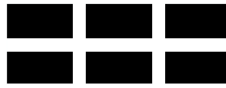

THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Banking Reform In Russia: A Window of Opportunity?

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William Davidson Institute Working Paper Number 601
August 2003

BANKING REFORM IN RUSSIA: A WINDOW OF OPPORTUNITY?

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Abstract

Only a successful implementation of an overall reform program will enable Russian banks to provide financial intermediation and assist in the country's development from a nascent market economy to a mature financial system. The chances for reform are better now than at any time during the last decade. Favorable political and economic conditions and a change in attitude among bank management have created an unusual window of opportunity. The paper analyzes the past performance of the Russian banking industry, evaluates the reform agenda of the monetary authority, and argues for an overall reform program in order to seize the available opportunity.

Key words: Russia, banking reform, transition.

JEL Classification: G2, P3

1 INTRODUCTION

The situation in the Russian banks has improved markedly since the dark days following the 1998 financial crisis. The banks have grown in terms of assets, equity, deposits, loans and profit. Many of these key indicators, measured as a percentage of GDP, now exceed their pre-crisis levels (Table I). These positive developments have taken place in step with Russia's general economic recovery.

Nevertheless, the sector reflects major structural weaknesses in the Russian economy. Russia does not have a functioning banking industry. The sector fails to provide a channel for collecting financial resources and directing them into value-added projects (Troika Dialog, 2002). Instead of contributing to capital accumulation, majority of the private banks remains effectively treasury functions for their owners' other (usually industrial) interests (Fitch Ratings, 2002).

There is little disagreement among analysts and policy makers that the banking sector in Russia is in dire need of reform. Why? At least four reasons can be cited. First, the ability to sustain the positive economic gains made in the last few years depend, to a large extent, on a well functioning banking sector. The current system cannot adequately support economic growth as very little of its activity consists of financial intermediation [Komulainen *et al,* 2003; Rautava, 1996; Ruehl, 2001; Tompson, 1997]. The role of the banking sector in facilitating economic growth depends, to a large extent, on its ability to mobilize savings and match its' supply with the demand for investment.[1] However, more than 95 percent of all corporate investment in Russia in 2002 were financed through equity and retained earnings rather than bank loans.

Second, reform will prevent a repeat of the 1998 banking crisis and avoid contagion by keeping the problems of Russian banks from igniting global financial turmoil similar to the experiences in Thailand and Indonesia in 1997. Third, Russia's desire to join the World

Trade Organization (WTO) points out to the urgency of reform as the banking and financial sector has to conform to WTO obligations.

Finally, there has been a significant increase in Russia's foreign investment inflow (US $20 billion in 2002 compared to US $9.5 billion in 1999). However, the changed composition of the inflow – sharp decrease in foreign direct investment and increase in commercial and trade credits and bond investment – indicate that it is actually Russian money coming home through repatriation (Ruehl, 2003). Being incapable of facilitating an efficient allocation of these capital inflows, the banking sector will try to cope with this liquidity influx by building up assets through increased lending and investment activities. This carries the danger of creating a bad loan portfolio and of bidding up assets prices, i.e., creating an asset price bubble (Ruehl, 2003). The biggest protection against such a scenario would be a strong, competent and efficient banking sector.

Despite widespread agreement on the need, there is much disagreement on the nature and speed of reform. Opinions range from imposing stiff capital requirements on domestic banks to removal of all restrictions on the activities of foreign banks.

The purpose of this paper is to analyze the evolving nature of banking in Russia since the break up of the former Soviet Union and suggest reforms that would help the banks in playing an adequate role in the nation's quest for sustained economic growth.

The paper proceeds as follows. The next three sections look at the early development in the banking system, the 1998 banking crisis and the response to the crisis. This is followed by a discussion of the current status of banking in Russia and associated problems. Finally, the study focuses on what should be the priority for banking sector reform and compares them with the steps taken by the monetary authorities. The paper ends with concluding remarks.

2 EARLY DEVELOPMENT

Commercial banking took shape in Russia in the late 1980s when the first non-state banks were formed under the 1988 law on cooperatives. As part of the economic reforms, the country moved away from the strictly centralized control of the mono-bank system to a relatively more diversified and functionally more specialized two-tier system. The central banking functions were vested with Gosbank [since 1991: the Central Bank of Russia (CBR)], while commercial banking functions were performed by five specialized institutions: Sberbank – savings; Vneshtorgbank – foreign trade; Promstroibank – industrial lending; Agroprombank – agricultural lending; and Zhilsotsbank – housing.

During the early years of transition, companies and other organizations were given the right to create their own financial institutions. These groups, known as the financial industrial group (FIGs), played an important role in shaping the banking system. In many cases, the ownership of the FIG banks were the same as the ownership of the key companies of the group. They functioned as an alliance, with banks helping restructure the companies and ease the cash flows between firms linked in a production chain. Individual entrepreneurs who participated in the voucher privatization program and 'loans-for-share' scheme generally formed FIGs. In most cases, the working capital requirements of the companies were met through bank financing and banks acted as merely their FIGs' financial vehicle, with the true value concentrated in the companies. (Fitch Ratings, 2002).[2]

During the early and mid-1990s, the sector evolved in an unregulated manner in which banks were involved primarily in speculating in the financial markets.[3] The presence of a large and high-yielding government debt encouraged banks to buy and sell Russian treasury bonds (GKO/OFZ) [especially in 1997-98]. They were also involved in providing subsidized credits to enterprises, financing trade operations, foreign exchange speculations, and engaging in non-monetary exchange of commodities. Instead of performing their

institutional role of financial intermediation, banks were involved in serious corporate governance abuse due to the presence of unreliable accounting standards, weak central bank supervision, cross-shareholding, poor transparency and corruption (Ippolito, 2002). Lax regulation and licensing policies meant that banks grew in numbers from less than 100 in 1988 to almost 2600 in 1995, nearly 2300 of which were operating (RECEP, 1997; Fitch Ratings, 2002).

Beginning in 1994, the Russian banks faced three major crises. The first was in November 1994, when ruble collapsed; the second was the liquidity crisis in the interbank market in August 1995 when a number of large banks failed; and, the third was the government's default on its ruble bonds and subsequent ruble devaluation in August 1998.

3 BANKING CRISIS OF 1998

The banking crisis of 1998 exposed the underlying structural flaws of the banking sector. While triggered by the ruble devaluation and the freezing of the short-term treasury bills (GKOs) operations, the banks were vulnerable to the crisis due to the high concentration of assets among highly leveraged and badly managed banks, increased foreign borrowing, exposure to exchange rate risk, credit risk, risk of default by the government and the consequent loss of client confidence. Despite the expectation by some analysts of a ruble devaluation since late 1997, the banks didn't change their risk profiles, as providing hedging with financial derivatives to foreign banks was very profitable. Banks borrowed at relatively low foreign interest rates, lend at high domestic interest rates and entered into unhedged off-balance sheet currency forward contracts.[4] Having been exposed to both price and credit risk, banks were unable to repay their obligations on forward contracts

when the devaluation actually took place in August [see Ippolito, 2002 and Perotti, 2002 for a detail description of the role of banks and financial groups during the crisis].

There are at least two differing views on the causes of the banking crisis in 1998. According to one, the crisis was caused by bank illiquidity rather than bank insolvency (Alexander *et al,* 2000). Based on this interpretation, the initial response of the government was to supply additional liquidity into the system. Multilateral donors including the World Bank and IMF, on the other hand, acknowledged the severe liquidity problems faced by the banks, but considered insolvency due to the growth of non-performing loan portfolio to be the primary cause of the crisis.

The crisis created a havoc leaving over half of all banks, including the major ones, insolvent. The number of banks dropped to about 1600. The crisis also saw, at least initially, a diminished economic and political role of the private sector banks, especially those owned by FIGs. However, these banks' former owners stripped their assets and recycled them into so-called 'bridge banks' which received all of their groups' businesses.[5] The interbank credit market also collapsed due to lack of liquidity and confidence.

Failure of the banking sector to perform financial intermediation during the 1991-98 period can be attributed to, among others, two main factors – high and volatile inflation, and persistence of large fiscal deficits and correspondingly large government borrowing requirements (Tompson, 2000). Coupled with political uncertainty, the crowding out effect of these two factors limited private sector firm's access to credit.

4 MEASURES FOLLOWING THE CRISIS

Immediately after the crisis, the Central Bank of Russia adopted two important measures: (i) a 90-day moratorium on the repayment of banks' foreign debts and foreign exchange term contracts; and (ii) transfer of all personal deposits from about three dozen troubled

private banks to the Sberbank.[6] These measures helped to achieve two goals: provide the banks with some breathing space within which to negotiate with their creditors on the restructuring of their due payments; and, help to protect personal deposits as the Sberbank was the only bank where household deposits were insured.[7]

Despite the urgent need for a thorough restructuring of the banking sector, nothing substantial happened during the early months after the crisis. This was mainly due to conflict of political interests among the various players involved: bank owners, the Central Bank, the Duma and the government. Eventually, the 'Law on the Restructuring of Credit Organizations' was approved in July 1999 leading to the formation of ARCO – an Agency for Reconstruction of Credit Organizations. The government also enacted the financial sector bankruptcies and bank restructuring legislation in February and July 1999, respectively.

However, a number of inherent problems made these legislative efforts relatively ineffective. First, in order to qualify for restructuring under the 1999 Law, a bank had to satisfy certain size criteria that favored the large banks. Second, ARCO proved to be weak as it had little starting capital, made no attempt to counter asset-stripping by problem banks in the process of their debt restructuring, and lacked power to close down inefficient banks or interfere with their operations against the will of the bank management. Third, the necessary institutional framework and political resolve to implement this legislation remained weak.

The early efforts for bank restructuring, therefore, failed to safeguard the rights of minority shareholders and creditors. Weak bankruptcy legislation, ineffective monitoring by the central bank, and failed attempts to liquidate insolvent banks were clear examples of lax in corporate governance that removed any residual confidence of the public in the banking sector.[8]

5 CURRENT STATUS[9]

As of the end of December 2002, 1329 credit institutions are licensed to conduct business transactions in Russia (Table II). Total assets of the sector are about U.S. $118 billion (35 percent of GDP) (CBR, 2002; see also Table I]. Corresponding figures are over 100 percent of GDP for the Czech Republic, over 70 percent for Estonia and about 60 percent for Poland [Komulainen *et al,* 2003). Money on deposits with banks represent only 19 percent of GDP compared to about 50 percent in the Czech Republic and Germany. Lending represents only 40 percent of bank assets. As a percentage of GDP, bank loans account for only 18.4 percent (Table I and Figures 7 and 8), far below the 25 percent average for Eastern Europe and 38 percent for Latin America (Troika Dialog, 2002). The little banking that is done in Russia is carried out by the 23 state-owned banks, such as, Sberbank and Vnesheconombank (VEB), and a small number of private banks, such as Alfa Bank and MDM Bank (see Tables VIII and IX). Most of the small banks do not deal with the general public and act simply as treasury operations for the companies that own them.

Figures 7 and 8 here

The stock of all ruble deposits entrusted to banks by households and companies increased manifold since the 1998 crisis (Tables IV and V and Figures 2 and 3).[10] This increase in

Figures 2 and 3 here

household deposits has been driven by time deposits, while demand deposits registered a decline (Table V). The maturity of household deposits has lengthened over the last four years. One-year to three-year ruble and foreign currency deposits grew particularly fast (Table IV). Claims on household and non-financial private enterprises account for almost

half of the bank's total lending (Table VI and Figures 4 and 5). The stock of bank claims on publicly owned enterprises is only 6 percent compared to bank credit to the private sector.

Figures 4 and 5 here

The main characteristics of the banking sector can be summarized as follows:

- *Small size* – In terms of a number of parameters, the banking sector in Russia is very small (Figues 1). The sector's total assets are 15 percent of GDP, against a 25 percent average in central Europe (Euromoney, 2003a). Moreover, banks finance about 5 percent of investment in the country, compared to 15 to 30 percent in many countries. Similarly, the 8 percent household deposits/GDP ratio is well below comparable international figures. Again, loans to the private sector and to nonfinancial public enterprises amount to less than 20 percent of GDP, compared to 80-120 percent in many West European countries.

Figures 1 here

- *Domination of state banks* – Despite the proliferation of banks, state-owned banks, specifically, Sberbank and Vneshtorgbank (VTB), dominate the banking sector in terms of both volume of activity and number of branches across the country. The state holds majority stake in over 20 banks that account for 37 percent of the sector's total asset (Troika Dialog, 2002). In addition, the state also holds minority shares in several hundred banks (Korhonen, 2001). Although one-third of registered banks are state-owned, they account for two-thirds of the banking sector's charter capital. Of the 3326 branches of operating credit institutions in Russia, 1162 are branches of Sberbank and its regional subsidiaries (Table II). This implies a branch to bank ratio of fewer than two for the rest of the system that does not indicate development of significant alternative network.

In a third of Russia's 89 regions there is no bank except Sberbank. It benefits from state guarantee of household deposits, a strong internal payments system and a key role in the distribution of state pensions (World Bank, 2002). As of the end of March, 2003, it holds a little over 66 percent of all household deposits in the banking system, and is responsible for around 30 percent of aggregate corporate lending (BOFIT, 2003a). The 29 next largest banks combined hold about 15 percent of household deposits and 40 percent of corporate loan stock (BOFIT, 2002).

- *House banks* – A large number of private banks do not operate as normal credit institutions, but rather act as treasuries for financial-industrial groups and large corporations (Ippolito, 2002). Instead of providing intermediation and other legitimate banking services to the general public, they are involved in the issuance and discounting of veksels for such activities as avoiding reserve requirements, tax evasion, money laundering, and facilitating capital flight (World Bank, 2002).[11] In recent years, a number of private banks have gained prominence due to their association with large financial-industrial groups. This is the case for Rosbank (linked to Interros), Doveritelni I Investizionni Bank (Rosprom) and Sobinbank (Lukoil). On the other hand, a number of banks lead the financial-industrial group, such as, Alfa Bank with Alfa Group and MDM Bank with MDM Group.
- *Phantom institutions* – Another striking feature of the banking industry is the existence of ghost or phantom institutions. For example, the number of registered banks actually operating in the market between 1997 and 2001 never exceeded 75 percent of the licensed banks.

- *Short-term nature of bank operations* – Bank's balance sheets are heavily weighted with short-term liabilities, as the number of potential investors with long-term interests in ruble assets is limited (Salonen, 2002). All household deposits are legally required to be available on demand, regardless of contractual maturity. Household deposits termed more than one year dominate in Sberbank while other banks get enterprise deposits with a maturity of 5 weeks or less. This inability to attract long-term liability limits credit expansion.[12]
- *Shortage of banking products* – Russia remains primarily a cash society although credit card business has recorded an upward trend in recent years. Consumer financing is also at a very initial stage and only a few banks in Moscow and St. Petersburg have invested in this area. Banks' lack of interest in consumer credit can be explained by shortage of medium- and long-term funding, absence of credit history and poor demand from customers (Fitch Ratings, 2002).
- *Concentration* – The sector is highly concentrated with just 30 banks accounting for more than two-thirds of system assets and half of system capital. Moreover, an overwhelming majority of banks are very small. According to the latest figures available, less than 250 banks have capital exceeding the European Union minimum capital requirement of 5 million Euros (World Bank, 2002a). Further, geographic concentration is also a strong feature. Almost half of all banking institution is based in the Moscow region and they represent about four-fifths of the system assets.

Russia's banking system lags behind that of other transition economies in a number of areas (see, for example, Table X). First, compared to these countries, the large state-owned banks in Russia have not been privatized. Consequently, these banks dominate the retail and corporate banking markets. Second, the Russian banking sector has received limited

foreign investment compared to other East European and Baltic States. In these countries, foreigners now control over half of the banking market; while Russian banks remain in the hands of the government and private domestic companies, themselves usually controlled by a handful of oligarchs. Third, the Russian system is highly fragmented and has remained largely unchanged in the last few years. In other transition economies, bankruptcy laws and regulatory reforms have been enacted in order to restructure failing or unprofitable banks, eliminate restrictions on foreign investment and initiate privatization.

6 WHAT IS WRONG WITH RUSSIAN BANKS?

The banking system is far from playing its traditional role of financial intermediary. Apart from the negligible share of fixed investment financed by bank borrowing, monetization and bank lending are small relative to GDP (Table X). Corresponding figures for other Central and East European economies are much higher. The role of the financial market as measured by bond issuance and equity market capitalization is also negligible relative to the other countries in the Table.

The sector suffers from a number of inherent problems. Distrust of banks along with tax avoidance and payment traditions remain leading reasons for the low level of deposits (19% of GDP in 2002, see Table I), although the large shadow economy also avoids banks (Korhonen, 2001; Salonen, 2002).[13] Most Russians prefer to keep savings (often in US dollars) hidden under their mattresses rather than in ruble in banks. Estimates of cash stashed in home range from a low of $20 billion to a high of $70 billion.[14] Lack of safe and attractive investment opportunities at home have led to money being moved abroad. Such capital flight and cash hoarding retards growth by reducing the amount of funds available for financing domestic investment (Figure 6).

Figures 6 here

The banks are undercapitalized, opaque in their ownership and operations, and poorly audited. Most of them are exposed to one or two major borrowers, sectors or commodities. Many small banks still follow the Russian Accounting System (RAS) rather than the International Accounting System (IAS). This limits the CBR's ability to evaluate the soundness of banking activity. Accounts prepared to RAS standards are intended to satisfy the requirements of Russian tax inspectors and bank regulators; while those prepared to IAS standards are aimed more at external investors, such as, shareholders, creditors and potential business partners. As a result, preparing accounts to IAS standards requires a far greater degree of discretion, risk analysis and meticulous reporting of a bank's economic activity. A related problem is the absence of reliable data on bank activity. Although a large amount of data is available, the use of RAS by many reporting banks allow them to inflate capital levels, deflate non-performing loans and prevent securities from being marked to market, thus making the data set suspect and of limited worth.[15]

7 UNFINISHED AGENDA

In the absence of a clear strategy, the process of bank restructuring in recent years has been slow, uncoordinated and inefficient. As piecemeal reform can only prolong the agony, the issue of overall reform needs to be confronted now. At a minimum, the following concerns need to be addressed. First, the monopoly position of Sberbank should be reviewed as its sheer size restrains competition. Decisions must be taken concerning the business strategy, appropriate organization, and functioning of the bank (Komulainen, 1999). However, due to the bank's relative size, social importance and regional service, any radical change in its operations ownership structure – which is majority-owned by the CBR - could have

negative and far-reaching effects (BOFIT, 2003; World Bank, 2002a). Therefore, authorities need to proceed with caution. Simultaneous efforts should also be made to provide incentives to competitors of Sberbank to grow and increase the volume and spectrum of services to clients.

Second, state-owned banks dominate the sector in terms of volume of activity and number of branches nationwide. The involvement of state-owned banks should be reduced, along with the withdrawal of the CBR from direct participation in the commercial banking business. Third, as 1,335 (as of March 2003) credit insitutions are currently licensed to conduct business transactions, greater trust in the system would be promoted by consolidation, i.e., fewer banks that have greater viability and are run more prudently.

Fourth, unlike most other central and eastern European countries, Russian banking sector remains unattractive for long-term investment by global financial institutions (Komulainen, 1999).[16] Foreign banks have, thus far, preferred to set up fully owned subsidiaries (Fitch Ratings, 2002).[17] One reason for the low interest shown by foreign banks is their caution in risk assessment due to the small size of the market and minimum retail banking opportunity.[18] As opening one or two branches in the major cities can do trade financing, foreign banks can avoid the large fixed capital necessary to open new branches. Attempts to attract foreign banking operation in Russia can only be successful with the implementation of a whole range of reforms including a lowering of capital requirements for foreign banks and allowing profit repatriation.

Finally, transparency and accountability should be established for improving public confidence in the banking industry. This calls for stronger supervisory and regulatory framework for banks, strengthened bankruptcy procedures, better creditor and depositor protection measures and reform of the judiciary system so that regulatory decisions can be implemented fully and enforced quickly.

The change in the CBR's top management in April 2002 offered hope of a clear political desire to implement long overdue structural changes in the sector. On July 11, 2002 President Putin signed a federal law affirming the independent status of the CBR. The new management team, with broad political support, has developed a reform agenda and a number of specific steps have already been taken.

First, all banks are scheduled to switch to the International Accounting Standard (IAS) by 2007.[19] It will force them to become more transparent and will weed out hundreds of small and unreliable banks that either do not meet the capital adequacy ratios or are not safe for customer deposits (World Bank, 2002). This will also encourage the consolidation of the sector around a few larger and more reliable banks. Related tax reform, besides reducing the profit tax on banks from 43 percent to 24 percent, will help to guide the tax accounting of banks towards the new standard (Korhonen, 2001). Second, a 'deposit insurance law' is awaiting final approval by the Duma in 2003. According to this legislation, from January 1, 2005 banks that qualify to participate in a deposit insurance scheme would pay 0.15 percent of their average quarterly deposits into a fund managed by ARCO.[20] After the law comes into effect, deposits up to 20,000 rubles in member banks would be fully insured, while deposits between 20,000 and 120,000 rubles would be covered up to 75 percent. The CBR will issue special banking licenses to commercial banks meeting tough financial criteria that will allow them to take retail deposits. This will help to reduce Sberbank's control of the retail business, lower the number of total banks, and level the playing field by enabling the private banks to expand and thereby inject competition into the sector.[21]

Third, the CBR has transferred its full ownership in the country's second largest bank, Vneshtorgbank (VTB), to the government. It has also lowered its stake in three major banks abroad by selling their shares to the VTB. In late 2002, the government reached a tentative agreement with the European Bank for Reconstruction and Development (EBRD)

over the sale of up to a 20 percent stake in VTB, and the state similarly plans to sell off its minority stakes in more than 500 small and medium-sized banks. The proposed sale of a large stake in VTB could provide a higher benchmark for the valuation of Russia's banking business than that afforded by Sberbank, the only bank stock currently traded. Meanwhile, the 12 percent ceiling on aggregate foreign ownership in the banking sector (which was meaningless due to low attraction of the banking market) has been lifted and trading in banking stock for non-residents has been liberalized thereby increasing liquidity (BOFIT, 2003). These steps may prompt a number of banks to start offering IPOs in the future.

Fourth, beginning in 2007, the minimum capital adequacy requirements for all banks have been set at 5 million Euros. As of 2005, the licenses of banks with less than 5 million Euro capital will be automatically revoked if their capital adequacy ratio falls below 10 percent. Currently, the threshold is 2 percent.[22]

Finally, legislative changes are also in progress with respect to protection in banking business, For example, a law on enforcing collateralized mortgages has been adopted, and improved legislation on bank bankruptcies is moving in the Duma. Similarly, laws on disclosure requirements for actual owners of banks and the quality of bank management are already in the enactment process (BOFIT, 2003b). New regulations requiring banks to tidy up their capital statements to rid them of artifically inflated capital based on assets or guarantees granted to third parties have been introduced. CBR expects to inspect the capital of all banks within the next two years.The new monitoring and reporting procedures and tighter requirements for capital adequacy have started to produce some results. Recent decisions by Gazprom, Lukoil, InterRos and several other corporations to sell off large stakes in their banks indicate a growing trend in turning banks from internal treasuries into profit generating centers (Troika Dialog, 2002).

8 CONCLUDING REMARKS

Russia stands at a turning point in its transition history. For the first time since the collapse of the former Soviet Union, the country's economy has been growing rapidly, boosted by growing domestic demand, higher energy prices, and a clear commitment to reform and fiscal discipline by the government. However, such growth, fuelled by the oil and energy sector and import substitution, has a narrow base as it is vulnerable to fluctuations in the international commodity price as well as exchange rates. Broadening this base depends upon the availability of financing to a much wider group of entities such as the small and medium-sized enterprises (SMEs).

Experiences from a number of other transition economies have shown that the SMEs are crucial in keeping the economy growing through job creation and technological and entrepreneurial innovation. Their role in the Russian economy, however, has been very small.[23] Unlike large corporations who are able to use retained earnings to finance expansion, the SMEs depend on the banks to provide the financial resources for growth. A lack of mechanism to match available resources with those willing to invest has hampered their growth. If financial intermediation functioned more smoothly, the SMEs could correct the existing imbalances and become the engine of strong growth.[24]

This is why banking reform is important in Russia. Given a thin equity market and low foreign direct investment, banks must be the bridge that will connect available resources with those willing to invest, both geographically and by sector. Some progress on reform has already been made. The new management team at the Central Bank of Russia, with broad political support, has developed a reform agenda which includes proposals for deposit insurance, creditor and depositor protection, improved bank transparency, better supervision and enforcement of quality standards in accounting, increased foreign participation and lower taxes on bank profits.

The chances for reform are better now than at any time during the last decade. Political and economic conditions have created an unusual window of opportunity. There is a clear sign of change in attitude among bank owners and management who have started to recognize the value of their businesses as a long term source of income that requires commitment of significant financial and managerial resources. The political leadership and the monetary authorities have also shown an honest willingness to complete banking sector reform. Such reform will not be a quick fix. Similar attempts in the past were met with stiff resistance from many vested interests. However, with changed political attitude, it may be different this time.

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Table I Russian Banking Statistics (as a percentage of GDP)

Year	Bank Assets	Bank Loans	Total Deposits	Household Deposits
1995	22.23	12.74	12.59	
1996	23.19	10.56	11.75	
1997	24.93	10.88	13.21	
1998	34.04	13.83	16.77	7.30
1999	32.51	11.93	15.34	6.20
2000	30.94	12.89	15.70	6.10
2001	32.70	16.24	16.99	7.50
2002	34.84	18.37	19.07	8.80

Household deposits for 2002 are for January-September period.

Source: Central Bank of Russia.

Table II Number and Structure of Credit Institutions

	1998	1999	2000	2001	2002	2003
Credit institutions	1476	1349	1311	1319	1329	1335
Licensed to conduct banking transaction, of which						
Banks	1447	1315	1274	1276	1282	1285
non-bank credit institutions	29	34	37	43	47	50
Credit institutions with license (permission)						
to attract personal deposits	1372	1264	1239	1223	1202	1200
to conduct transaction in foreign currency	634	669	764	810	839	843
Credit institutions with a foreign stake in authorized capital, licensed to conduct banking transactions, of which	142	133	130	126	126	128
100% foreign-owned organization	18	20	22	23	27	29
50-100% foreign ownership	12	12	11	12	10	9
Branches of operating credit institutions in Russia of which	4453	3923	3793	3433	3326	3304
Sberbank branches	1852	1689	1529	1233	1162	1157
branches of 100% foreign-owned banks	4	4	7	9	12	12

All figures are for December 31 of each year. Figures for 2003 are for March 31.

Source: Central Bank of Russia.

Table III Credit Institutions Grouped by Registered Authorized Capital, Dec. 31

	1998	**1999**	**2000**	**2001**	**2002**	**2003**
Total number of credit institutions	1476	1349	1311	1319	1329	1335
The percentage share of institutions in each category of authorized capital						
Less than 3 million Rubles	23.8	17.0	13.3	9.7	7.7	7.0
3 m.- 10 m.	31.4	17.0	21.5	16.5	14.5	13.6
10 m.- 30 m.	23.6	23.2	23.9	24.0	21.9	21.4
30 m.- 60 m.	12.8	18.8	19.3	19.3	19.0	19.0
60 m. – 150 m.	4.9	6.9	9.7	13.0	14.9	15.2
150 m. – 300 m.	1.4	3.2	5.2	7.4	9.3	10.0
more than 300 m.	2.0	3.9	7.1	10.1	12.7	13.8

The categories are in million Rubles. Figures for 2003 are for March 31.

Source: Central Bank of Russia.

Table IV Structure of Personal Ruble Deposits in Credit Institutions Classified by Maturity, Dec 31

	1998	**1999**	**2000**	**2001**	**2002**	**2003**
Total deposits (mil. Rubles)	140982	202783	304659	446408	649123	700656
The percentage share of deposits for each maturity period						
Demand deposits	38.13	30.27	33.03	25.82	20.71	19.19
Up to 30 days	0.31	0.14	0.09	0.06	0.07	0.12
31–90 days	9.36	9.1	6.89	5.05	3.60	3.68
91-180 days	44.48	52.04	40.36	30.69	23.85	22.88
181-365 days	2.75	4.59	7.17	9.15	12.93	13.20
1-3 years	3.97	3.03	11.86	28.57	37.27	39.27
3 years and more	1.0	0.82	0.6	0.66	1.57	1.65

* Figures for 2003 are for February 28.

Source: Central Bank of Russia and author's calculation.

Table V Structure of Corporate Ruble Deposits in Credit Institutions Classified by Maturity, Dec.31

	1998	**1999**	**2000**	**2001**	**2002**	**2003**
Total (mil. Rubles)	5535	24821	51317	68121	101319	98493
The percentage share of deposits for each maturity period						
demand deposits	5.24	6.79	4.02	3.48	4.01	4.53
up to 30 days	26.25	26.99	11.01	24.13	18.08	14.00
31-90 days	19.84	25.96	33.83	19.72	24.89	18.91
91-180 days	12.63	19.35	17.53	15.82	16.50	16.92
181-365 days	12.50	8.82	14.02	15.35	17.37	23.03
1-3 years	15.45	7.52	12.50	11.66	10.40	13.88
3 years and more	8.09	4.58	7.08	9.85	8.76	8.73

* Figures for 2003 are for February 28.

Source: Central Bank of Russia and author's calculation.

Table VI Structure of Aggregate Assets of Credit Institutions (in percentages), Dec. 31

	1998	1999	2000	2001	2002	2003
Reserves	6.81	8.95	11.83	10.12	10.77	11.14
Foreign assets	20.27	20.72	18.72	15.94	13.67	13.02
Claims on general government	23.95	24.49	20.66	17.25	15.98	16.16
Claims on non-financial public enterprises	3.09	2.62	2.91	2.34	2.79	2.74
Claims on non-financial private enter. & households	31.22	29.19	34.06	41.04	43.12	43.02
Claims on other financial Inst.	0.67	0.73	0.57	0.66	0.75	0.82
Other assets	14.00	13.29	11.25	12.65	12.93	13.10

* Figures for 2003 are for February 28.

Source: Central Bank of Russia and author's calculation.

Table VII Structure of Aggregate Liabilities of Credit Institutions , (in percentages), Dec. 31

	1998	1999	2000	2001	2002	2003
Demand deposits	14.23	13.97	17.40	17.30	16.25	14.81
Time & savings deposits & foreign currency deposits	25.86	25.54	26.73	27.48	30.94	32.35
Restricted deposits	2.02	0.57	0.25	0.62	1.46	1.01
Money market instruments	3.49	6.03	7.50	7.63	9.05	8.59
Foreign liabilities	18.28	12.45	9.78	9.31	9.07	8.37
General government deposits	1.83	1.60	2.14	2.01	1.51	1.79
Liabilities to monetary authorities	6.54	11.2	8.05	7.32	5.11	4.76
Capital accounts	14.93	16.36	17.17	18.09	17.97	19.19
Other liabilities	12.82	12.27	10.97	10.25	9.62	9.62

*Figures for 2003 are for February 28.

Source: Central Bank of Russia and author's calculation.

Table VIII Banking Sector Structure, First Half, 2002

	Sberbank	**Foreign banks**	**Largest local banks**	**Medium banks**	**Small banks**
Number	1	22	28	50	1212
Asset range, $ mil.	29000	100-2800	250-3800	100-250	<100
Capital range, $ mil.	3500	30-200	80-700	30-80	<30
Share of assets, in %	26	7	42	7	18
Share of capital, in %	13	5	45	9	28
Share of retail savings, in %	72	3	13	5	8
ROE (in %)	20	14	5	6	4
ROA (in %)	1.7	1.8	0.9	1.3	1.1
Leverage (capital/assets), in %	8	13	17	23	26

Note: Based on Russian accounting standards. The total number of banks during this period was 1313.

Source: Troika Dialog (2002).

Table IX Top 20 Retail Banks, First Half, 2002

Bank	**Assets**	**Rank by assets**	**Equity/ Assets**	**Retail deposits/ liabilities**	**Market share**
	$ mill.		%	%	%
Sberbank	29576	1	11	73	69.10
Alfa Bank	3848	4	19	20	2.3
Bank of Moscow	2380	13	7	18	1.4
Gazprombank	3843	5	18	12	1.4
Vneshtorgbank (VTB)	4561	2	37	11	1.2
Rosbank	2325	8	11	13	0.9
Raiffeisen	1029	26	10	25	0.8
Int. Moscow Bank	2818	16	5	8	0.8
Promstroybank	1337	20	9	17	0.7
Uralsib	1143	10	18	18	0.6
Menetap	943	23	11	20	0.6
Avtobank	436	41	13	39	0.5
MDM	1834	7	15	9	0.5
V-bank	446	60	11	33	0.5
Surgutneftagaz	1163	52	4	10	0.4
Impex Bank	445	45	13	29	0.4
Nikoil	472	31	18	29	0.4
Petrocommerce Bank	784	12	24	16	0.3
Petrovsky	270	123	7	33	0.3
Zapsibcombank	316	94	10	27	0.3
Source: Troika Dialog (2002)					

Table X Financial Market Depth (percentage of GDP), end of 2001

Country	M2	Claims on private sector	Domestic credit	Total bond outstanding	Equity market capitalization
Russia	24	17	24	3	27
Czech Rep.	71	45	50	15	16
Germany	71	130	148	56	57
Hungary	43	35	50	26	20
Japan	123	96	145	107	92
Poland	43	26	38	20	15
Slovak Rep.	66	25	62	13	3
UK	113	69	141	43	153
USA	64	76	89	115	137

Sources: World Development Indicators, IFC Emerging Markets Bonds Electronic Database, IMF International Financial Statistics, Barnard and Thomsen (2002), and author's calculation.

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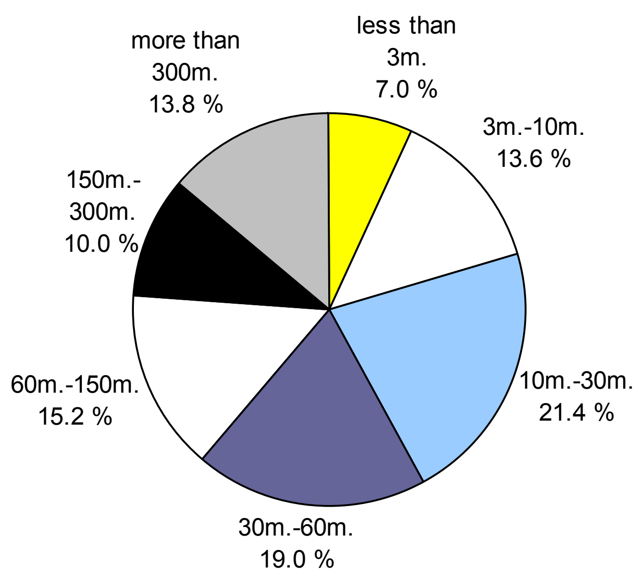
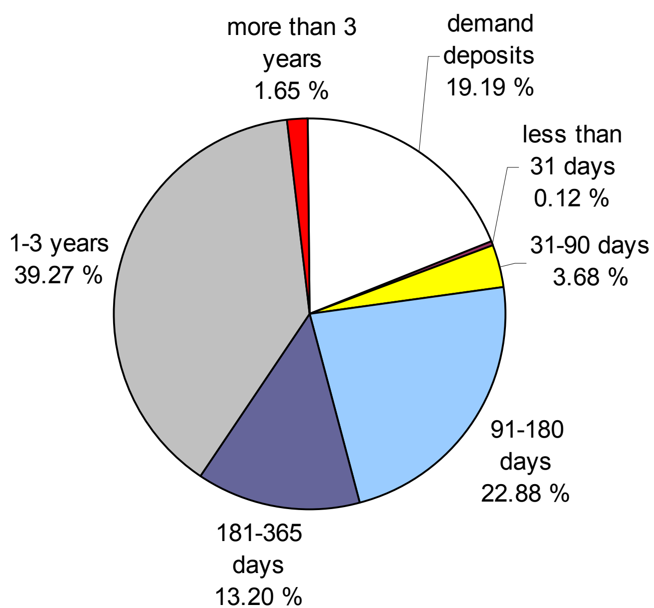


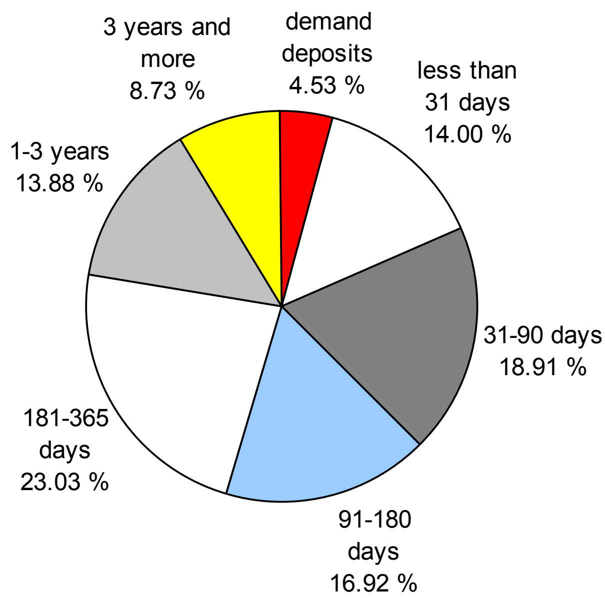
Source: Central Bank of Russia

Figure 1. Credit Institutions Grouped by Registered Authorized Capital, million rubles, March. 31, 2003



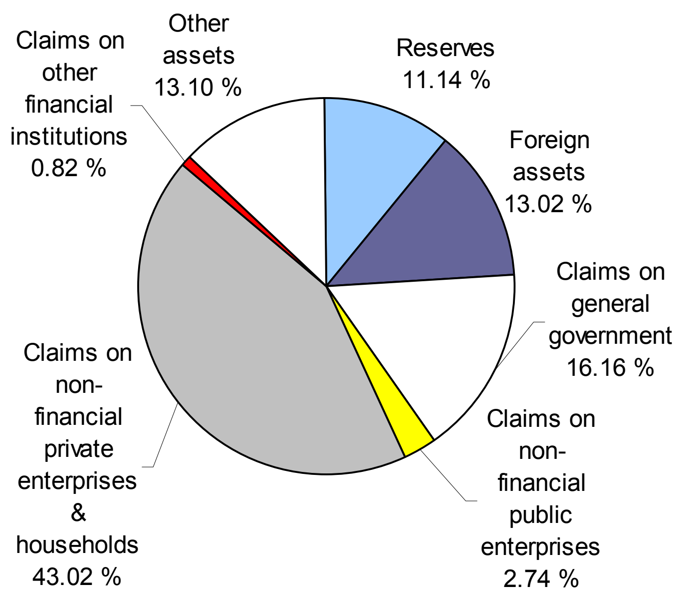
Source: Central Bank of Russia and author's calculation

Figure 2. Structure of Personal Ruble Deposits in Credit Institutions Classified by Maturity, Feb. 28, 2003



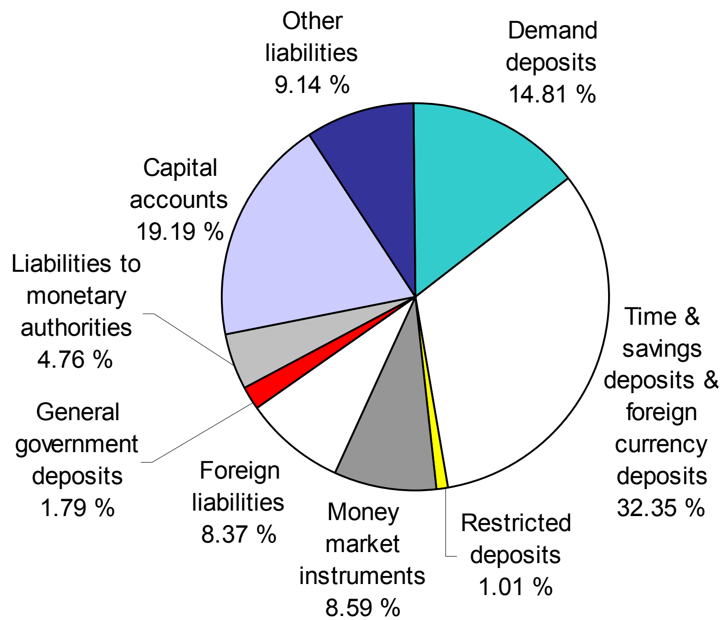
Source: Central Bank of Russia and author's calculation

Figure 3. Structure of Corporate Ruble Deposits in Credit Institutions, Classified by Maturity, Feb. 28, 2003



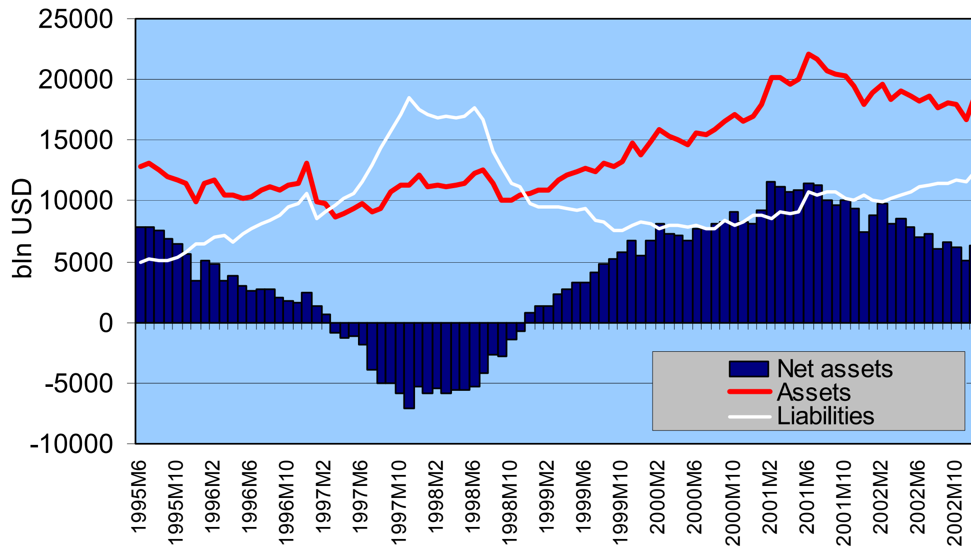
Source: Central Bank of Russia and author's calculation

Figure 4 Structure of Aggregate Assets of Credit Institutions, Feb. 28, 2003



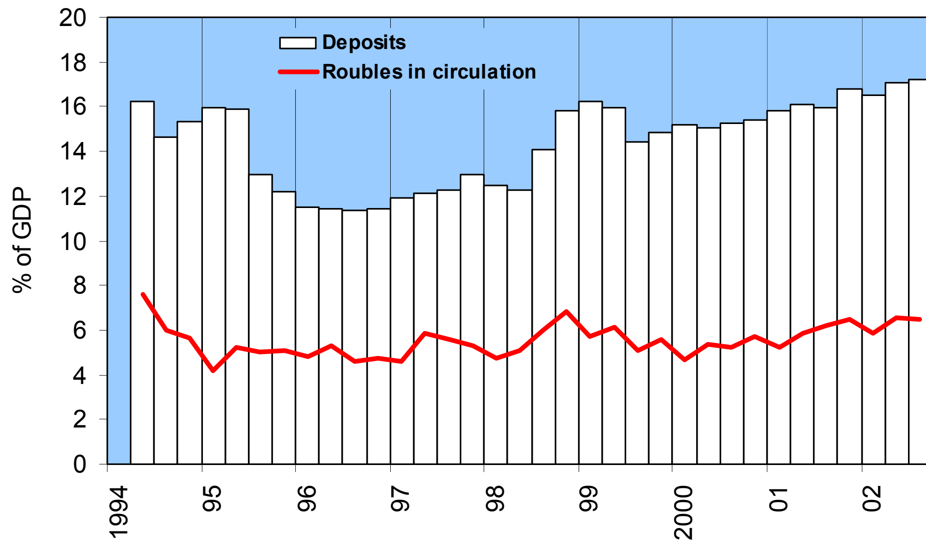
Source: Central Bank of Russia and author's calculation

Figure 5 Structure of Aggregate Liabilities of Credit Institutions, Feb. 28, 2003



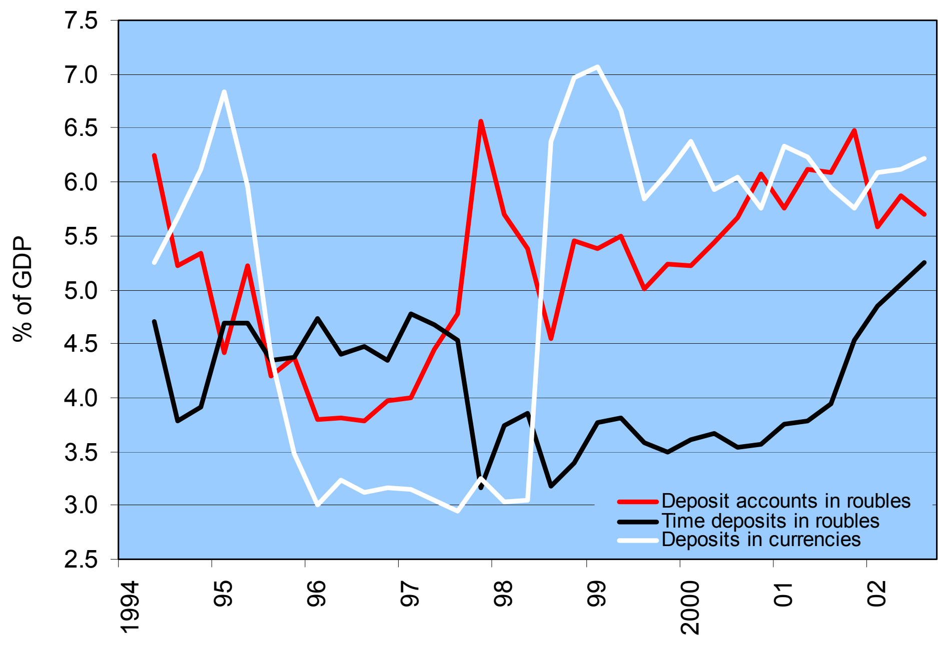
Source: Central Bank of Russia

Figure 6 Deposit Money Banks' Foreign Assets and Liabilities



Source: IMF, International Financial Statistics

Figure 7 Deposits in Russian Banks and Cash Roubles in Circulation, % of GDP



Source: IMF, International Financial Statistics

Figure 8 Deposits in Russian Banks, % of GDP

FOOTNOTES

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* I would like to thank, without implicating, Tuomas Komulainen, Iikka Korhonen, Vesa Korhonen, Jouko Rautava, Pekka Sutela and an anonymous referee for helpful comments. I owe a great debt to Inna Verbina whose ideas and encouragement got me launched on the study of the Russian banking structure. The paper was written during my visit to the Institute for Economies in Transition (BOFIT) at the Bank of Finland. The hospitality and financial support from BOFIT is gratefully acknowledged.

[1] Banks can reduce the transaction costs of both the borrowers and lenders by lowering the search and risk assessment cost and the cost of monitoring and enforcing any contracts between the two parties [Sutela (1998), Tompson (2000)]. This also allows banks to overcome mismatches between them. It is particularly relevant for Russia where high-return investment projects may require the commitment for long periods; however, given the presence of informational asymmetries between borrowers and lenders and the high degree of political and economic uncertainty, savers may not be willing to give up control of their wealth for a long period of time.

[2] The dominant strength of the Russian oil, gas and metal industry has helped to keep this model intact even to this day. These industries generate all-important foreign currency revenues, and have an interest in controlling banks to optimize cash flows and reap maximum financial and political advantage from them. A number of FIGs have also used banks for maximizing offshore cash flows in their elaborate tax avoidance schemes.

[3] For a critical review of the banking sector in the early years of transition see, among others, Tompson (2002).

[4] Setting aside off-balance sheet items, the open foreign currency position of the commercial banks just prior to the crisis amounted to about 18 percent of the balance sheet total (Thiessen, 2000, Table 1).

[5] The bridge banks took over the assets but not the liabilities. This was possible due to the weak enforcement of property rights.

[6] See, for instance, RECEP (1999).

[7] Until May 1999 about 60 to 70 percent of ruble deposits at commercial banks were transferred to Sberbank. The Sberbank's share in total ruble denominated deposits increased from about 80 percent before the crisis to nearly 90 percent in summer of 1999 (Thiessen, 2000).

[8] Sberbank was the only bank that enjoyed consumer confidence. This, in turn, created incentives for future moral hazard.

[9] In addition to the text, the Tables and Charts also show the current status of the banking sector. They are self-explanatory and, to conserve space, are not described in detail.

[10] Similar increase has been recored in foreign currency deposits (CBR: *Bulletin of Banking Statistics*, various issues).

[11] Veksels are short-term interenterprise debt obligations. The veksel market initially developed in mid-1990s, dried up after the 1998 crisis, but started to recover soon thereafter. It has now grown into a market for fixed-income financial instruments which are issued for raising short-term cash (one week to one year) for financing current operations of enterprises and banks. Liquid veksels now amount to about US $4.7 billion, twice the amount of corporate bonds (Euromoney, 2003b).

[12] Banks typically lend for periods of 3 to 6 months, with credits extended for more than a year generally account for less than 10 percent of total lending (Tompson, 2000).

[13] Tompson (2000) argues that the state's reliance on the banking system as an instrument for monitoring enterprise finances and collecting taxes constitutes the single greatest incentive to disintermediation.

[14] *The Moscow Times*, February 4, 2003, page 7.

[15] The case of Inkombank in 1998, its' last year of operation, exemplifies the problem: the bank's RAS results showed a profit of $422 million (despite losses of $700 million on their loan portfolio), while its IAS results showed a loss of $355 million (Tompson, 2000).

[16] Of the largest thirty Russian banks, only six are foreign-owned, and the share of the foreign banks amounts to no more than 7 percent of the banking sector's total assets (see Table VIII).

[17] As of the end of December 2002, 27 fully foreign-owned bank subsidiaries and another 10 banks with foreign majority ownership are operating in Russia (Table II).

[18] One factor inhibiting foreign investment is the risk associated with providing credits in an environment characterized with weak legal enforcement. Existing foreign banks had to invest considerable resources for managing their credit risks (World Bank, 2002a). Like their domestic counterparts, this has led them to encourage lending to large corporations. Their corporate and interbank loans contain very limited exposure to Russian risk.

[19] The move to IAS was initially expected to take effect in 2004.

[20] The scheme involves the creation of an insurance fund, managed by ARCO, and made up of contributions from all the involved banks. The government will contribute the first $100 million and will cover any unexpected deficit. Sberbank will also join the system but

will retain its state deposit guarantee until early 2007 (see Fantini, 2003 for a further discussion on deposit insurance].

[21] Critics have suggested that Sberbank is blocking the passage of the deposit insurance bill, fearing – since it holds most deposits – that its contributions to the fund would pay for the mistakes of more reckless private banks (*Economist*, February 8, 2003, pp. 30-31).

[22] Joint Government/CBR Strategy for the Development of the Banking Sector of the Russian Federation (finalized in December 2001).

[23] Goskomstat data suggest that the share may be as low as 10-15 percent of GDP compared to about 50 percent in advanced transition economies. According to World Bank (2002b) estimate, SMEs must reach a threshold of 40 percent of total employment to become the engine of economic growth. This share is around 20 percent in Russia (Komulainen *et al,* 2003). The modest share of SMEs can be attributed to the heavy dependence on the oil and energy sectors. Barnard and Thomsen (2002) attributes the dominance of conglomerates based in the natural resource sector partly to the 'Dutch disease' effect of high oil price in the international market and the real appreciation of ruble. Poor investment climate outside the primary commodities sector as well as administrative barriers imposed at different levels of government also explain the lack of a dynamic SME sector.

[24] A new World Bank survey shows that recent deregulation has improved things for the SMEs: for the first time, Russian small businesses report that their biggest challenge is competition from each other rather than the heavy hand of government (*Economist*, February 8, 2003, pp. 30-31). But bureaucracy, corruption, and lack of bank loans are still their major problems.

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