Hobbling Along: Russian Banking Reform

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Overview

In the aftermath of Russia's August 1998 financial crisis, many observers hoped that genuine reform and restructuring would occur in the Russian banking sector. Unfortunately, almost a year and a half after the crisis, the sector hobbles along with only a few half-steps taken towards effective restructuring. Although some banks have been closed, consolidation into a few strong and competitive banking institutions has not occurred. While many analysts anticipated the emergence of only 450-500 strong and competitive banks, the reality is that over 1,300 banks still existed in late 1999 (from 1,700 banks at the beginning of 1998). In addition, authorities have revoked and reinstated the licenses of bankrupt banks in seemingly arbitrary ways. Major bankers have also been guilty of asset stripping in the aftermath of August 1998, and have successfully transferred assets from bankrupt entities to new banks. None of them have been called into account for their fraudulent practices. Finally, improved profitability and liquidity, the absence of an exchange rate crash, and growth of 1.9% in the Russian economy in 1999 create a positive environment for Russian banks to move forward. However, these bright spots are likely to prove meaningless unless Russian authorities take more focused and effective steps toward reform in the banking sector.

The Functions of Russian Banks

The Russian banking sector is quite underdeveloped. Domestic loans to the private sector and to non-financial public enterprises in Russia total only 10% of GDP. The same figure for Poland is 20%, while it is 80-120% for West European countries. The sector is also small in terms of assets and capitalization. As of August 1999, the Central Bank of Russia (CBR) reported that total assets of Russia's top 30 banks&endash;representing as much as 60% of the country's total banking assets&endash;amounted to only Rur979 billion or approximately $37.7 billion. The sector's total capital (minus Sberbank) as of October 1999 was reported to be Rur85 billion or $3.7 billion. To put this in perspective, the amount of capital in Russia's banking sector is roughly equivalent to one-seventh of the capital base of Citigroup in the United States. The Russian government continues to play a central role in the banking system, with the CBR owning 45% of Sberbank, 96% of Vneshtorgbank (Sberbank and Vneshtorgbank form the core of the sector), 50% of Mezhgosudarstvennyi Bank, 45% of Roseximbank, and 20% of Vneshekonombank.

Unlike in most developed economies, where banks' central role is that of financial intermediation (i.e., mobilizing savings and investing them for the highest potential returns), Russian banks do minimal retail business. Except for Sberbank, Russian banks take very few deposits and make few loans. The role that Russian banks do play may be divided into six areas.

1. Banks act as the financial arm of large enterprises or groups of enterprises. They settle payments for these "clients," provide banking services to managers and employees, and engage in investment activities on behalf of their enterprise-owners. A good example would be Gazprombank, the financial arm of gas behemoth Gazprom.

2. Russian banks manage Russia's "quasi-money" system, issuing *veksels* or promissory notes to help companies and government agencies manage intricate operations of barter, credit, and taxes.

3. Until August 1998, banks were lenders of last resort to the central government in Moscow and were chief purchasers of the government's treasury bills or GKOs. In fact, some banks held as much as 70% of their capital in government paper and were the first to go under in the wake of the government's default in August 1998.

4. Russian banks also fulfill a treasury function for the central government. If they meet minimum asset requirements or compete successfully in the bidding process, they could qualify as repositories and/or transfer agents for state funds&endash;including customs revenues, budget subsidies, state wages, tax payments, and reconstruction funds (e.g., for Chechnya after the 1994-1996 war). In 1998, up to Rur4.15 billion in federal funds were reportedly misallocated by "authorized" banks serving as the government's treasury arm.

5. Russian banks provide short-term credit for the Russian economy, especially in the import-export sector.

6. Using foreign or offshore accounts, banks have been (and still are) key facilitators of Russian capital flight.

Outstanding Issues

Reform of Russia's banking system will be critical to the country's long-term economic development. Without a banking system that fulfills the function of financial intermediation, efficient capital accumulation is highly unlikely in Russia's financial system. Without capital accumulation, real investment in the economy will continue to decline or be sluggish at best (indeed, real investment declined by 16% on average in Russia from 1991). With a more professional and trustworthy banking system, one can imagine the mobilization of an estimated $30 billion in savings currently under Russian "mattresses" and the deployment of these resources towards genuine value-creation in the Russian economy.

Acting Russian president Vladimir Putin has pledged his allegiance to continued market reform in Russia. To help bridge the gap between his word and reality, Russian authorities will have to address at least four issues in the banking system: mismanagement and corruption, government-led financial restructuring, strategic foreign investment, and accounting reform.

1. Mismanagement and Corruption.
After the financial disaster of August 1998, some of Russia's largest banks stripped assets from their institutions, transferred them to "bridge entities" or new banks, and refused to fulfill their obligations to domestic and international creditors. A prime example of this practice was Uneximbank, which simply transferred assets to the new Rosbank. Managers and major shareholders were able to benefit from transferred assets partly with help from Russian authorities, who announced a 90-day moratorium on external debt payments in August 1998. After August, authorities also continued pumping money into bankrupt but allegedly "socially important" banks (e.g., SBS-Agro). These official actions not only helped postpone the day of reckoning for Russian banks, but also served to deepen the culture of mismanagement and corruption that was already widespread in the sector. Clearly, Russian authorities will have to be more serious about cleaning up the banking system if they want it to become an engine of economic growth.

2. Government-Led Financial Restructuring.
The Russian government created ARKO, the Agency for Restructuring of Credit Organizations, in the wake of the August 1998 financial crisis. The agency began operations in March 1999, using a capital base of Rur10 billion and armed with the mandate to coordinate the liquidation of insolvent Russian banks, restore the solvency of specific institutions, and provide a network for timely and accurate settlement of payments. ARKO's mandate, however, has proven too broad for the agency, given its limited resources and lack of political clout. Experts estimate that ARKO needs Rur50-60 billion to fulfill its mandate, but the 2000 federal budget sets aside only Rur1 billion for the agency. Political coordination is also sorely missing in the agency's work. For example, in June 1999, just hours after the agency announced that it was making a $128 million loan to Promstroibank, the CBR declared that it was revoking the bank's license. Success in restructuring the banking sector will depend not only on more capital and stronger political authority for ARKO, but also on the development of a host of legal and regulatory measures on bank bankruptcies, market transparency, protection of shareholder and depositor rights, and deposit insurance. The prospect of all these measures moving forward simultaneously is bleak, but Russian authorities should focus on developing and implementing concrete measures in as many areas as possible, as soon as possible.

3. Strategic Foreign Investment.
The share of foreign capital in Russia's banking system in late 1999 was 12.6%, but Russian policymakers frequently discuss increasing the legal limit for foreign capital to 25%. Indeed, a larger infusion of foreign capital would clearly help the banking system. As the experience of Poland and Hungary show, such capital--coupled with the introduction of western-style management and business strategy--could greatly enhance

growth, efficiency, and competitiveness in the banking system. At the moment, there are 21 banks in Russia with 100% foreign ownership and 12 banks with over 50% foreign ownership. More than 150 other banks have some percentage of foreign capital, but in general, foreign banks have not rushed to expand their presence and operations in Russia. To the contrary, banks like the Republic Bank of New York have opted to scale back their Russian operations dramatically. In a welcome development, some foreign banks in Russia have shifted their activities from the Russian financial markets to more regular commercial banking (e.g., new individual and commercial accounts, transfers, Letters of Credit, currency operations, trade finance, and documentary operations). These banks, however, have limited scope for distribution and are hampered by political and legal risks that they cannot hedge. These realities will continue to prevent the development of foreign strategic investment in the Russian banking sector in the near to medium term--unless the Russian government takes steps to convince the foreign banking community that the business environment in Russia is truly changing for the better.

4. Accounting Reform.
The accounting practices of many Russian banks continue to have little basis in economic reality. Reporting standards and practices are shoddy, and it is often extremely difficult for western analysts and other interested parties to get reliable financial statements from Russian banks. Creative accounting and blatant manipulation of numbers are common practices, and few institutions subscribe to International Accounting Standards (IAS). After August 1998, the Central Bank approved changes in Russian Accounting Standards (RAS) to allow banks to defer 1997 losses and offset them against 1998 gains on government securities of the same series--hence allowing banks to pad their 1997 earnings. This underlined the government's irresponsible approach *even after* the financial disaster of August 1998 had struck.

Conclusion

1999 proved to be a much better year for Russian banks than many had originally anticipated. Liquidity in the sector increased due to rising commodity prices (especially oil) and growing government coffers. The Central Bank reported in September 1999 that up to 1,000 banks were operating profitably and that the sector as a whole was overcoming its state of crisis. However, it is clear that the banking sector has experienced only a temporary respite rather than a definitive break from crisis. The next 1-5 years will be important to watch. Indeed, the first part of 2000 has already been marked by greater volatility in the sector. When commodity prices dip again, as they inevitably will, Russian banks will again experience low liquidity. In addition, banks have yet to settle numerous forward contracts with domestic and foreign counterparties, and liquidity and profitability could tighten as such liabilities come due. A renewed emphasis by multilateral institutions--including The World Bank, IMF, EU, and EBRD--to assist Russian reforms in accounting practices, bank supervision, bankruptcies, and overall restructuring is quite welcome. But these efforts will be nullified unless the Russian government itself decides to take banking sector reform more seriously. In the words of Richard Thomas of Standard and Poor's: "The issues of personality, politics, and brinkmanship that govern the Russian financial system continue to... [underline] the questionable banking and legal practices in Russia and [point] to the weak and arbitrary nature of the country's credit culture." Russian failure to implement measures to change this assessment will mean that the banking sector, at best, will hobble along in the foreseeable future. Limping alongside it will be the larger economy; left behind--the lost hopes for a better life for most Russians.

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