried out payment transactions that were to accompany – and thus verify – the execution of orders and directives pertaining to the real economy. In the context of arbitrarily determined "prices," enterprise profits were redistributed by the state or used otherwise according to the central plan, and "credits" granted to firms by the central bank in effect constituted automatic transfers and were not really expected to be paid back. Bankruptcy was practically unknown in the centrally planned economy. "Money," except that paid out to workers and employees, was largely constrained to fulfilling bookkeeping functions. Gosbank was supported by a special purpose bank, the Sberkassa (State Workers' Savings Bank) (Lane, 2002, p. 11).

Until the end of the 1980s, private property rights with regard to means of production were generally outlawed and banking skills were all but nonexistent. Given the central planners' lack of information on the real productive capabilities and efficiency of many enterprises subordinated to their instructions, these enterprises were in a position to demand and receive from the state more inputs than they really needed to fulfill the central plan, which perpetuated wasteful modes of production ("soft planning"). Owing to the general rigidity and inefficiency of the system, central planning could not have survived without a robust and supple underground or informal economy. However, given that the informal economy was mostly illegal, such basically market-oriented activities had to be continuously disguised.

The USSR Governmental Decree on the Reorganization of the Banking System (1987) formally created a two-tier banking system. Gosbank was renamed "Central Bank of the USSR" and tasks which resembled commercial banking activities were separated from the central bank and transferred to various newly created specialized state-owned institutions: Promstroibank (which granted investment credits to the industry, construction, transport and communications sectors), Agroprombank (which served kolkhozes, sovkhozes and agroindustrial complexes), Zhilsotsbank (which served residential construction, light industry and trade). Vneshekonombank was established to deal with foreign creditors of the Soviet state. The Sberkassa (with its approximately 70,000 branches and outlets throughout the USSR) was consolidated into Sberbank (Sberegatelny bank/Savings Bank). Sberbank collected household deposits and granted loans to the government largely as a contribution to budget finance. The Soviet central bank was thus left with the function of carrying out monetary policy and banking supervision, while at the same time it was still in charge of the central credit plan (Laurila, 1996, pp. 86–87).

The (all-Union) Law on Cooperatives and subsequent regulations of the USSR central bank permitted the setting up of private commercial and cooperative banks, most of which were established by state-owned enterprises and organizations. The following years witnessed the rapid weakening of Soviet central and state authority. Elements of central planning started to disintegrate. In December 1990 the Russian Soviet Republic enacted its own Central Bank Law, declaring the Russian office of Gosbank the Central Bank of Russia (CBR) and subjecting it to Russian republican jurisdiction. This effectively turned the Soviet monetary authority into an umbrella organization of central banks of the Soviet republics. The same year the Russian Law on Banks and Banking Activity was passed,[3] and Vneshtorgbank was created to service foreign trade transactions of the Russian Soviet republic.

Despite the fact that the country was as yet far from featuring basic market-oriented institutions, the total number of operating credit institutions on Russian territory grew from 6 at end-1988 to 1,360 at end-1991. This development was promoted by the initial virtual absence of effective commercial banking regulations (IMF, World Bank, OECD, EBRD, 1991, p. 31). After the collapse of the USSR and the demise of central planning, the CBR formally took over the remaining functions of former Gosbank in the Russian Federation. Licensing and prudential regulations remained under the sole jurisdiction of the CBR. The boom in new banks continued, promoted by a very liberal licensing policy (in particular low charter capital requirements, which e.g. in 1992 amounted to USD 200,000) and a generally lax regulatory environment with poor enforcement. The total number of operating banks expanded to 2,517 by end-1994.

3 The Early Years of Independence and Transition

In the first years of transition, commercial banking was very profitable, in contrast to other branches of the economy whose activity contracted strongly. To be more precise, banks' activities – but not necessarily banking activities proper – flourished. Some credit institutions with an obvious potential for expansion were created by important resource-oriented enterprises, heavy industrial firms, central as well as regional authorities and former Soviet organizations. Yet, apart from the above-mentioned specialized state-owned banks, most credit institutions remained extremely small. At end-1994, the total capitalization of the sector was estimated at about 4% of GDP, and the total volume of commercial bank credit amounted to approximately 20% of GDP (Walter, 1999, p. 7).

Like other state-owned credit institutions, Sberbank (the Savings Bank), was – and still is – equipped with a state household deposit guarantee. Sberbank has retained the majority of household accounts. Other specialized banks continued to administer "directed credits," which, in effect, constituted a remnant of Soviet times. Directed credits were cheap (or soft) loans extended by the monetary authorities or the government to "strategic enterprises" in industry or agriculture, or to other beneficiaries. Newly founded banks largely received money from their owners or tried to attract funds from households by offering

[3] *Although this law has been amended several times since, it is still in force today.*

higher deposit rates than Sberbank. In many instances, newly founded credit institutions have been owned by one or a few firms and called "pocket banks" or "agent banks," since they have essentially functioned as extended treasury or financial departments of the respective enterprise(s).[4] Many of them continue to do so today.

The privatization of the specialized banks as well as of the (state-owned firms') "pocket banks" proceeded largely through management and employee buy-outs (MEBOs), as well as through the privatization of the owner firms themselves, which mainly took place through voucher schemes. These types of privatization brought little new know-how and capital to banks and often left incumbent managements unchanged. Sberbank, Vneshekonombank and Vneshtorgbank were excluded from privatization, with majority stakes of these institutions remaining in the ownership of the CBR/the state. While Vneshtorgbank successfully added some commercial banking activities to its business, Vneshekonombank essentially remained a special state agency for servicing former Soviet foreign debt inherited by Russia.

In the first years of transition the main sources for banks' profits were furnished by speculation or arbitrage activities in connection with: high and variable inflation (sometimes bordering on hyperinflation), the continuing depreciation of the ruble, exchange rate instability, the opening up of the country to market-oriented foreign trade, steps to liberalize foreign exchange transactions as well as generous refinancing by the CBR. Annual inflation (CPI, year on year) increased from about 160% in 1991 to over 2,500% in 1992 and came to 840% in 1993 (table 1). Credit institutions profited from conditions of macroeconomic instability, even if their rent-seeking activities were not, strictly speaking, of a banking nature.

Thus banks first of all converted funds they received into foreign currency and paid negative or low real interest rates on ruble-denominated accounts.[5] Currency dealing and foreign exchange services were in high demand. Second, at the expense of state-owned companies in particular, banks benefited by deliberately extending the period between the receipt and the payment of funds, e.g. directed credits, and by speculating with these funds in the meantime. Third, banks granted sizeable commercial credit on their own to firms and benefited from relatively high spreads. The possibility that these loans would turn nonperforming did not pose a problem as long as cheap refinancing was forthcoming from the central bank. Fourth, opportunities arose through the accumulation and use of privatization checks or vouchers issued by the government to the population in 1992 and 1993. These vouchers were resellable and some credit institutions purchased and invested considerable amounts.

Finally, banks drew advantages from acting as financial intermediaries in the strongly expanding Russian trade with countries of the "far abroad" (i.e. the non-Baltic, non-CIS countries), notably with respect to exports of energy and raw materials and imports of consumer goods. Given the lack of effective

[4] *In some cases, these "pocket banks" had in fact constituted former state-owned enterprises' financial departments that were later divested from the firms.*

[5] *During most of the 1990s, the only major alternative Russian citizens had to holding their savings in bank accounts was hoarding them at home in storage facilities like mattresses or jam jars (called "banki"). Hard currency circulating in Russia outside the banking sector has been estimated to oscillate around USD 30 billion to USD 50 billion.*

foreign exchange regulations, many of these transactions had the additional advantage of allowing banks to "leave" a substantial amount of hard currency abroad. In an environment of weak banking supervision and currency rules, credit institutions became instruments for (facilitating) capital flight. This also goes for transferring profits abroad and avoiding (evading) taxes.

4 Tightening of Macroeconomic Policy, Interbank Loan Crisis (1994 to 1995)

The subsequent years witnessed a substantial decline of most of these early sources of easy profits. Monetary policy was tightened sharply; quasi-automatic refinancing and directed credits were curtailed as from 1994. Progress in stabilization, which brought about much lower inflation and exchange rate volatility, reduced profits from inflation rents, the servicing of foreign currency exchange and speculation (OECD, 1997, pp. 81–82). Annual inflation fell to about 130% in 1995, 22% in 1996 and 11% in 1997. Real lending interest rates to nonbanks became positive in the second half of 1994. From early 1995 onward, the monetary authorities made a vigorous attempt to stabilize the exchange rate, leading even to some months of nominal appreciation against the U.S. dollar. In July 1995 the authorities introduced a crawling exchange rate corridor for the ruble vis-à-vis the U.S. dollar, which was chosen as the nominal anchor for the Russian currency.

Table 1

Russia: Macroeconomic and Monetary Indicators

Year-end	GDP growth (real)	CPI inflation (year on year)	CPI inflation (annual average)	Exchange rate	Exchange rate	Central bank refinancing rate (uncompounded)	Broad money (M2, nominal change)	Broad money (M2)	Current account balance	Gross foreign currency reserves (excluding gold)	External debt[1]
	%			RUB/USD	RUB/EUR, before 1999 RUB/ECU	% per annum		% of GDP		USD billion	% of GDP
1991	-5.0	161.0	93.0	0.13	. .	. .	125.9	68.0	. .	. .	. .
1992	−14.5	2,506.0	1,526.0	0.51	. .	. .	642.6	37.0	. .	. .	. .
1993	-8.7	840.0	875.0	1.27	. .	210.0	416.1	21.4	. .	. .	. .
1994	−12.7	204.4	311.4	3.55	. .	180.0	166.4	16.0	3.4	5,00	43.7
1995	−4.1	128.6	197.7	4.64	5.89[2]	160.0	125.8	13.9	2.3	14,40	36.6
1996	−3.6	21.8	47.8	5.56	6.63[2]	48.0	30.6	14.4	2.8	11,28	36.7
1997	1.4	10.9	14.7	5.96	6.54[2]	28.0	29.8	16.0	0.0	12,90	44.6
1998	−5.3	84.5	27.6	20.65	25.31	60.0	19.8	17.0	0.1	7,80	70.4
1999	6.4	36.8	86.1	27.00	27.77	55.0	57.2	14.6	12.6	8,46	90.3
2000	10.0	20.1	20.8	28.16	26.90	25.0	62.4	15.7	18.0	24,26	61.0
2001	5.1	18.6	21.6	30.14	27.15	25.0	40.9	18.0	11.1	32,54	49.1
2002	4.7	15.1	16.0	31.78	33.53	21.0	32.4	19.7	8.6	44,05	44.1
2003[3]	7.3	12.0	13.6	29.45	36.82	16.0	50.5	24.1	9.0	73,18	38.1

Source: CBR, Goskomstat, IMF, EBRD, wiiw.
[1] 1994 and 1995: Public debt only.
[2] Average annual rate.
[3] Preliminary data or estimates.
Note: In this table, RUB also represents the old ruble (RUR), which was in force until December 31, 1997.

An important amendment to the Central Bank Law was passed in May 1995. It reinforced the CBR's legal independence from the government and strengthened its authority as bank supervisor and lender of last resort. Licensing requirements, minimal capital adequacy ratios and other prudential regulations were tightened and better monitored, resulting in mergers of small banks and the withdrawal of licenses. The number of operating credit institutions began to decline in 1994 and fell to 2,029 at end-1996 and about 1,600 in mid-1998 (table 2).

The first sustained progress in stabilization caught many banks off guard, triggering mounting liquidity problems. The initial effect of lower inflation and higher real interest rates also squeezed the liquidity of enterprises. The curtailment of central bank refinancing contributed to a decline of commercial bank credit, which fell from 34% of GDP in 1993 to 12% in 1995. Many banks responded to these pressures by raising more and more funds on the interbank loan market, which led to a spiral of borrowing, eventually resulting in an explosion of overnight interest rates and the subsequent collapse of the interbank market in August 1995. Given that the central bank provided only partial accommodation, the crisis caused several hundred banks to fail, including two relatively large ones, Tveruniversalbank and Natsionalnyi Kredit.

The CBR revoked a considerable number of licenses, and some of the first bank bankruptcies occurred. Tveruniversalbank e.g. was formally declared bankrupt and wound up; Natsionalnyi Kredit was rehabilitated, though. This process can be interpreted as a first sign of nascent hard budget constraints in the Russian banking sector. It was possible, however, to avert a systemic banking crisis. The fallout from the interbank loan crisis of August 1995 made it increasingly difficult for banks other than Sberbank to attract household savings. After declining to 60% in 1994, the share of household deposits in Sberbank climbed back to 75% of total household deposits in the banking sector at the beginning of 1997 and came to 70% in mid-1998.

5 Liquidity Squeeze, New Profit Sources and Increased Differentiation of the Banking Sector (1995 to 1997)

The very ambitious IMF-sponsored efforts toward macroeconomic stabilization since the mid-1990s were based on very restrictive monetary and exchange rate policies which led to sharply tightened monetary conditions. After a phase of partly excessive liquidity, the economy found itself in a liquidity squeeze, which was exacerbated by sharply rising imports driven by real appreciation. Nonpayment and the mounting of overdue liabilities (between companies and vis-à-vis employees) became a widespread phenomenon throughout the economy and also affected the government budget. Even though no expansive fiscal policy was pursued in terms of noninterest expenditure, the resulting shortfall of budgetary revenues and rising interest payments increased the budget deficit considerably. Based on the imperative of noninflationary deficit financing, the government budget started to absorb remaining liquidity via the issuance of state obligations, ultimately attracting foreign funds to provide liquidity (Reininger, 2000, p. 53).

Russian credit institutions soon made efforts to adapt to the changed situation and to find some new sources of profits. In the general post-1995 environment of tightened liquidity constraints, many banks supported some new ways to facilitate the exchange of products and services between enterprises and institutions, including government bodies. By assisting in barter and nonmonetary deals or issuing "veksels" or bills of exchange, banks helped overcome liquidity bottlenecks in financing transactions of private as well as state-owned firms. Veksels, often traded on the secondary market, proved to be quite profitable monetary surrogates for many banks. It was a frequent practice for credit institutions to issue loans in their own bills of exchange. Veksels were sometimes even accepted by (regional) government authorities in lieu of tax payments. At times, banks transformed defaulted ordinary loans into veksel credits in order to adjust the look of their balance sheets.[6]

A number of banks continued to operate on the basis of close relations with authorities at various levels, which included being "authorized" to hold budget accounts with little or no interest, granting loans equipped with state guarantees to designated enterprises, participating in various government financial programs as well as extending credits to government structures. Connections with local (and sometimes national) politics could take the form of incumbent administrations drawing on bank resources to fund election campaigns and personal projects (Lane, 2002, p. 19).

Perhaps the most important, but – as it turned out later – most dubious new source of income for banks was investment in high interest-yielding government securities. The rapid expansion of the market for state securities in connection with still high budget imbalances that were no longer monetized offered banks liquid, high-yield and, it seemed, low-risk investment. Not least due to an inefficient tax system, the federal budget deficit (according to IMF methodology) amounted to 5.4% of GDP in 1995, 7.9% in 1996 and 7.0% in 1997. The securities banks invested in were GKOs (Gosudarstvennye kratkosrochnye obiazatelstva – state short-term obligations or treasury bills) and OFZs (Obligatsii federalnogo zaima – federal bonds). GKOs were introduced in 1993, OFZs in 1995. Until 1997, significant limits were put on foreign investors in this market, which, together with uncertainties surrounding the presidential elections of 1996, contributed to pushing up interest rates, so that real returns on GKOs topped 75% on average in the whole of 1996. This may help explain some of the banking "success stories" of that year. At the end of 1997, holdings of state securities reached about 30% of banks' assets and in the first half of 1998 even surpassed the volume of corporate loans (see also table 3).

Thus, while initial speculative incentive structures of the early years of transition had largely evoporated, new short-term factors and rent-seeking opportunities emerged. Credit institutions' proximity to and dependence on the state changed, but remained substantial. But also vice versa, the dependence of the state on banks made itself felt – federal authorities e.g. relied more and more on banks to finance their growing debt, and regional administrations drew on banks' resources to finance pet projects. There was one other major factor that brought considerable wealth to a few larger and well-connected banks: cash privatization measures, in particular the shares-for-loans auctions in the second half of 1995. Banks' preeminence in these schemes may be explained by the coincidence of at least three factors: First, in the mid-1990s most aspects of economic policymaking (at the federal level) had been subordinated to the objective of macrostabilization and noninflationary financing of the budget deficit. Second, for various reasons, progress with privatization in the post-voucher era had ground to a halt. Third, in a cash-strapped society, credit institutions proved to be "kings" (Tompson, 2002, p. 62; Allan, 2002, p. 153).

A major goal of the shares-for-loans scheme was to raise money for the treasury: The federal government accepted credits extended by banks to help finance

[6] *By 1997–98, various forms of quasi-money are estimated to have covered half of the industrial transactions in Russia.*

the budget deficit on the basis of auctions of packages of state shares in certain valuable firms (among them firms in the oil, electricity and metallurgy sectors) that would serve as collateral for granted credits. In the event of nonrepayment of the credits, the banks in question had the possibility to sell collateralized shares or to keep them. Although the auctions should have been competitive and transparent, in many instances they were not, and numerous violations of established rules reportedly occurred.[7] In some of the most important cases, winning bids were only slightly above the very modest starting prices.

Virtually all of the auctions were surrounded by controversy. Accusations of corruption, insider dealing and fraud abounded. As a rule, authorities did not repay the loans. In the end, some relatively large and well-connected Moscow-based banks, most notably Oneximbank and Bank Menatep, cheaply acquired major stakes in such important resource-oriented firms as Norilsk Nikel (associated with the largest nickel deposit in the world), Yukos (oil), Sidanko (oil), Surgutneftegaz (oil and natural gas), Novolipetsk Metallurgical Kombinat, Murmansk and Novorossisk Shipping Companies. The "winners" thus made handsome windfall profits and struck it rich.

The expansion of the GKO market and the shares-for-loans auctions accentuated a process of differentiation in the Russian banking sector that had already gotten under way earlier. One can distinguish at least three different groups of banks operating in the second half of the 1990s. Sberbank was (and still is) in a class of its own. Toward the end of the decade, the state-owned institution maintained around 200,000 employees and 33,000 branches and service posts on the territory of the Federation. This dwarfs the number of outlets of all other Russian banks put together. Sberbank accounted for almost a quarter of all assets of the banking sector at the beginning of 1997. Apart from retaining the lion's share of household deposits, it massively invested in state securities, which began to dominate its portfolio.[8] Sberbank also acted as an agent of the federal government in financing programs and handled the accounts of the Ministry of Finance.

Second, an increasing share of banking capital and assets came to be concentrated in a small group of Moscow-based banks. Among these were former state-owned specialized credit institutions, major players in the GKO market, prominent "winners" of the above-mentioned auctions, participants in numerous government programs as well as constituent parts of emerging financial-industrial groups (FPGs or Finansovo-promyshlennye gruppy), often with strong shareholding interests in many enterprises. At the beginning of 1997, the 22 largest Moscow-based banks accounted for 31% of net assets and 45% of credits of the banking sector. It is safe to assume that privileged access to state resources was pivotal to the expansion of Moscow-based banks.

A third group consisted of all other banks, mainly comprising institutions based outside Moscow. This group included a large number of tiny banks specializing in various short-term activities. Most of them functioned as pocket banks. Some credit institutions of this group were implicitly subsidized by regional authorities and granted loans to local industry. Only one or two banks

[7] *Foreign banks were excluded from bidding practically everywhere.*

[8] *In 1996 and 1997, Sberbank held around one-third of the total value of Russian government bonds.*

based in St. Petersburg were comparable in assets and clout to the large Moscow banks. In 1996 many regional credit institutions also acquired access to the GKO market (OECD, 1997, p. 92).

Boosted by the outcomes of the shares-for-loans deals, a number of FPGs gained influence and prominence in the second half of the 1990s. FPGs were usually set up by industrial enterprises and banks; occasionally state authorities (of various affiliations) participated, too. FPGs could be formally established (according to a presidential decree of December 1993, which even promised them some benefits) or informally created. Participating members were often – but not necessarily – tied together by cross-ownership of shares. In many cases, the ownership structure of FPG banks and major enterprises was complex and opaque, with offshore companies sometimes holding important positions.

In some regards, these conglomerates functioned as networks to cope with a difficult and unstable overall economic environment. In this respect, even behind-the-scenes connections with state organs could help. Banks would typically act as financial "clearing houses" of respective groups, provide convenience functions and finance investment projects of member firms (connected lending).[9] This may have contributed to conserving structures unviable in the long term. Some of the more important FPGs and largest Moscow-based banks have been headed by powerful "oligarkhs." Given the continuing weak presence of foreign investors in Russia, (home-grown) financial-industrial groups have at times even been depicted as elements of an alternative route to leading the country to industrial maturity.

Table 2

Russia: Banking Sector-Related Indicators

Year-end	Banks (of which in majority foreign ownership)	CPI inflation (year on year)	Deposit rate (average)	Lending rate (average)	Total assets of the banking sector	Domestic credit (nominal change)	Domestic credit to enterprises	Share of nonperforming loans in total loans	Household deposits	Funds attracted from enterprises and organizations	Capital (own funds)	Capital adequacy of banks with positive capital (capital/risk-weighted assets)
	number	*%*	*% per annum*		*% of GDP*	*%*	*% of GDP*	*%*	*% of GDP*			*%*
1994	. .	204.4	. .	. .	. .	335.6	12.1	. .	. .	. .	. .	. .
1995	2,297 (21)	128.6	102.0	320.0	. .	87.8	8.7	12.3	. .	. .	. .	. .
1996	2,029 (22)	21.8	55.1	146.8	. .	48.3	7.4	13.4	. .	. .	. .	. .
1997	1,697 (26)	10.9	16.8	32.0	30.1[1]	22.2	9.5	12.1	7.5[1]	5.8[1]	4.6[1]	23.4[1]
1998	1,476 (30)	84.5	17.1	41.8	39.8	68.2	12.6	30.9	7.6	13.0	2.9	19.8
1999	1,349 (32)	36.8	13.7	39.7	33.3	34.1	9.9	28.1	6.2	9.7	3.5	26.7
2000	1,311 (33)	20.1	6.5	24.4	33.4	13.7	11.0	16.1	6.3	9.9	4.1	24.9
2001	1,319 (35)	18.6	4.9	17.9	34.9	30.0	13.7	12.2	7.5	10.0	5.0	24.3
2002	1,329 (37)	15.1	5.0	15.6	38.1	29.6	15.3	11.4	9.5	10.1	5.4	22.2
2003[3]	1,329 (41)	12.0	4.5	13.0	42.1	51.5	17.8	. .	11.4	10.4	6.1	21.1[2]

Source: CBR, EBRD, OeNB.
[1] *Mid-1998.*
[2] *Mid-2003.*
[3] *Preliminary data or estimate.*

[9] *The economic efficiency of banks' activities in reallocating scarce financial resources within groups has been in doubt (Jasper, 1999, p. 50).*

6 Structural Imbalances and External Factors

For all these impressive and sometimes even breathtaking activities, credit institutions had not approached what is generally seen as the essence of commercial banking: efficient financial intermediation between savers and the real sector. In other words, incentives were skewed in such a way as to make the granting of loans intended for financing enterprises' productive capital formation difficult. Commercial bank loans to the nonfinancial sector declined to about 10% of GDP in 1997 (table 2). But this low share largely reflected loans to owner companies, very short-term credits and trade credits. Long-term (over one year) investment loans amounted to less than 1% of GDP. Large Moscow banks participating in FPGs have not shown any greater inclination to devote their funds to long-term investment than the banking sector as a whole. Some of the reasons for this major shortcoming of Russian banking will be identified in the following.

First, banks inherited problems from the past: They had difficulties in identifying profitable investment opportunities, encountered enterprises lacking a business reputation and a reliable credit history, and were equipped with insufficient skills for project evaluation. Second, banks suffered from problems connected to the way transition has materialized in Russia: There is a predominance of insider control in enterprises, the legal system is complicated, contract enforcement is weak or arbitrary and, more generally, the rule of law is not effectively assured. A long-standing and pivotal obstacle in this respect appears to be that creditor rights are insufficient, even if credits are collateralized. Third, the long-lasting economic contraction, which generally weakened incentives to invest in future production, weighed on banks.

Fourth, last but not least, banks were allured to lend to the government budget, which itself suffered from the liquidity squeeze of the whole economy. Thus, within the excessively tight monetary conditions of lacking liquidity, the sovereign debtor partly crowded out bank lending to the real sector. Not only domestic banks, but also foreign banks were more attracted by the highly profitable and seemingly less risky government debt market. On one account, namely the weakness of creditor rights, the (general) Bankruptcy Law, enacted in March 1998, was meant to improve the situation. But enforcement remained problematic.

Given this overall state of affairs, it is easy to understand why foreign banks have not rushed to Russia to engage in core banking activities there. In addition to the difficult environment, a number of administrative restrictions on the activities of foreign-owned banks were introduced by the CBR in 1993, among them a 12% limit on the share of foreign capital in the aggregate capital of the Russian banking sector. Some of these constraints – though not the 12% limit – were relaxed or removed in subsequent years. But the actual share of foreign-owned capital came to less than 4.5% on average in the period from 1996 to 1998 and thus remained far below the mentioned threshold and was very modest also in comparison to Central European countries at this time.

The further opening of the state securities market to nonresident investors in the course of 1997 (supported by the IMF) drove down GKO yields. This liquidity injection, which triggered cuts in key interest rates, supported some moderate recovery, with GDP reaching its first – if feeble – post-transformation real growth. Faced with capital account liberalization and decreasing GKO profits, Russian credit institutions managed to access new profit routes for themselves: They took up low-interest credits abroad to finance their GKO purchases, offered their services as intermediaries to foreign investors in GKOs, and offered foreigners forward contracts to cover currency risks. Russian banks did not deem these transactions to be very risky, given the continuing commitment of the CBR to defend its exchange rate corridor. Moreover, this exchange rate policy was part of the official economic strategy of the authorities and was endorsed by the IMF. All the same, capital flight from Russia, which was largely channeled through banks, remained buoyant in the heyday of GKO placements.

Starting in late 1997, a number of warning signs showed up. The continuous appreciation of the ruble in real terms ever since the introduction of the exchange rate corridor eroded the competitiveness of Russian industrial goods, and imports surged. In the fall of 1997, the country was severely hit by contagion from the Asian crisis via two main channels: First, the Asian crisis was one of the main reasons for the sharp fall of energy and raw material prices in the world market. Second, financial contagion led to a sudden reversal of capital flows, with accumulated foreign portfolio capital rushing for the exit. These factors together led to a strong deterioration of Russia's external accounts, and the liquidity squeeze reemerged in an even more acute form. Investors were withdrawing from the GKO market, although the central bank had hiked interest rates substantially and intervened strongly to defend the ruble, thereby cutting its foreign exchange reserves. The situation temporarily stabilized in the first quarter of 1998, but fundamentals, including the weak fiscal situation and tax administration, continued to deteriorate. Parliament repeatedly failed to enact a reformed tax code that was meant to raise revenues. Political instability connected to the abrupt change of government in spring further sapped confidence.

7 The Financial Collapse of August 1998 and Its Immediate Repercussions

Banks apparently started to sense that the ruble might be devalued in the second quarter of 1998 and essentially ceased to issue forward contracts in May of that year. Despite skyrocketing interest rates, by June/July 1998 the authorities were no longer able to roll over mature state securities by issuing new ones. Despite hasty attempts of some banks to reshuffle their portfolios, in July 1998 securities (still) made up over a third of all banking sector assets. Even the assistance package of USD 22.6 billion the international financial community granted to Russia, including the immediate disbursement of an IMF credit tranche of USD 4.8 billion at end-July, could not sufficiently calm investors and remedy the situation. In announcing their default on the internal debt and the devaluation of the ruble on August 17, 1998, the authorities dealt the banking sector a terrible blow. The declaration of a 90-day moratorium on private payments on obligations to foreigners was meant to give banks some respite to rearrange their activities. A strong and sharp depreciation of the ruble was followed by a spike in inflation which reached 85% in 1998 (year-end), then fell to 37% in 1999 and gradually receded further (table 1).

The vast majority of the large Moscow banks that had participated in the GKO market, taken up foreign currency loans or issued forward contracts immediately became illiquid, insolvent and decapitalized. Sberbank, a major holder of GKOs, was also severely affected. Many risky loans that banks had extended became nonperforming. Payment arrears between banks exploded, and the payment system collapsed. Most large banks holding deposits no longer served depositors trying to withdraw their money, and some banks, faced with runs, simply closed their doors. According to CBR calculations, aggregate banking capital, expressed in U.S. dollars, shrank from USD 19.1 billion at end-July 1998 to USD 3.7 billion at end-December 1998, thus amounting to less than 3% of GDP (table 2) (Bank of Russia, 1999, p. 88). At the beginning of 1999, the total assets of the Russian banking sector were estimated to amount to about a fifth of GDP, whereas in Hungary or Poland banking assets surpassed two thirds of GDP. A due diligence study of 18 of the largest Russian banks (but excluding Sberbank) carried out by World Bank experts at the request of the CBR and referring to the financial situation of banks in October 1998 is reported to have found that all reviewed credit institutions, except three, had negative net worth (Euromoney, 1999, pp. 262–263).[10]

Table 3

Structure of Balance Sheets of Russian Credit Institutions

	Assets								Liabilities							
End of period	Total assets	Claims on non-financial private enterprises and households	Claims on non-financial public enterprises	Claims on general government	Claims on other financial institutions	Foreign assets	Reserves/liquid assets	Other assets	Demand deposits	Time and savings deposits and foreign currency deposits	Money market instruments	General government deposits	Liabilities to monetary authorities	Foreign liabilities	Other liabilities	Capital accounts
	%															
Old structure[1]																
1995	100	57.3	57.3	18.3	0.2	13.5	10.7	–	56.6	56.6	. .	. .	2.3	8.8	12.8	19.5
1996	100	45.4	45.4	30.3	0.0	14.6	9.5	–	50.7	50.7	. .	. .	1.4	11.8	11.2	24.9
1997	100	43.7	43.7	31.5	1.3	11.8	11.8	–	52.0	52.0	. .	. .	1.4	16.9	6.5	23.3
1998	100	40.6	40.6	27.8	0.8	23.6	7.3	–	46.5	46.5	. .	. .	7.7	21.8	7.2	16.9
New structure																
Mar. 1998	100	38.6	4.7	34.6	1.0	10.8	10.3	–	22.5	26.7	6.1	2.8	0.7	16.9	–	24.2
Jun. 1998	100	40.0	4.8	33.3	0.8	11.6	9.4	–	33.7	33.7	7.5	2.9	2.0	20.2	3.5	30.1
1998	100	31.2	3.1	24.0	0.7	20.3	6.8	14.0	14.2	25.9	3.5	1.8	6.5	18.3	14.8	14.9
1999	100	29.2	2.6	24.5	0.7	20.7	9.0	13.3	14.0	25.5	6.0	1.6	11.2	12.5	12.9	16.4
2000	100	34.1	2.9	20.7	0.6	18.7	11.8	11.3	17.4	26.7	7.5	2.1	8.1	9.8	11.3	17.2
2001	100	41.0	2.3	17.3	0.7	15.9	10.1	12.7	17.3	27.5	7.3	2.0	7.3	9.3	10.9	18.1
2002	100	43.1	2.8	16.0	0.8	13.7	10.8	12.9	16.3	30.9	9.1	1.5	5.1	9.1	9.7	18.0
2003	100	47.8	2.5	12.8	1.0	10.5	13.3	12.2	17.3	30.7	9.4	1.5	3.5	11.8	9.8	15.7

Source: CBR Bulletin of Banking Statistics, various issues, 1995–2004.
[1] In the old structure, the "Foreign liabilities" column was labeled "Foreign clients' deposits" and the "Capital accounts" column was called "Equity capital."
Note: The share of foreign currency deposits in the sum of time and savings deposits and foreign currency deposits came to 42% at end-1996, rising to 50% at end-1997 and 67% at end-1998. Since then, it has fallen continuously, reaching 42% at the end of 2003.

The central bank was in a very difficult situation, since it neither had the necessary means at its disposal to refinance or recapitalize all or most large illiquid credit institutions (in particular with respect to their foreign debt obli-

[10] *All of Russia's five largest credit institutions as at July 1998 (save Sberbank, which was not reviewed) featured among the banks with negative net capital. The combined losses of the 18 banks in the wake of the crisis were calculated at USD 9.8 billion.*

gations), nor was it vested with sufficient legal and coercive power to take effective control of the problem banks and force them to restructure. The Russian government was not able (or willing), either, to provide sufficient resources for a genuine overhaul of the banking sector.[11] Therefore, policies to overcome the systemic crisis were hesitant, of limited effectiveness and controversial – although the central bank proved to be successful in restoring the operative capacities of the sector in relatively short time.

The CBR's first important step in reaction to the crisis was to relaunch the payment system and stave off a banking panic. This was done by reducing mandatory reserves of commercial banks and, in various cases, accepting GKOs at nominal value as reimbursement of credits despite the fact that GKOs had been frozen. A number of prudential regulations were relaxed, particularly those regarding minimum capital and capital adequacy, with the goal of giving the sector some time to recover. The CBR extended emergency loans to a number of credit institutions in need of liquidity. By far the largest loans and liquidity injections were granted Sberbank (Ippolito, 2002, p. 15). State-owned Vneshtorgbank also received substantial financial assistance. Further, private depositors at 6 distressed large Moscow banks and at about 30 other banks were allowed to transfer their accounts to Sberbank (which offered a state deposit guarantee). The devalued exchange rate for converting foreign currency deposits, however, implied considerable losses for depositors. By October 1998, interbank payments had more or less been reestablished and further runs by the population were averted.

8 Reaction to the Shock and Some Limited Restructuring

After the strong contraction in 1998, the Russian economic recovery started in 1999, supported by the significant easing of monetary conditions, as the exchange rate had fallen by 40% in real-effective terms by the beginning of 1999 and nominal key interest rates were raised much less than the sharply accelerating inflation rate (table 1). The ruble's substantial depreciation boosted the competitiveness of Russian manufacturing and import substitution. Then, importantly, oil and raw material prices started to recover again and rose quickly during 1999. In particular, oil prices doubled (from a low level) in the first half of the year. Liquidity in the economy sharply adjusted, contributing to a decline of payment arrears between enterprises and also to a rise in tax revenues (Reininger, 2000, p. 54). The fact that these changes impacted on the banks, but that the banks in turn hardly contributed anything to the recovery very well reflects the state of the banking sector at the time. In November 1998 the CBR and the Russian government presented a reconstruction plan for the banking sector, which, however, quickly proved to be inapplicable because initial lists of large Moscow banks worthy of rehabilitation implied too high a financial burden for the authorities (Walter, 1999, p. 15; OECD, 2000, p. 76).

Although the CBR continued to withdraw the licenses of insolvent banks after August 1998, the speed of this activity did not accelerate in the following

[11] *Furthermore, no debt-for-equity swap programs, which would have allowed foreign strategic investors to gain control of large parts of the banking sector, were implemented.*

months or in 1999.[12] Almost all banks that had their licenses removed were small or very small. Unfortunately, the monetary authorities were not able to bring decisive reform efforts to bear on larger banks; they could not nor did they prevent a further deterioration of the situation in a number of ailing entities. When the CBR in the fall of 1998 tried to revoke the licenses of, and appoint external administrators to, two large insolvent Moscow banks (Inkombank and SBS Agro), these decisions were contested and initially overturned in the courts. Only after considerable delays and legislative changes (see below) were the two institutions declared bankrupt.[13]

The situation provided incentives for asset stripping, fraud and capital flight.[14] In a number of instances, managers organized the transfer of assets of insolvent credit institutions to new structures (often called "bridge banks," "shadow banks" or "mirror entities"), leaving liabilities (particularly debts to non-FPG creditors) in the "shell" of the old bank. Bridge banks were usually controlled by the shareholders of the old banks and were often run by the same managers. For example, Oneximbank created Rosbank; Menatep St. Petersburg took over assets of Bank Menatep in Moscow and other regions; Impeksbank succeeded Rossisky Kredit; SBS Agro became part of the Soyuz Group and set up the First Mutual Credit Society (Euromoney, 1999, p. 258). The central bank leadership was criticized for an apparent lack of will to bring about decisive adjustments to the banking sector. Altogether, according to IMF estimates, the direct fiscal cost of the Russian financial crisis was minimal, compared to other crisis countries, but indirect effects via disruptions to the system, exchange and interest rate volatility and loss of confidence were significant (IMF, 2003a, p. 22).

1999 and the following years witnessed some limited progress in bank restructuring, though no breakthrough was achieved. Two new laws spelled out more precisely the formal rules for bank bankruptcy and rehabilitation: the Law on the Insolvency (Bankruptcy) of Credit Organizations and the Law on the Restructuring of Credit Organizations. The first law came into force in February 1999, the second in June 1999. The bank bankruptcy law strengthened the authority of the CBR to confront problem banks by requiring them to file for bankruptcy when their license is withdrawn. The bank restructuring law provided the legal foundation for the establishment of the state Agency for the Restructuring of Credit Organizations (Agenstvo po restrukturizatsii kreditnykh organizatsii – ARKO). This agency, actually already set up in December 1998, was made the sole body responsible for rehabilitating problem banks.

[12] *Actually, the withdrawal of licenses slowed down. In the period between the end of August 1998 and the end of March 1999, the CBR revoked about 88 licenses for violations of banking legislation and regulations. This was 46 less than in the same period a year before. On the other hand, the share of respective banks in total assets of the sector, while modest, was higher than a year before.*

[13] *Inkombank was finally declared insolvent by court in February 2000. The liquidation procedure took three years and left many creditors disappointed. In July 1999, the CBR introduced temporary administration in SBS Agro; an "amicable settlement" on the institution's bankruptcy was reached in February 2001 but fell far short of the expectations of most depositors.*

[14] *According to CBR estimates, illegal capital transfers abroad amounted to USD 25 billion in 1998, fell to USD 15 billion in 1999 and rose again to USD 23 billion in 2000. Capital exports have often been carried out in connection with offshore centers that give banking secrecy the highest priority, e.g. Cyprus, the British Channel Islands, the Bahamas (Pleines, 2002, pp. 120–121).*

According to the law, the CBR is obliged to transfer banks satisfying certain criteria of financial distress to ARKO's control (unless the monetary authority decides to revoke the banks' licenses outright). In the event of a transfer, ARKO is vested with significant authority over the bank in question, including the ability to write down shareholders' capital or to repudiate improper transactions undertaken by the bank's management (IMF, 1999, p. 91). But ARKO was only granted RUB 10 billion (about EUR 380 million at the exchange rate of mid-1999) of charter capital by the Ministry of Finance and has not received substantial financial support from any other source. Partly due to the paucity of financial resources, to some problems of coordination of its activities with those of the CBR as well as to persisting legal and political obstacles (see below), ARKO has not yet shown much impact on the banking sector.[15]

Despite the consolidation of its legal position, the CBR's attempts to effectively bankrupt (formerly) large banks and seize assets before they disappear or are moved to "safe havens" repeatedly ran up against problems of legal complexity and political resistance. Although the CBR eventually did revoke the licenses of a number of larger insolvent banks, this was typically only achieved after considerable delays. New laws were found to be inconsistent with a host of unchanged pieces of legislation. Further, liquidation procedures remained complicated and were often drawn out. The surviving political power of some oligarchs at the head of financial-industrial groups as well as corruption continued to hamper banking reform in Russia.[16] The enforcement of rights of minority shareholders and creditors remained selective at best. Bankruptcies and liquidations were liable to protect insiders and expose outsiders to considerable losses and disadvantages. On a number of occasions the behavior of the CBR and ARKO themselves seem to have been nontransparent and their handling of insolvent banks arbitrary (Vassily et al., 2000, pp. 19–20).

Added up, this probably also reflected a lack of political resolve to carry out serious bank restructuring efforts. In any case, the opportunity for an in-depth clean-up of the sector afforded by the crisis was missed. This contrasts with what happened in some Central European countries which had also encountered financial crises. Despite the authorities' assistance, the situation of Sberbank remained difficult. The CBR-owned credit institution had been a major purchaser of GKOs and, after having received substantial transfers of accounts as mentioned above, in mid-1999 had about 90% of all household deposits in Russia on its books. This once again made it a quasi-monopolist for private savings.

After their most important previous profit sources had been wiped out, Russian commercial banks were in want of new sources. In the weak and uncertain post-crisis situation of 1999, not much showed up. After the value of the entire banking sector's holdings of state securities had strongly shrunk, in the first months of 1999 banks appeared to reshuffle some of their activity (back) to "investing" in cash balances and deposits in foreign currency. Clearly, given the initial burst of inflation after the August 1998 devaluation and the accom-

[15] *Altogether, ARKO approved or conceived restructuring plans for about a dozen mostly smaller credit institutions. Among the bigger banks it temporarily assisted, Rossisky Kredit and SBS Agro are worth mentioning, but both were eventually wound up.*

[16] *After the passage of the bank bankruptcy law, about half of the top ten credit institutions were reported to have transferred most of their business to newly established "shadow entities," a move which was inconsistent with creditor rights.*

Table 4

Indicators of Real Growth of the Russian Banking Sector

	Assets	Corporate loans	Household deposits	Funds of enterprises and organizations	Own funds (capital)
Mid-1998[1]	100.0	100.0	100.0	100.0	100.0
End-1999	67.0	70.4	54.2	103.3	59.7
End-2000	90.1	109.4	69.7	143.8	84.6
End-2001	106.4	146.9	91.0	159.5	113.1
End-2002	125.2	174.7	122.4	172.5	125.8
End-2003	151.1	222.4	160.8	205.0	157.4

Source: CBR, BFI (Konsaltingovaya gruppa – banki, finansy, investitsii), own calculations.
[1] End-June 1998 = 100.

panying increased volatility of the exchange rate, renewed possibilities of benefiting from currency arbitrage and speculation emerged. But, owing to the quick reduction of inflation in subsequent months, this "window of opportunity" soon drew to a close again.

A more important motivation for acquiring sizeable foreign currency accounts may have been a desire to build up some low-risk investment abroad after having suffered a home-grown economic calamity. While liquidity recovered, possibilities for profitable investment in Russia were scarce for the time being.[17] Among the healthiest credit institutions appear to have been those attached to rich owners or clients, like profitable exporters and "natural monopolies," such as natural gas (Gazprom) and electricity. But the overall profitability of the sector was clearly negative in 1999 (OECD, 2000, p. 78).

9 Recovery and Fragile Expansion (since 2000)

The impact of the ruble devaluation on the Russian economy was reinforced by further rising oil and raw material prices, growing rents from related exports, sustained political stability since 2000, prudent macroeconomic policies and some positive effects of structural reforms, e.g. tax reforms.[18] Russian GDP has continued its recovery and expansion until present (June 2004). Economic growth rates have been robust indeed (2000: 10.0%, 2001: 5.0%, 2002: 4.3%, 2003: 7.3%, first quarter of 2004: 7.4% year on year). Higher capacity utilization facilitated initial swift growth; investments then rose. Current account surpluses have been strong (table 1).

Inflation declined further – although not as quickly as the authorities hoped for – and reached 15.1% at end-2002, 12.0% at end-2003 and 10.1% in May 2004 (year-on-year). The slowness of the decline was partly attributable to the continued inflow of large foreign exchange earnings. Given that the CBR has intervened against resulting ruble appreciation pressures and that it does not have sufficiently effective sterilization instruments at its disposal, the inflows translated into a swelling of the quantity of money and inflationary pressures. The CBR's foreign currency reserves (including gold) expanded swiftly, reached a record level of EUR 68.2 billion at end-March 2004 (about 17% of GDP) and are continuing to grow. Buoyed by the rising liquidity in the economy, budget-

[17] *As the CBR commented, "The dynamics and structure of banking assets in 1999 were largely determined by banks' desire to reduce risks and by a lack of profitable and safe areas for investment." (Bank of Russia, 2000, p. 78).*

[18] *Apart from tax reforms, the overall environment of Russian banking has been influenced by a host of other reforms undertaken so far in the Putin era, among them customs, labor market, pension, enterprise regulatory, land, energy and infrastructural reforms.*

ary revenues increased significantly. In addition, negative real interest rates and debt rescheduling decreased the level of interest payments. The fiscal situation improved radically and the federal budget even featured surpluses as from 2000. By the fall of 2003, about three quarters of the crisis-induced real effective depreciation of the ruble had been eliminated; this jeopardized the new-found competitiveness of the nonenergy branches of industry.

Rising earnings and the wealth of raw material extractors, exporters and linked industries attracted banks and provided a new base for banking activities. This development was later complemented by the steady recovery of the wage level and by pronounced pension adjustments (albeit from very meager post-crisis points of departure).[19] The stabilization of the general economic uptrend supported attempts to broaden fledgling financial intermediation. Sberbank was first to react by expanding its credit portfolio (already in mid-1999); most other banks followed later (in 2000). After having been overtaken by inflation during the financial crisis, real lending interest rates turned positive again. Real deposit rates remained mostly in negative territory, though. According to the CBR, by the end of 2001, the Russian banking sector had more than compensated the losses caused by the crisis, and its profitability had been restored. For the first time, typical banking activities started to play a substantial role in banks' endeavors in Russia, although these activities were not yet fully market-oriented.

Banking recovery gathered momentum in 2002 and 2003. As tables 2 and 4 show, at end-2003, total banking assets in real terms were about 50% higher than in July 1998 (just before the crisis). By end-2003, banking assets reached 42% of GDP (or approximately EUR 160 billion). The total volume of loans to the corporate sector more than doubled in real terms in the mentioned time span, coming to almost half of total assets. The volume of household deposits climbed by 60% (BFI, 2003a, p. 19).[20] Banks' total capital in real terms was more than 50% larger in December 2003 (amounting to 6% of GDP) than in July 1998 (Bank of Russia, 1998–2004). Profitability rose, with banks' return on equity (ROE) passing from 8% in 2000 to 12% in the first half of 2003 (BFI, 2003a, p. 19). Yet these data are based on official Russian accounting standards (RAS), which tend to put greater emphasis on formal reporting requirements than on material elements and economic meaning.[21] As can been seen in table 3, reserves and liquid assets are relatively high.

The quality of measured capital is questionable and loan loss provisioning may not fully reflect risks. A (still) not infrequent way of dressing up the books appears to be that banks grant loans to their shareholders, who then use the funds to "boost" capital.[22] If high assets risks were accurately taken into account, a number of credit institutions could end up with negative net worth. The still modest level of capitalization of most Russian banks contributes to higher

[19] *But mistrust of private depositors (many of whom had lost large parts of their bank savings twice during the reform period) has only been gradually overcome.*

[20] *Strong deposit and lending growth continued in the first quarter of 2004. At end-March 2004, total household deposits were 20% higher (in real terms) than a year before and total loans to companies had expanded 30% over the previous year.*

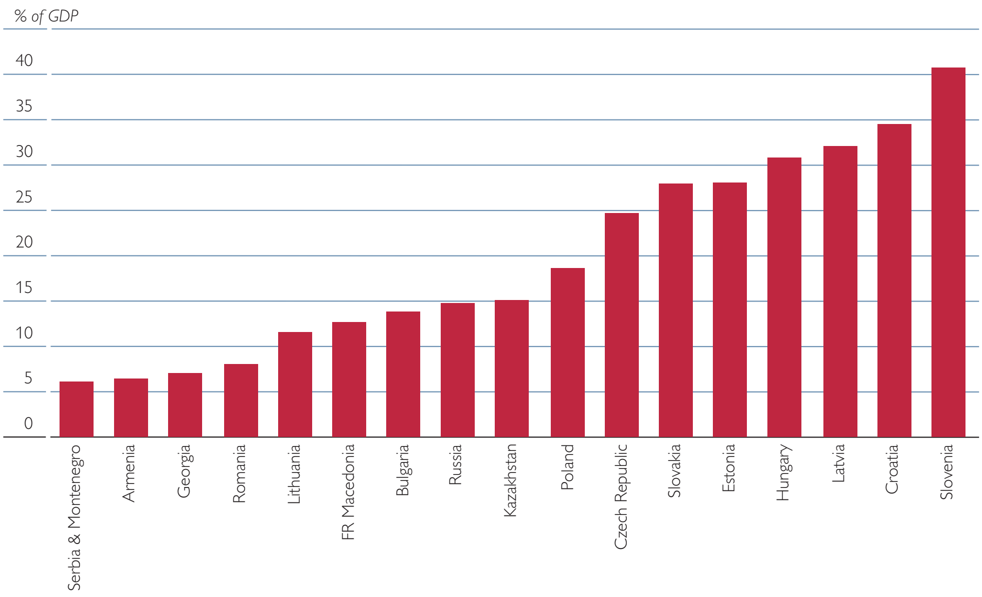
[21] *For a concise comparison of RAS and IAS, see Banerji et al., 2002 p. 49.*

[22] *This is also dubbed "roundtripping of loans to shareholders" (Odling-Smee et al., 2003). 60 out of 180 credit institutions recently examined by the CBR were reported to have shown signs of fictitious capital. According to some expert estimates, between 20% and 60% of banking capital may be accounted for by fictitious assets (Kostikov, 2004, p. 5).*

(potential) credit risk, fewer loans and less public trust. Compared to other transition economies, and in particular to the new EU member countries, the degree of financial intermediation has remained relatively low in the Russian banking sector, even though the situation improved in the period from 2001 through 2003, when the gap was somewhat reduced.

Chart 1

Domestic Credit to the Private Sector in 2001



Source: EBRD Transition Report 2002.

Thus, household deposits in Russian credit institutions grew from 6% of GDP at end-1999 to 11% at end-2003, and domestic loans to the enterprise sector correspondingly expanded from 10% to 18% of GDP (see table 2 and chart 1). Credits to firms averaged around one third of GDP in the central European new Member States of the EU in 2003. Only 4% to 5% of investment financing in Russia comes from banks, compared to over 15% in many other countries (Komulainen et al., 2000, pp. 9–10; Mazzaferro et al., 2002, p. 16). In particular, the Russian banking sector has not linked the great need for capital in small and medium-sized companies (SMEs) to the large amount of existing capital generated by the big natural resource businesses.[23]

10 Structure and Activities of the Banking Sector

When the dust of the crisis had settled, it was clear that state-owned credit institutions had become the dominant players in Russia. Coming to 1,327 as of end-May 2004, the total number of Russian banks is still high. The total number of licensed credit institutions essentially stopped declining in 2000. Since then, license withdrawals have been, by and large, offset by new licenses granted.[24] The head offices of more than half of all credit institutions remain in Moscow

[23] *According to expert estimates, banks cater to only about one-fifth of the potential market for credit to SMEs. The total amount of current loans to small business does not exceed USD 1.5 billion, which corresponds to about 3% of the total credit volume extended to enterprises (Plisetsky, 2003, p. 16).*

[24] *The only country with more commercial banks than Russia appears to be the U.S.A., which has some 9,000 banks.*

or Moscow Oblast. Today, Russian commercial banks can be subdivided into four basic groups: first, the big state-owned banks Sberbank and Vneshtorgbank; second, the next 15 to 20 mostly private banks, currently dominated by institutions owned by big raw material producers; third, numerous small banks; fourth, foreign-owned credit institutions.[25] The largest two dozen banks have more assets than all the remaining 1,300 credit institutions put together. 80% of Russian banks continue to be very small, with equity capital per bank not exceeding EUR 5 million, 50% of Russian banks do not have more capital than EUR 1 million. These "dwarf banks" are often undercapitalized and many of them are not considered to be stable institutions. On the other hand, given their flexibility and adaptation to their environment, a number of these banks are deemed to play useful roles in the regions (OECD, 2002, p. 59).[26]

Sberbank remains by far the biggest player in the market. Although it has been closing some of its outlets in recent years, it still has about 190,000 employees and 20,000 branches and service points across Russia at its disposal, and it is the only bank present in a few outlying and far-flung areas of the federation – which to some degree may reflect an infrastructural role. Sberbank's branches and outposts continue to dwarf those of all other banks put together (about 2,200). This implies an average branch-to-bank ratio of less than two for the rest of the sector. The state Savings Bank claims about a quarter of total banking assets. Owing to increased competition, Sberbank's market share of total household deposits declined to 61% at end-March 2004 (which corresponds to the share it had in the mid-1990s). A large part of deposits at Sberbank are pension accounts. While Sberbank used to be the largest buyer of public debt instruments, it has over recent years strongly expanded its exposure to the corporate sector, in particular to the oil and natural gas industries, with a high level of concentration of loans, thus incurring greater risks. Sberbank's share in the sector's total credit volume grew from over one-fifth at end-1998 to almost 32% at end-2000, before receding to 29% at end-2003.

Vneshtorgbank has also widened its activities from financing foreign trade to crediting industrial and commercial enterprises. As of end-2003, Sberbank and Vneshtorgbank together accounted for one-third of the total amount of Russian banks' credit portfolios (see also table 8). Thus, the large state-owned banks have become preeminent not only in deposit taking, but also in lending. If we add the banks that are (more than 50%) owned by various central, regional and local authorities and state bodies, 38% of banking sector assets were reported to be in public ownership.[27] At end-2003, majority state-owned banks accounted for 39% of loans to the real sector and for 70% of household deposits. While state-owned credit institutions loom larger, private banks have become more oriented to servicing business as opposed to government organs. The majority of private credit institutions, whether small or large, remain agent or pocket banks. This may help explain why many Russian banks do not have any branches at all. Most of the larger banks are probably members of FPGs. Excluding Sberbank and Vneshtorgbank, the 15 to 20 next largest credit insti-

[25] *The fourth group partly overlaps with the second and the third one.*

[26] *In some regions, pocket banks may be the only local competitors to Sberbank.*

[27] *Altogether, state bodies reportedly hold majority stakes in more than 20 banks and minority stakes in over 800 credit institutions (Chowdury, 2003, p. 8).*

Table 5

Structure of Personal Deposits Disaggregated by Maturity

	Demand deposits	Deposits with a maturity of up to one year	Deposits with a maturity of over one year
	%		
Mid-1998	41.2	51.8	7.1
End-1998	37.6	55.2	7.3
End-1999	30.5	63.9	5.6
End-2000	31.5	57.1	11.3
End-2001	25.0	51.0	24.0
End-2002	20.0	45.2	34.8
End-2003	18.5	38.5	43.0

Source: Bank of Russia Bulletin of Banking Statistics, various issues.

tutions together account for slightly fewer assets, and have granted slightly more loans, than Sberbank.

The rise in natural resource prices has boosted the fortunes of many banks connected to large producers and exporters of oil, gas, metals and other raw materials. Among the largest "RawMat banks" are Gazprombank (associated with the natural gas monopolist Gazprom), Rosbank (linked to Norilsk Nickel), Bank Petrokommerts (attached to Lukoil) and Surgutneftegazbank (Hainsworth, 2002, pp. 26–27).[28] The resource price rises appear to have strengthened, or injected new "life" into, a number of financial-industrial groups. Doubtlessly, after the crisis of 1998 many banks no longer retain the dominant positions in FPGs they once had (in the wake of the shares-for-loans deals). Preeminence is held by the resource enterprises themselves. The endurance of FPGs also has to be seen against the backdrop of a lingering problematic environment for financial intermediation in Russia and slow-moving progress of reforms in this field. It continues to be difficult for Russian banks to "lend on the free market."[29]

Average maturities of deposits and loans have increased over the past few years. For example, the share of medium- and long-term loans (with maturities exceeding one year) in the total volume of corporate credits expanded from 35% at end-1999 to 38% at end-2003; the corresponding share of medium- and long-term household deposits increased from 6% to 43% in the same time span (table 5). Particularly the latter evolution can be taken as a sign of growing trust in the banking system. In 2003, retail deposits overtook commercial deposits in Russian banks for the first time (table 2). There are even signs that money Russians have traditionally stored in their homes is partly flowing into the banking sector (Aris, 2004b, p. 100). However, owing to the fact that Russians are legally entitled to withdraw money on short notice even from their longer-term deposits, banks' resource bases have not necessarily become more stable. The level of "dollarization" of banking is still relatively high in Russia: Approximately one-third of loans to enterprises and one-third of household deposits are denominated in foreign currency, predominantly in U.S. dollars (although the euro has been slowly making inroads) (table 6). Comparing the level of disposable income to the level of retail accounts between Russia and other countries

[28] *Gazprombank may currently qualify as the largest pocket bank.*

[29] *According to nonofficial estimates, around half of all Russian bank loans were extended to related parties or insiders in 2001 (RECEP, 2002, p. 13).*

Table 6

Structure of Corporate Loans in Rubles and Foreign Currency[1]

	Rubles	Foreign currencies
	%	
Mid-1998	58.4	41.6
End-1998	33.2	66.8
End-1999	54.9	45.1
End-2000	66.5	33.5
End-2001	69.0	31.0
End-2002	65.5	34.5
End-2003	67.0	33.0

Source: Bank of Russia Bulletin of Banking Statistics, various issues.
[1] *Predominantly U.S. dollars.*

indicates that retail accounts could be two to three times larger in Russia than they are at present, which reflects Russia's catching-up potential.

One of the reasons why Russia is trailing behind other economies with respect to the size of its retail deposits is the persistence of negative real deposit interest rates. Despite many changes, it remains relatively difficult – particularly for the population at large – to preserve the real value of savings. Many people (as well as banks) are increasingly investing in real estate – which has given rise to a possible speculative bubble on the housing market. In 2003 the U.S. dollar prices for real estate in Moscow grew by 40%, in the first quarter of 2004 by 7% to 8%.[30]

Consumer loans have been growing briskly in recent years, albeit from a very modest starting point. Their share in total credits expanded from 4.5% at end-1999 to 10.0% at end-2003 and 12% to 13% in March 2004. After financing purchases of household appliances and automobiles, some banks marked a milestone by launching mortgage loan programs. Russian credit institutions have continued to assist in exporting capital after the financial crisis; however, capital flight has been on a declining trend in recent years, although it appears to have regained some momentum in the second half of 2003. Many observers believe this (temporary?) reacceleration of capital flight is linked to the "Yukos affair" – the Russian judiciary's investigation (since July 2003) into charges of corporate wrongdoing and tax evasion on the part of the management of the oil firm Yukos and the arrest (in late October 2003) of the CEO of Yukos. While overall net private capital outflows fell in 2003 by almost two-thirds to USD 2.9 billion, a USD 8.7 billion net outflow was recorded in the third quarter, followed by a USD 2.5 billion net inflow in the fourth quarter of the year (EBRD, 2004, p. 64).

On the other hand, enterprises have been trying to supplement insufficient domestic bank credit by raising funds in domestic and international capital markets. In 2002 the – very modest – Russian bond market was booming. The face value of outstanding corporate bonds rose from EUR 2.8 billion in January 2002 to EUR 6.8 billion a year later. Russian direct corporate borrowing abroad, which bypassed the domestic banking system, has expanded vigorously in the wake of sharply declining global interest rates, lower sovereign spreads and easier access to foreign capital markets.[31] Expectations of upward pressure on

[30] *Information supplied by Vasily Astrov (wiiw).*
[31] *This became possible after restrictions on cross-border borrowing were lifted in October 2001.*

the exchange rate of the ruble have contributed to the attractiveness of taking up funds abroad. Indeed, at the end of 2003 corporate liabilities incurred abroad reached a level which exceeded one half of what the sector owed to domestic banks.

Russian credit institutions themselves have increasingly taken up funds abroad. Throughout 2003, their (positive) net investment position abroad declined to around zero. Russian banks have also issued eurobonds. Already at end-2001 Gazprombank made a large emission (of USD 200 million), followed at end-2002 by Alfabank (USD 175 million), MDM bank (USD 200 million) and other institutions staging smaller issues (BFI, 2003b, p. 110). The fact that Moody's granted investment grade rating to Russia in October 2003 boosted banks' efforts to mobilize funds on international financial markets. While Russian sovereign debt has continued to decline, Russian private external liabilities have been on the rise.

If funds taken up abroad are on-lent to enterprises, they almost exclusively benefit large and financially attractive companies.[32] Russian SMEs have no choice but to try to solicit credits domestically, if at all (Astrov, 2003, pp. 36–37). Lending to SMEs has remained feeble generally, owing to a number of informational and institutional obstacles, including a lack of information on small firms' credit records and cumbersome procedures which have to be observed when extending credits to SMEs, even if they were originally tailored for big loans (Astrov, 2003, p. 47). Increasing competition is witnessed by a trend of declining spreads between banks' deposit and lending rates. Thus the average spread fell from 18% at end-2000 to 8.5% at end-2003 (table 2). Other indicators of improvements in the overall investment climate are some recent large contracts with foreign investors in the energy sector, holding out the prospect of an imminent rise in FDI.[33] But the Yukos affair and questions it raises about the security of property rights in Russia may dampen some expectations about FDI.

Foreign direct investment and ownership continue to play only a minor role in Russian banking – in stark contrast to many other transition countries. At end-March 2003, the 37 majority foreign-owned banks accounted for about 8% of total banking assets and 7% of banking capital (table 7). Foreign-owned banks have mainly focused their business on servicing international enterprises and big domestic exporters and manufacturers, but some foreign banks have also ventured into catering to wealthy Russian private customers. Foreign-owned credit institutions hold important positions on the interbank loan markets. The International Moscow Bank (Mezhdunarodny Moskovsky Bank or MMB),[34] Citibank (U.S.A.) and Raiffeisenbank (Austria)[35] were among the largest 15 Russian credit institutions (measured by assets) at end-2003

[32] *The recent swift expansion of corporate foreign debt has given rise to concern, particularly in the event of a sharp decline in oil prices.*

[33] *For example, BP announced in February 2003 an investment valued at USD 6.8 billion over three years. If carried through, this project would dwarf all other foreign investment undertaken in the country. The total inflow of FDI in the first nine months of 2003 came to nearly USD 5 billion, an increase by 77% against the corresponding period of the previous year. However, it is not yet clear whether this is just a spike in FDI activity or whether it will usher in more far-reaching changes.*

[34] *The MMB has a number of foreign shareholders, among them Hypo-Vereinsbank (HVB, Germany), Merita Nordbanken (Finland/Sweden) and the EBRD.*

[35] *Raiffeisenbank ranked seventh in terms of intake of household deposits at end-2002.*

(table 8). ING Bank Evrazia (Netherlands), Commerzbank (Germany), ABN AMRO (Netherlands) and Deutsche Bank (Germany) featured among the top 40.

The relatively weak presence of foreign capital in the Russian banking sector is certainly in part attributable to the impact of the crisis of 1998, when many foreign-owned banks and foreigners had lost a lot of money. This impact has not yet fully worn off. The 12% limit on the share of foreign capital in the aggregate capital of the Russian banking sector was declared invalid by the CBR in the fall of 2002.[36] But some administrative restrictions on foreign participation in the Russian banking sector still exist, the most important one being a (de facto) ban on the opening of branches of foreign banks (as opposed to the more onerous process of establishing subsidiary banks).[37] Moreover, the purchase of bank equity by foreigners generally requires an authorization by the CBR. Mergers and acquisitions appear to be money- and time-consuming and particularly difficult to carry out administratively in Russia.

Some risks relate to possible unequal treatment of foreign versus Russian-owned banks in the actual interpretation of laws and regulations by courts. Opening up the domestic market to foreign banks remains a politically contentious issue; many Russians seem to fear that weak and undercapitalized domestic credit institutions would not withstand competition from foreign "predators" who would "gobble up" the sector. In any case, as long as the country's investment climate remains relatively unfavorable for foreign banks, there does not seem to be a chance or danger that foreign banks could move into Russia on a large scale.[38] The banking sector is thus largely deprived of an important source of competition and modernization.

Table 7

Share of Foreign-Owned Credit Institutions[1] in the Russian Banking Sector

	Assets	Loans and other placements with enterprises	Loans, deposits and other placements with banks	Correspondent accounts with non-resident banks	Household deposits	Funds of enterprises and organizations	Equity capital
Mid-1998	6.7	8.9	14.6	6.4	0.7	7.2	5.0
End-1999	10.6	9.9	31.8	10.0	1.8	14.9	10.3
End-2000	9.5	7.1	33.0	15.7	1.7	14.0	9.4
End-2001	8.8	7.2	31.3	20.1	2.3	11.7	7.7
End-2002	8.1	7.1	25.9	22.9	2.3	10.3	7.1
End-March 2003	7.7	6.9	22.3	24.9	2.2	10.4	6.7

Source: CBR, BFI (Konsaltingovaya gruppa – banki, finansy, investitsii).
[1] Refers to banks with more than 50% foreign ownership of statutory capital.

[36] *Actually, the 12% limit, while often cited, never really played an incisive role. Only during some months of 1999, when subsidiary banks of nonresidents were recapitalized after the financial crisis, was the stipulated quota actually exceeded (e.g. March 1999: 13.5%), and in this case the authorities seem to have turned a blind eye. Then, following Russian banks' recovery, the share of foreign capital declined again (BFI, 2003b, p. 81).*

[37] *There does not appear to be a law or explicit normative act of the CBR that would ban the opening of branches of foreign banks. Still, only Bank Austria and the Armenian bank Anelik seem to have succeeded in surmounting administrative barriers and opening Russian branches. This unsatisfactory state of affairs for foreign banks is one of the issues being discussed in Russia's WTO accession negotiations (Handelsblatt, 2003b).*

[38] *The banking sector is estimated to account for only about 1% of the total amount of foreign investment in Russia. In contrast, in Poland FDI in the financial sector makes up about one-fifth of total FDI in the national economy (Gamza, 2003, p.11; BFI, 2003b, p. 53).*

11 Recent Policy Efforts and Current Situation (2003 to 2004)

In 2001 and 2002 amendments to the law on banks and banking activity, the bank insolvency law and the central bank law enhanced the legal framework for licensing and restructuring credit institutions and for prudential supervision (Perret, 2001, p. 44; Rucker et al., 2001, p. 129). Among other novelties, consolidated accounting was introduced for bank groups, and bank bankruptcy procedures were streamlined. In December 2001, the CBR and the government adopted a medium-term "Strategy of Russian Banking Sector Development," essentially a joint plan for further banking sector reform. The document inter alia proposes measures to create a level playing field for state and private banks, to strengthen accounting standards and improve commercial banks' risk management. The authorities also strive for better law enforcement with regard to credit contracts and other contracts.

The change at the helm of the CBR in March 2002 heightened the central bank's awareness of the major unsolved structural problems affecting the sector. Bank supervisors have been undergoing retraining with the goal of alerting them to reviewing material compliance of banks with prudential standards instead of pure formal checking. In September 2002, procedures for on-site as well as off-site bank inspections were reinforced and a special CBR department, the Main Inspectorate for Credit Institutions (Glavnaya inspektsia kreditnykh organizatsii, GIKO), was set up (Kommersant bank, 2002, pp. 25, 28). A new general bankruptcy law was enacted in October 2002, updating earlier 1998 legislation. The new rules inter alia enhanced the transparency of bankruptcy proceedings and strengthened the rights of secured creditors. However, full and effective application requires complementary advances in related reform areas. In the face of strong vested interests, banking reform has continued to encounter difficulties. In the most recent months, however, reform efforts appear to have intensified.

In late 2002, the authorities reached a tentative agreement with the EBRD on the sale of a stake of up to 20% in VTB; the IFC also plans to participate in the privatization of VTB, possibly with a debt-equity swap. The federal government has asked regional, local and other state bodies to sell off their remaining minority stakes in numerous banks. For a number of reasons the authorities are not planning to privatize Sberbank in the near future. The bank is very large in relation to the entire sector and any radical adjustment might destabilize the situation. While any sale to a foreign investor would be politically unacceptable, selling to domestic investors could be risky, given lingering doubts about existing skills and corporate governance. Owing to its extensive regional service, Sberbank does appear to have some social importance.

For the moment, the authorities' strategy seems to be to foster the development of the sector as a whole, hoping that in this process the relative importance of Sberbank will decline, facilitating its privatization in the future. After the adoption of antimoney laundering legislation and regulations in early 2002, Russia was removed from the "black list" of uncooperative countries of the Financial Action Task Force on Money Laundering (FATF, an international institution linked to the OECD) in October 2002. In June 2003, the country even gained membership of the FATF.

Today, the most important risks Russian credit institutions face differ from those before the financial crisis: There is neither a notable currency mismatch between claims and liabilities nor do banks record a heavy exposure in investment in short-term government paper. But there remain substantial structural weaknesses. The recent swift expansion in lending bears a considerable risk potential, taking into account the often noncompetitive nature of lending operations (insider lending, related party transactions) and their partly fragile basis (poor corporate governance, high prices for oil and raw materials). This is aggravated by the fact that a small number of debtors and creditors account for the majority of both loans and deposits (reflecting high portfolio concentrations). Moreover, notwithstanding considerable improvements, many Russian credit institutions may still lack the capacity to accurately price and manage their risks. The ownership structure of many banks remains intransparent. So-called "evergreening" continues to be practiced, i.e. concealing dubious loans by handing out a fresh credit to cover the repayment. There are doubts on the soundness of credits, which points to the persistent vulnerability of the Russian banking sector.[39] Despite progress in attracting personal deposits, there is still some mistrust in Russian credit institutions, which points to the lingering memory of the fallout caused by the 1998 crisis.

Any sustained fall of the oil price or pronounced downturn of the business cycle would certainly constitute a genuine stress test for Russian banks. According to recent IMF estimates, a hypothetical decline in asset quality of a similar dimension as witnessed during the 1998 crisis, for example caused by a sharp and sustained reduction in raw material prices, would have an impact equivalent to 3% to 5% of GDP and wipe out the capital of banks accounting for some 80% of sector assets. But the authorities would be in a much better legal and material position to intervene than some years ago.[40]

Since late 2003, the authorities seem to have been successful in passing or moving forward a number of important banking reform initiatives, thereby appreciably stepping up the pace of change. The upgrading of prudential supervision, the introduction of international accounting standards (IAS), the adjustment of minimum capital requirements to EUR 5 million (from currently EUR 1 million) and the creation of a general mandatory deposit insurance scheme feature among major planned banking reform measures that have been discussed for a long time in Russia. Opposition to IAS and higher capital requirements comes particularly from the Association of Russian Banks. It rightly fears that enforcement would leave many smaller credit institutions unable to secure their licenses to operate. The Association argues that small banks have their own niches.

Pivotal components of updated prudential rules have already reached the statute books. The CBR recently radically revised its Instruction No. 1 On Banks' Mandatory Norms (Ob obiazatelnykh normativakh), which entered into

[39] *According to assessments by some Russian and foreign experts, the share of potentially problematic loans in banks' total loans may amount to between around 40% to 70% (Vedomosti Forum, 2003, p. 22).*

[40] *According to the IMF, sustained distress would be a valid assumption if the price of a barrel of oil were to drop to low double digits (e.g. USD 12 to USD 14) for an extended period (up to one year). Regarding the above-mentioned figures, one should note that IMF staff had conducted an exercise of mapping RAS data into IAS data for an extensive sample of large banks before doing stress test calculations (IMF, 2003a, pp. 7, 21–25).*

force in April 2004. Instruction No. 1, which constitutes a major element of the CBR's regulatory framework, had remained unchanged in substance for a decade. The new rule exemplifies efforts to shift from form to substance in regulation and, according to experts, may bring about a real improvement in the quality of CBR supervision in that it reduces opportunities for banks to manipulate their accounts in order to meet prudential ratios. Another welcome change relates to a new instruction on the calculation of bank capital for use in prudential ratios, which tightens the rules for making such calculations. But implementation promises to be difficult. Retraining regulatory staff will be a major challenge, since their overall approach will need to undergo a fundamental adjustment (OECD, 2004, p. 202–203).[41]

Higher capital requirements are planned to become effective for all banks in 2007; currently, they only apply to new banks. The binding adoption of IAS, originally envisaged for 2004, has recently been postponed to 2006 or 2007. As of the beginning of 2004, Russian banks are required to draw up financial statements in accordance with IAS – alongside RAS. But the IAS reports are not to be used for regulatory purposes until 2006 or 2007.[42] These obligations and standards, once properly introduced, can (and should) be used as a basis for reliably assessing and screening banks. According to estimations, around half of Russian banks would have significant trouble in immediately and exclusively applying the IAS regime, as their net assets would probably be substantially lower when measured by international standards. Today, most banks would have major problems to fulfill tightened minimum capital requirements owing to their undercapitalization. Many would only be left with the option to merge or go under.

Draft deposit insurance legislation was finally submitted to the State Duma in early 2003, passed and signed into law in December of the same year. This piece of legislation constitutes perhaps the most important banking reform adopted in recent years. Such insurance is considered an essential step toward boosting confidence in the sector and creating a level playing field for state-owned and private credit institutions. Sberbank (and other state-owned banks) will thus lose the privilege of monopolizing household deposit guarantees. The law provides for the introduction of guarantees on accounts up to a threshold of RUB 100,000 (around EUR 2,840 as of June 2004) in banks authorized to participate in the insurance; these banks are to finance the scheme with their own premium contributions, equivalent to 0.6% of respective savings volumes. Premiums are to go into a fund managed by ARKO (the Agency for Restructuring of Credit Organizations). The state will step in if the fund's financial means are insufficient to carry out its mandate. Sberbank has opposed this legislation. In order to counter moral hazard inherent in the insurance scheme, the authorities intend to make access to deposit insurance subject to stringent conditions (inter alia, higher standards for capital, transparency and management). Thus, unsound and imprudently managed credit institutions may lose the authorization to hold deposits or even lose their banking licenses.

[41] *In this important endeavor the CBR can enlist European support: The ECB, together with nine national central banks – including the OeNB – are participating in an EU-funded Tacis project which will provide training to 400 staff members of the CBR and is designed to strengthen banking supervision in Russia. The project was launched in late 2003.*

[42] *Numerous pieces of legislation may require revision for IAS to be fully enforced (Renaissance Capital, 2002, p. 59).*

Table 8

Russia's Top 20 Banks (as at January 1, 2004)

Rank	Bank	Majority owner	Location of headquarters	Assets		Extended credits[1]		Liabilities[1]		Private deposits[1]		Equity capital		Profit before taxes
				RUR billion	*% of total banking assets*	*RUR billion*	*% of total*	*RUR billion*	*% of total banking liabilities*	*RUR billion*	*% of total*	*RUR billion*	*% of total banking capital*	*RUR billion*
1	Sberbank	State	Moscow	1,502.45	26.8	564.18	29.1	966.38	30.0	693.03	67.5	147.79	18.1	39.45
2	Gazprombank	Gazprom (state)	Moscow	219.71	3.9	48.45	2.5	128.34	4.0	14.61	1.4	28.50	3.5	5.58
4	Alfabank	Alfa group (FPG)	Moscow	195.97	3.5	101.37	5.2	121.29	3.8	23.93	2.3	23.24	2.8	0.30
5	Mezhdunarodny Promyshlenny Bank	Shares distributed among legal entities (total number 40)	Moscow	136.90	2.4	90.54	4.7	87.20	2.7	0.72	0.1	28.75	3.5	0.55
6	Rosbank	Interros FPG	Moscow	114.72	2.0	33.67	1.7	56.95	1.8	11.84	1.1	11.49	1.4	1.10
7	MDM (Moskovsky Delovy Mir) Bank	MDM FPG	Moscow	114.05	2.0	39.34	2.0	72.15	2.2	5.90	0.6	8.93	1.1	0.67
8	Bank Moskvy	City of Moscow	Moscow	111.05	2.0	53.65	2.8	80.14	2.5	25.50	2.5	10.98	1.3	1.98
9	MMB (Mezhdunarodny Moskovsky Bank)	HVB Bank / CBR	Moscow	80.96	1.4	21.92	1.1	75.67	2.4	7.05	0.7	5.74	0.7	3.03
10	Promstroybank	Shares distributed among legal entities and private individuals (total number 20,733)	St. Petersburg	68.10	1.2	30.37	1.6	43.31	1.3	8.28	0.8	5.22	0.6	2.06
11	Uralsibbank	Nikoil Banking and Investment Group (75% of voting shares), Republican government of Bashkortostan, Bashneft	Ufa	65.38	1.2	24.37	1.3	35.81	1.1	7.40	0.7	11.29	1.4	1.03
12	Citibank	Citigroup	Moscow	62.49	1.1	28.29	1.5	52.06	1.6	11.84	1.1	8.21	1.0	2.54
13	Raiffeisenbank	RZB Austria	Moscow	62.20	1.1	18.84	1.0	39.71	1.2	9.13	0.9	4.14	0.5	2.76
14	Bank Petrokommerts	Lukoil	Moscow	44.41	0.8	12.81	0.7	25.66	0.8	3.90	0.4	7.83	1.0	1.77
15	Bank Menatep St. Petersburg	Menatep FPG	St. Petersburg	37.65	0.7	16.76	0.9	36.28	1.1	6.61	0.6	3.22	0.4	0.34
16	Promsviazbank	Shares distributed among legal entities (total number 12)	Moscow	37.36	0.7	13.75	0.7	20.69	0.6	1.72	0.2	4.02	0.5	0.53
17	Nomosbank	Shares distributed among legal entities related to the defense sector	Moscow	36.64	0.7	14.69	0.8	15.38	0.5	1.19	0.1	4.95	0.6	0.36
18	Trastbank	Bought out by its managers from Menatep FPG	Moscow	34.60	0.6	×	×	×	×	×	×	5.35	0.7	1.01
19	Nikoilbank	Mr. Alekperov (head of Lukoil), Mr. Tsvetkov (CEO of Nikoilbank)	Moscow	34.54	0.6	14.73	0.8	16.25	0.5	3.67	0.4	6.66	0.8	0.45
20	Bank Zenit	Shares distributed among a group of individuals (mostly bank managers) and legal entities from the Republic of Tatarstan (Tatneft a.o.)	Moscow	32.15	0.6	14.79	0.8	19.95	0.6	2.30	0.2	3.25	0.4	0.93

[1] *As at January 1, 2003.*

Note: Vneshekonombank is not listed here. It is a special state-owned institution that was established in the final years of the Soviet Union and whose main task is to service former USSR debt assumed by the Russian government.

Source: CBR, Ekspert (March 22, 2004), WIIW, Interfaks.

The planned implementation calendar of this ambitious screening process promises to pose a tremendous challenge for the CBR, not least because of the very demanding time scales set out in the legislation. The law entered into force at end-December 2003. The deadline for credit institutions to apply for admission to the scheme expires end-June 2004. The CBR in turn is required to carry out a thorough examination of each bank applicant within nine months of application. This implies that the central bank will need to conduct intensive reviews of a very large number of banks (probably over 1,000) by end-March 2005. Credit institutions rejected at first application will have the option to apply for a second review, triggering new deadlines, which are to produce a final decision by end-November 2005 at the latest. This process is not only bound to stretch the resources of the CBR, it is also liable to severely test its capacity and political will to enforce much more rigorous banking standards. It could also bring about a major shake-up of the banking sector (OECD, 2004, pp. 202, 214).[43]

12 Conclusions

Russian banks have come a long way and have been through many ups and downs since the collapse of communism. Changing incentives have not always meant improving framework conditions. In a somewhat exaggerated manner, one could divide Russian banking developments since the end of the USSR into three periods: (1) the first half of the 1990s, featuring an initial phase of arbitrage and speculation driven by very soft budget constraints, excessive liquidity as well as inflation and exchange rate instability; (2) the second half of the 1990s, bringing a very ambitious effort toward stabilization, excessive tightening of monetary conditions and a liquidity squeeze that was accompanied by a different phase of speculation – with government securities on exchange rate stability, then a major crisis implying painful adjustment; (3) currently we are in a third phase, in which initially a sharp devaluation, later rising and buoyant oil prices contributed to strong economic growth, underpinned by political stability, a prudent macroeconomic policy mix and probably the first fruits of structural reforms.

Genuine financial intermediation, though still largely short-term and not yet fully market-oriented, may finally be starting to emerge. In this sense, only in recent years have distorted incentives for banks likely been losing some of their weight. Given that the Russian equity market is thin, underdeveloped and focused on a few large energy firms, carrying on banking sector reform can be considered pivotal if Russia is to sustain economic expansion and live up to its growth potential in the medium and long run. Higher growth requires more investment, and more investment requires efficient financial intermediation across sectors. It is Russia's fledgling small and medium-sized enterprises that particularly need banks. According to Goskomstat estimates, the share of SMEs in GDP in Russia is much lower (around 15%) than in more advanced transition economies (up to 50%). SMEs may provide an important outlet to absorb labor laid off by industrial restructuring, much of which still awaits Russia. They can also contribute to diversifying the economy.

[43] *According to recent official estimates, only 400 to 500 of around 1,300 Russian banks may be eligible for the deposit insurance system. Considering current indicators and conditions, the other 900 would be "left outside." Therefore, a "compromise" might be sought. The CBR may not actually exclude all banks that turn out to be ineligible for the system.*

In order to set the stage for attracting more funds into the banking sector and achieving more efficient intermediation it would appear necessary to further improve the CBR's ability to effectively supervise credit institutions. Important steps have already been taken with respect to upgrading prudential regulations. The CBR should persevere in its efforts to put substance over form in reporting requirements, to improve the quality and risk orientation of regulations and to apply existing rules more strictly.

In particular, the requirement to draw up financial statements in IAS as of 2004 should be vigorously enforced. Moreover, higher capital requirements and the use of IAS for regulatory purposes should be implemented as soon as possible. Loan loss provisioning rules should be redesigned to rely more on a qualitative assessment of risks; the resulting likely higher loan loss provisioning requirements should be applied, and, according to the IMF, nonviable banks should be shut down, unless owners are willing to immediately increase capital (IMF 2003a, pp. 8, 11). However, owing to the social importance of some banks that may be among the only ones serving (outlying) regions, such banks should be subject to restructuring programs. It would be strongly advisable to fine-tune the introduction of the deposit insurance system with a strengthened implementation of prudential regulations.

Given insufficient capacities for credit risk assessment in many banks, respective skills of bankers would need to be upgraded. The establishment of credit information services or bureaus would reduce another important obstacle to sound lending, namely lack of information on the owners and the credit record of potential borrowing firms, particularly SMEs. However, some reluctance on the part of banks would have to be overcome, given mutual mistrust of many banks in Russia and given that pocket banks may not want to make information on their key clients available to competitors. Crediting procedures for SMEs should be simplified. Debt recovery and access to credit collateral should be generally strengthened and effectively enforced.

In order to facilitate restructuring, mergers and acquisitions of banks should be made administratively easier to carry out. The complementarity and interdependence of reforms should be observed. Banking reform cannot be successful without progress in real sector reform, e.g. overcoming modest corporate governance standards and strengthening the rule of law. Real sector firms should be subjected to the disciplines of the market. Applying IAS only to banks would be inadequate. A level playing field – in form, substance and actual treatment – is also required with respect to Russian-owned and foreign-owned banks.

Russia's banking sector needs to be transformed into a genuine banking system. Without a strong banking system, the country may not be able to persevere in its quest of catching up with other emerging markets (chart 1). On the whole, the incentive structure and systemic framework for banking in Russia have no doubt improved in recent years; recent months have seen impressive efforts to intensify reforms. But new risks and exposures, particularly to a drop of raw material prices or to a sharp economic downturn, have emerged. Progress so far does seem to hold out hope that the overall operating environment will adjust in a direction already taken by other transition countries which are further advanced in banking reforms.

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