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The Banking Sector Rescue in Russia

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Filippo Ippolito<sup>1</sup>

## The Banking Sector Rescue in Russia

### Abstract

The 1998 financial meltdown brought to public attention the vulnerability of Russia's banking sector, which was severely hit by the crisis. The Russian government and the CBR (Central Bank of Russia) acted in a timely manner in setting up a basic intervention plan for the rapid restoration of solvency. Unfortunately, these measures were not followed by a correction of the real problems behind the crisis. The Central Bank and the Russian government failed to exploit a unique chance to carry out significant reforms in the financial sector, leaving unresolved many of the flaws that afflicted Russian banks before the crisis. This paper reconstructs the events surrounding the Russian financial crisis and evaluates the subsequent rescue of the banking sector.

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<sup>1</sup> St. Antony's College, Oxford.

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## Introduction

On the 13th of August 1998 George Soros argued in a letter to the *Financial Times* that the turmoil in Russia's financial markets had reached a 'terminal phase' and recommended a 15-25% devaluation of the Russian rouble (RUR) against the dollar. At the same time the Russian equity market fell by 15% and the yields on short-term government debt rose sharply.<sup>2</sup> The Russian authorities claimed that there were no financial grounds for the deterioration of the situation, which in the words of Prime Minister Kirienko, belonged 'in the realms of psychology'. President Yeltsin announced that he strongly rejected any possibility of devaluing the rouble, saying his government was fully in control of the situation in spite of the battering the country's markets had received. 'There will not be a devaluation of the rouble. My conviction is not simply based on my own fantasy or my wish that we should not have a devaluation. My conviction is based on the fact that everything has been calculated. The situation is fully under control.'<sup>3</sup>

Three days after this statement, with the Central Bank losing its reserves and no additional financial support likely to be forthcoming from abroad, the Russian government devalued the rouble. Russia widened its currency corridor to trade in a band between 6 and 9.5 roubles to the US dollar. Russia then declared its intention to restructure all official domestic currency debt obligations falling due at the end of 1999 and imposed a 90-day moratorium on the repayment of private external debt, in order to aid its commercial banks. The moratorium also applied to banks' obligations on selling (short) positions on currency forwards contracts, as well as margin calls on repurchase operations (repos) with foreign banks. Less than three weeks later, on September 9, the exchange rate had reached 21 roubles to the dollar, more than three times the 6.29 roubles to the dollar that had prevailed on August 14.<sup>4</sup>

The crisis had dramatic consequences for Russian banks and revealed how vulnerable they were. A significant number of them reported heavy losses on forward contracts and on short-term rouble denominated government bond (GKO) portfolios. The main losers were among the top 20 banks. As in other banking crises, retail and corporate depositors withdrew their money from banks, further worsening the balance sheets of credit institutions and generating widespread panic among savers, resulting in a bank-run. Fearful that the financial system would collapse, the Russian government and the Central Bank mounted a rescue of the banking sector that included intervening in the daily operations of some problem banks while establishing a series of capitalisation and restructuring programmes.<sup>5</sup>

The crisis showed that the banking sector's problems were not quickly surmountable, because they had deep-rooted causes that required serious reforms. Since the collapse of the Soviet Union, the banking sector had evolved in an unregulated fashion. Banks, instead of playing their institutional role of financial intermediaries, had primarily been involved in speculating in financial markets. Lending to the real sector had been sluggish throughout the 1990s due to a lack of protection and enforcement of property and credit rights. Given the existence of a large and high-yielding government debt, buying and selling Russian treasury bonds became the core and sole business of some large banks. Unreliable accoun-

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<sup>2</sup> *Financial Times*, 13-Aug-1998, 'Russian woes add to investor nervousness'.

<sup>3</sup> *Financial Times*, 14-Aug-1998, 'Yeltsin rejects option to devalue rouble'.

<sup>4</sup> *Financial Times*, 18-Aug-1998, 'Russia's shrinking options: John Thornhill explains why Russia has devalued the rouble and asks whether it will work'.

<sup>5</sup> On bank restructuring see Dziobek (1998), Enoch, Garcia and Sundararajan (1999), Woo (2000), Garcia (2000), Frydl and Quintyn (2000), and Frydl (1999).

ting standards allowed for massive hiding of problem loans. Weak Central Bank supervision failed to impose coherent risk management and respect for international standards on capital adequacy ratios. Cross-shareholdings, poor transparency and corruption led to serious corporate governance abuses.

Restoring solvency was the first, badly needed phase of the rescue. Was it followed by a 'second phase' in which Russia's authorities carried out the necessary reforms outlined above? This work argues that immediate Central Bank intervention helped shore up the system, avoided a potentially disastrous bank run and began improving bank balance sheets. However, the rescue failed to revitalise the banking sector as the nation's financial intermediary. In fact, we can argue that the Central Bank and the government carried out only reactive restructuring and not strategic. They were capable of intervening in a constructive way in the immediate situation but the rescue had no follow-up.

Why is the absence of serious banking reforms so important? Because the lack of a deep restructuring of the financial system can have dire consequences for the future of the Russian economy. It is crucial to understand that serious reforms are of utter significance for the realisation of an efficient banking system, which, in turn, is vital for Russia's economic growth.<sup>6</sup> Russia is only one in a long list of countries that have experienced financial difficulties in recent decades. The experience from other countries shows that there might be some general rules that can be helpful when planning a rescue. Probably the most important of these rules is that systemic, and not just reactive, restructuring has to be imposed when needed.<sup>7</sup>

## Structure

Part 1 offers an overview of the Russian financial crisis and explains the reasons behind the vulnerability of credit institutions. Part 2 outlines the 'first phase' of the rescue, which chronologically covers the years 1998-1999. It shows how the intervention of the Central Bank of Russia (CBR) and of the Russian government was proactive on some fronts, like restoring solvency, and feeble on others, like preventing asset stripping and protecting minority shareholders. Part 3 covers the years 2000-2001 and examines recent banking trends and the contemporary structure of the Russian banking system, and underlines the unresolved problems that still afflict it.

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<sup>6</sup> For studies/research on the importance of the banking sector in transition economies, see Pissarides (1998), Buiters (1998), and Schoors (2001).

<sup>7</sup> For other banking crises, see Demirgüç-Kunt (1997), McQuerry (1999), Goldstein (1996), Garcia-Herrero (1997), Drees and Pazarbasıoglu (1998), Baliño and Ubide (1999), and Kanaya and Woo (2000). For a review of the determinants of banking crises, see González-Hermosillo, Pazarbasıoglu and Billings (1997), Hardy and Pazarbasıoglu (1999), González-Hermosillo (1999), Demirgüç-Kunt and Detragiache (2000), Demirgüç-Kunt, Detragiache and Gupta (2000), and Johnston, Chai and Schumacher (2000). For a more theoretical study on banking crises, see Mitchell (1999).

# 1 The Russian Financial Crisis of August 1998

In the four years preceding the crisis, Russia started to receive foreign capital inflows. This was part of a worldwide boom in capital flows into emerging markets. Stabilisation efforts had successfully achieved a rouble-dollar peg in July 1995 and financial support from the IMF and the World Bank that also led to two important debt rescheduling agreements with Russia's creditors in 1996 and 1997.<sup>8</sup> After the political uncertainty surrounding the Presidential campaign during the first half of 1996, prospects looked more encouraging. Foreign investors were allowed as of February 1996 to buy short-term treasury bills (GKOs) in primary markets and repatriate the related income. All these were positive incentives for investing in Russian markets. Before plunging dramatically, the stock market rose 142% in 1996 and a further 184% in the first eight months of 1997.

After the collapse in stock prices, concerns immediately surfaced over the possibility of a general financial crisis in Russia. Foreign investors, who were attracted by the high GKO yields, purchased large amounts of futures on the USD/Rouble exchange rate, i.e. had long positions, in order to hedge their GKO portfolios in case of a depreciation of the rouble against the US dollar. Correspondingly Russian counterparts had short positions on the same contracts and were thus exposed to the rouble devaluation. The cautious attitude of foreign investors further heightened concerns over Russia's international reserve position and the credibility of its exchange rate commitment. The mounting 'flight to quality' of portfolio investors that began shifting away their capital from risky countries to safer ones, made it increasingly difficult for the Russian government to roll over its GKO debt and made the defence of the rouble more costly.<sup>9</sup>

The crisis revealed the underlying structural flaws of the banking sector. While triggered by the rouble devaluation and the freezing of GKO operations, the fundamental reasons for the crisis were formed in 1996-1997. Sberbank's monopoly in the retail sector led to the inaccessibility of banks to personal deposits. During the short-lived financial market boom of 1996-1997 a large share of the dominant Moscow banks secured substantial foreign loans, leading to a rise of foreign-denominated bank liabilities relative to their assets. As of July 1998, 75% of the foreign currency liabilities were concentrated in the 20 largest banks, generating a share of foreign loans in balance sheet liabilities for these banks of over 20%. Banks servicing financial-industrial groups (FIGs) financed their holdings via short-term foreign loans (both unsecured and backed by fixed income securities or stock). A number of banks suffered from an imbalance in the maturity structure of foreign-denominated assets and liabilities, with the latter being generally of a more short-term nature. During the course of 1998, banks sought to address the growing imbalance in their open foreign positions by issuing new credits in, or converting old credits into, foreign currency.<sup>10</sup>

The excessive risks taken by many credit institutions were exacerbated by inadequate risk and liquidity management at commercial banks, inefficient nationwide settlement and clearing systems, poor monitoring by the CBR and market participants' overestimation of the CBR's ability to support the rouble. Managerial problems, related to the fact that the majority of large banks were run by the same people who simultaneously controlled their

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<sup>8</sup> Russia concluded an agreement with the Paris Club of official creditors covering \$38 bn of Soviet-era debt. In addition, an agreement was reached in October 1997 with the London Club of commercial creditors covering \$33 bn. See Gould-Davies (1999) for an analysis of the relations between Russia and the IMF.

<sup>9</sup> For a review of the international capital market events surrounding the Russian crisis, see BIS (1999). For an analysis of the determinants of the Russian banking crisis, see Tompson (1999).

<sup>10</sup> Kharas (2001), Buchs (1999), EBRD (1998).

respective industrial holdings, also played their part. Due to the very opaque structure of FIGs, any growth in the market value of their industrial holdings was not translated into an increase in the value of their core banks. Thus, a bank's management often made strategic decisions with the intention of increasing the value of the industrial wing of the holding, leaving the bank with treasury functions only. Because of this strategy, the financial and market positions of these banks became primarily dependent on their industrial holdings.<sup>11</sup>

## The impact of the crisis on the banking sector

While a significant number of banks were affected by the financial crisis, by far the main losers were among the top 20 banks. Excluding Sberbank and a few others, which remained relatively unscathed, most large banks suffered significant losses from: (1) positions on foreign exchange (FX) forward contracts; (2) the devaluation of GKO portfolios; (3) liquidity shortages due to the outflow of client accounts; and (4) defaults on margin call payments and security payments on short-term borrowings. The devaluation effect and negative returns on GKO investments resulted in the overall drop in banking capital of 40% by October 1998. Thus by November 1998, consolidated banking equity accounted for less than 9% of assets (in 1997 the overall capital/assets ratio was 16%).

Many large banks experienced a significant outflow of deposits in the aftermath of the crisis. Almost all of them lost 10% to 45% of their retail deposits in real terms (see Figure 1.1 for the general trend and Figure 1.2 for selected banks).<sup>12</sup> Sberbank kept the majority of its rouble-oriented customers – i.e. pensioners and the lower middle class, but it lost over 30% of its USD-denominated deposits, which, overall, accounted for RUR 15 bn. To protect individual deposits, the CBR decided to transfer individual savings – including those in dollars - from insolvent banks to Sberbank, the only one that provided deposit insurance.<sup>13</sup> Despite this measure, individuals lost a significant share of their savings that were deposited at commercial banks. Even those USD deposits transferred to Sberbank effectively lost ca. 50% of their value, because they had to be withdrawn at a fixed rate of 9 roubles per dollar instead of the much higher current exchange rate.

However, due to the high share of non-cash settlements in the economy, expensive credit resources and low financial intermediation, large companies were not significantly hit by the banking crisis. Key corporate clients had significant influence over their bankers through cross-shareholdings. Thus, corporations were able to move their accounts from insolvent banks to more liquid financial institutions in time. For example, Rossiisky Kredit, Inkombank, and Menatep lost from 50% to 70% of their deposits between August and September (Table 1.1). Some of the largest corporations focused on the establishment of new banks with low leverages and stable liquidity positions. Key clients of the banks were also able to net off mutual liabilities with their banks using common affiliated companies. Such netting effectively reduced the value of assets available to foreign creditors and retail depositors, whose resources were initially used for financing loan portfolios. Some of the outflows of corporate deposits from Avtobank and Mosbiznesbank were partially related to the fact that Gazprom moved all its export operations from commercial banks to its subsi-

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<sup>11</sup> Troika Dialog (Jan 1999).

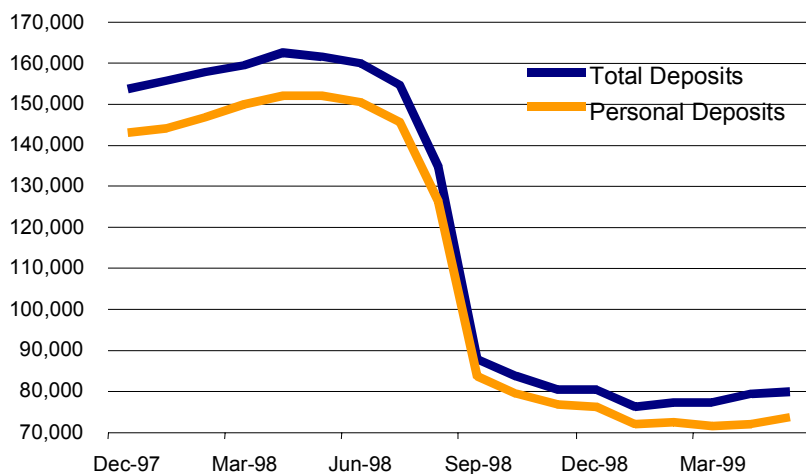
<sup>12</sup> The relatively low outflows of retail deposits from SBS-Agro, Menatep, and Rossiisky Kredit of 10-20%, reflects the fact that these banks were the first to freeze the repayment of deposited sums.

<sup>13</sup> On the role of deposit insurance, see Demirgüç-Kunt and Detragiache (2000), Schumacher (2000).



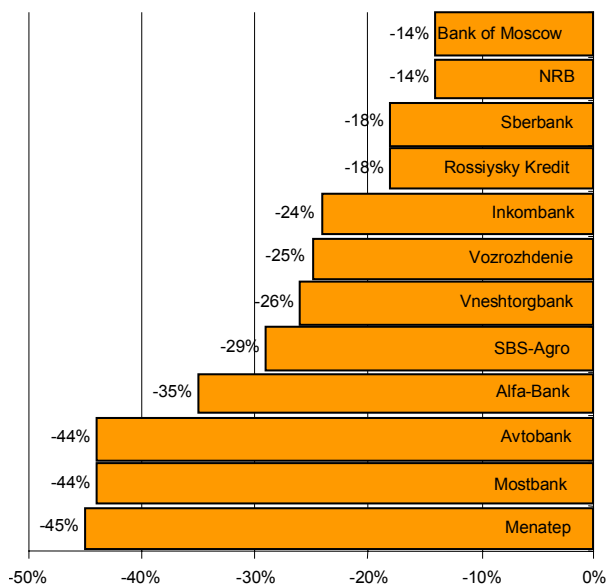
diary, Gazprombank. Similarly, some more stable banks, like the Bank of Moscow and Sberbank, benefited from deposit reallocation.

Figure 1.1 Total and Personal Deposits (mln rubles, dec-97 prices)



Source: Bulletin of Banking Statistics, CBR

Figure 1.2 Outflow of Retail Deposits from Selected Banks (Aug-Sep 1998)



Source: Troika Dialog

Table 1.1 Transfer of Corporate Deposits among Selected Banks (Aug-Sep 1998)

Avtobank	-14%
Oneximbank	-5%
SBS-Agro	-19%
Alfa-Bank	-3%
Rossiisky Kredit	-78%
MFK	-34%
Vozrozhdenie	-15%
NRB	-41%
Most-Bank	-24%
Menatep	-56%
Sberbank	+34%
Vneshtorgbank	+5%
Bank of Moscow	+32%
Inkombank	-48%

Source: Troika Dialog, Interfax

## Why banks were so vulnerable

One of the popular myths about the Russian financial crisis is that most banks sank because of their large GKO portfolios. Effectively the official explanation given by the CBR and the government indicated the GKO default and the rouble devaluation as the main causes of internal financial trouble. Despite widespread belief, this explanation of the crisis is partly unfounded. Firstly, starting in October 1997 large banks stopped initiating massive forward deals with foreign banks, when non-residents began to reduce their investment in GKO. Secondly, only some of the top 20 banks still had significant GKO exposures on their balances by the time the market collapsed on Aug. 17. Before the GKO default, the majority of commercial banks significantly decreased their GKO portfolios and invested proceeds in USD reserves. By the time the GKO default occurred, commercial banks had only 7-10% of their assets invested in GKOs. Over two thirds of Russian banks had less than 2% of their assets invested in GKOs.<sup>14</sup> Alfa Bank and Sberbank were good examples of such portfolio reallocation. In an interview given in November 1998, Oneximbank's head, Vladimir Potanin, told reporters that bankers knew by August 14 that the Kirienko government would devalue on August 17. He also stated that this gave the bankers time to convince Kirienko that the measures also needed to include the infamous 90-day debt moratorium.<sup>15</sup>

The high concentration of assets among highly leveraged and badly managed banks, extraordinary exposure to foreign exchange risk, and the loss of client confidence were the major reasons for the systemic financial crisis. Bankers had expected a devaluation of the rouble since the end of 1997, but they did not modify their risk profiles, because providing hedging with financial derivatives to foreign banks was very profitable. Banks had accumulated large obligations on forward contracts that were taken out by other banks - often foreign - to hedge their currency risks. A large part of these forward contracts had been taken out to hedge GKOs. When the devaluation took place, Russian banks became unable

<sup>14</sup> Troika Dialog (January 1999), Perotti (The role of financial groups in Russia's banking crisis).

<sup>15</sup> Brunswick Warburg, Daily News Review, 06-Nov-1998.

to repay their obligations on forward contracts. While Western banks had been operating mainly through 'USD buy' contracts, the larger Russian banks were involved both in 'USD buy' and 'USD sell' contracts, with each other and with numerous small- and medium-sized banks. Thus, Russian banks turned out to be exposed both to price risk on the contracts, which was exacerbated by the devaluation of the rouble, and credit risk arising from the dubious nature of some of their counterparts.<sup>16</sup>

Banks began reporting their forward positions on January 1, 1998, when the CBR required an accounting of all FX exposures on special off-balance sheet accounts.<sup>17</sup> The accuracy of this information, however, is dubious, due to technical problems and the inability of the CBR to control the correct reporting of forward contracts. There are several estimates on the amount on forward contracts. The Moscow-based investment bank Troika Dialog estimated the total face value of outstanding contracts to be approximately USD 6.5 bn. (Table 1.2)

Table 1.2 Estimated breakdown of forward liabilities to non-residents.  
Main Participants

Bank	\$ mln	%	% of Capital	Bank	\$ mln	%	% of Capital
Incombank	1884	29%	719%	Sberbank	379	6%	23%
Onexim	1442	22%	203%	NRB	224	3%	50%
Vneshtorgbank	1062	16%	136%	Menatep	91	1%	37%
MDM	634	10%	713%	MFK	80	1%	46%
Avtobank	602	9%	299%	Mezhkombank	67	1%	67%
Total					6.500	100	

Source: Troika Dialog estimate on the basis of banks' RAS as of 01.07.98

Indeed, a critical audit of 18 large Russian banks conducted by the Bank Review Unit of the World Bank, based on principles of due diligence and international accounting standards, confirmed suspicions that the massive failure of banks (especially large ones) was primarily due to currency mismatching and excessive risk-taking. Connected lending and excessive risk-taking in the FX market were the most destructive factors. Russia's top banks found that the greatest damage to their capital was dealt not by losses on securities but by extending risky loans, many of which were never returned. The failure of the government to redeem GKO's and OFZ's (Federal Bonds), and the depreciation of other government paper, accounted for just 18% of banks' losses, while estimated damage from bad loans and forward contracts comprised the remaining 82%. Foreign exchange losses accounted for 28 percent of net charges. At the same time, loan-loss provisions amounted to USD 64.3 billion and accounted for 34% of the net charges to capital of the banks, which included Menatep, Mosbiznesbank, Promstroybank, SBS-Agro, Oneximbank and

<sup>16</sup> Reuters, 21-Aug-1998.

<sup>17</sup> There were two types of forwards: deliverable and non-deliverable. The majority of forwards with non-residents were non-deliverable, meaning that Russian banks needed only to pay the FX margins. Deliverable forwards required payments at full face value at a set rate.

Forward contracts were not marketable instruments, since they had no standardised requirements regarding maturity, face value and settlement methods. They provided little legal protection in the case of non-payment. As an example, there was the decision of the Moscow Arbitrage Court on September 2, 1998. The Court was considering a dispute between two Russian banks over money owned under 'non-deliverable forwards'. The Court decided that forward transactions constituted a bet, and that the petitioner's claims on these transactions were therefore not enforceable.

Rossiisky Kredit. The government's default on most of its rouble debt in August 1998 aggravated the situation, but it was not the main cause of the banks' woes.<sup>18</sup>

Finally, the results of the audit, which showed the little weight of GKO in bank portfolios, reflected the fact that several large banks and particularly Sberbank had taken part in the debt exchange programme on the 15th of July 1998. In July the Russian government offered investors a chance to exchange short-term rouble t-bills for seven- and 20-year dollar Eurobonds in order to reduce the volume of short-term debt, which weighed heavily on Russia's budget. The debt exchange was seen as a key component of a loan agreed between Russia's top debt negotiator Anatoly Chubais, the International Monetary Fund (IMF), the World Bank and the Japanese government.<sup>19</sup> At the time the Central Bank and Sberbank combined accounted for about half of the outstanding (USD 41 billion face value) short-term rouble-denominated Russian treasury bill (GKO) market.

When in mid-July the Russian government fully acknowledged that a restructuring of the debt was inevitable, it was not clear whether Sberbank would take part in the debt swap or not.<sup>20</sup> The new issue was carried out and amounted to USD 2.97 billion worth of bonds due in 2005 and a similar amount of bonds due in 2018. An additional USD 500 million of 2018 bonds was sold for cash. Sberbank swapped USD 2.5 billion rouble-denominated Treasury Bills, i.e. GKOs, for the Finance Ministry's new Eurobonds. That amount totalled about 10 percent of the bank's debt portfolio.<sup>21</sup>

### *A case study: Tokobank*

Tokobank offers interesting anecdotal evidence in support of the thesis that many Russian banks were already weak before the financial crisis. Tokobank literally imploded because of a large share of irredeemable loans. There was no need for external factors. Bad management caused bad lending, bad lending caused insolvency. Tokobank's story was also remarkable because it anticipated the many cases of captured bankruptcies, asset stripping, and violation of minority shareholders rights that became a typical feature of the after-crisis.

Tokobank, founded in early 1990, was widely regarded as the symbol of Russian banking's bright future. By 1995 Tokobank was one of the largest commercial banks in

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<sup>18</sup> The results of the audit conducted by the Bank Review Unit were held back for some time by Central Bank chairman Viktor Gerashchenko, who argued that, if released, it would shatter confidence in the banking sector. The report calculated that the combined losses of the 18 banks in the wake of the crisis were USD 9.78 billion (about 100 billion roubles). The World Bank's findings contradicted the estimates made by the Central Bank, which put the damage dealt by the crisis at a mere USD 500 million. Of the 18 audited banks, 15 had been among the 30 largest Russian banks as of July 1998. The review revealed that 14 of the 18 banks had negative capital in September-October 1998, and all of Russia's 5 largest banks (not including Sberbank, which was not reviewed) were among those 14.

<sup>19</sup> The accord provided for Russia to receive USD 22.6 billion in several loan disbursements over the next two years. The Russian Finance Ministry would receive only USD 4 billion to fund expenditures or the redemption of outstanding GKOs. A majority of the loan disbursements was supposed to go to Russia's central bank as reserves to maintain the stability of the rouble.

<sup>20</sup> There was a lot of confusion among investors about the role of Sberbank in the operation. In an official statement, central bank chairman Sergey Dubinin said that Sberbank would not swap its GKOs for new bonds because of monetary policy considerations. At the same time, Russia's Finance Ministry said that Sberbank was entitled to take part in an offer to exchange short-term treasury bills for dollar-denominated bonds. *Nezavisimaya Gazeta* 16-Jul-1998, 'Сбербанк не отказывался от евробондов' (Sberbank did not reject Euro-Bonds).

<sup>21</sup> Reuters, 03-Aug-1998.

Russia and *Euromoney* magazine named it the best bank in Russia.<sup>22</sup> Its Executive Vice President, Alexei Matveev, often stressed that the bank's underlying idea was to escape the sluggishness, dependence and ineffectiveness of state-owned institutions. Good incentives and good management were the key ingredients of success.

Just about three years had passed when, on May 5 1999, Tokobank was placed under temporary administration by the CBR for poor management and ill-advised lending. Tokobank's management argued that the temporary administration had to be seen as a preventive and cautious measure, which followed a perceived threat to Tokobank's clients and creditors, but that the bank was not experiencing significant difficulties. Nicholas Stern, chief economist at the European Bank for Reconstruction and Development (EBRD), which possessed a 9.6 percent stake in Tokobank, said he believed problems in the bank were short-term. The EBRD said it was in receipt of Tokobank's 1997 results audited according to international standards and showing the bank to be solvent in the medium term with strong capital adequacy.<sup>23</sup>

Three full weeks had not yet passed since these statements when the situation began to seriously deteriorate and Tokobank moved from illiquidity to insolvency. The management presented a rescue plan at a meeting with foreign creditors - with whom it was exposed for an estimated total of USD 320 million - but failed to convince them of the merit of its achievements. A Russian court declared Tokobank bankrupt but liquidation progressed in an unexpected way. Vladimir Stolyarenko, first deputy chairman of Bank Imperial, was chosen as head of the temporary administration. Ironically his bank was to lose its licence four months later.<sup>24</sup> The bankruptcy plan was devised at a creditors meeting in which foreign creditors were marginalized.

Seeing an inevitable disaster lying ahead, the EBRD decided then to sell its stake, exercising a secret option to swap equity for debt.<sup>25</sup> The concealment of the put option by the EBRD left many investors dismayed. One Moscow banker bitterly said of the EBRD, 'First the EBRD gave its stamp of approval but it didn't do its homework. Then it tried to escape from the sinking ship, letting the others drown'. Unfortunately for the EBRD, Tokobank's administration refused to acknowledge the exercise of the swap option and the EBRD's stakes were entirely written off. David Hexter, an EBRD director, said: 'We are deeply distressed by the way the liquidation of Tokobank is taking place. It does not respect creditor rights. It does not respect shareholders rights. It is a model of how not to conduct a liquidation'. Mr Hexter finally argued that a predator bank - which he never named - had orchestrated a campaign to strip assets out of Tokobank while it was being run by a temporary administrator.<sup>26</sup>

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<sup>22</sup> Matveev (1996)

<sup>23</sup> Reuters, 08-May-1998

<sup>24</sup> Reuters, 26-Aug-1998,

<sup>25</sup> Interfax, 07-Sep-1998.

<sup>26</sup> *Financial Times*, 27-Apr-1999, 'EBRD hits at Russia over bank reform: concern over Tokobank liquidation'.

## 2 The Rescue of the Financial System: 1998-1999

### The 90-day moratorium and the transfer of personal deposits to Sberbank

Immediately after the crisis, the government adopted two important measures that greatly helped in the survival of banks and provided a partial protection of deposits. The first of these measures was the 90-day moratorium on the repayment of banks' foreign debts and foreign exchange term contracts. The second was the transfer of personal deposits from several troubled banks to Sberbank.

Under the 90-day moratorium Russian banks were allowed to withhold payments of: a) the principal amount of foreign currency borrowings from non-resident counterparts (i.e. syndicated loans); b) margin calls on repurchase transactions; and c) settlements of forward foreign currency contracts. Technically, Russian banks were given a three-month period in which to negotiate with their creditors on the restructuring of due payments, which became unfeasible after the sharp rouble devaluation. The moratorium was beneficial primarily for large problem banks with high FX exposure. Some fundamentally solvent banks, such as Alfa-Bank, Avtobank, Vneshtorgbank, and NRB, either paid their liabilities despite the moratorium or rolled over their loans. The moratorium, however, had only temporary effects.<sup>27</sup>

The second step of the government intervention was to choose Sberbank as a vehicle for protecting personal deposits. Sberbank was the only bank that granted deposit insurance; therefore, other large troubled banks were requested to transfer the accounts of their clients to it.<sup>28</sup> At the beginning of September the representatives of Inkombank, Bank Menatep, Mosbiznesbank, Most-bank, Promstroybank and SBS-Agro were invited by the CBR to sign an agreement with Sberbank about the transfer of their personal deposits.<sup>29</sup> The six banks held 37 billion roubles of the 53 billion roubles of retail deposits held in commercial banks. A few weeks later Rossiisky Kredit followed the other banks.<sup>30</sup> 'The precise and responsible fulfilment of this decision is the only natural way to protect most deposits and at the same time make it possible for many leading banks to bring stability to their work,' the Central Bank said.<sup>31</sup>

<sup>27</sup> When it expired on November 16, the overall liabilities of Russian banks to foreign debtors were estimated to be more than USD 11 bn. The short-term loans, which matured during the moratorium, accounted for USD 4.1 bn and syndicated loans for another USD 350 mln.

<sup>28</sup> *Nezavisimaia Gazeta*, 03-Sept-1998, 'Частные вклады переведут в Сбербанк?' (Will personal deposits be transferred into Sberbank?).

<sup>29</sup> *Nezavisimaia Gazeta*, 09-Sept-1998, 'Соглашение о передаче вкладов Сбербанку' (Agreement about the transfer of deposits to Sberbank).

<sup>30</sup> *Kommersant-Daily*, 17-Nov-1998, 'Вкладчикам 'Российского кредита' предложено перейти в Сбербанк' (The depositors of Rossiisky Kredit are offered to transfer to Sberbank).

<sup>31</sup> The implementation of the transfer programme took some time. At the end of November 1998, the Supreme Court of the Russian Federation intervened against the resolution of the CBR about the transfer of personal deposits. The Supreme Court determined the resolution was illegal. Nevertheless, the operation went on. Reuters, 02-Sep-1998, CBR, 24-Nov-1998, 'Телеграмма от 12 октября 1998 г. N 281-Т' (Telegram n°281-T, 12 Oct 1998). *Kommersant-Daily*, 13-Oct-1998, 'Анонс' (Announcement), *Kommersant-Daily*, 09-Mar-1999, 'Заканчивается перевод вкладов в Сбербанк' (The transfer of deposits to Sberbank is concluded), *Kommersant-Daily*, 25-Mar-1999, 'Сбербанк заплатит вкладчикам Российского кредита' (Sberbank will pay the depositors of Rossiisky Kredit). *Kommersant-Daily*, 14-Apr-1999, 'Сбербанк заплатит обманутым вкладчикам из Кузбасса' (Sberbank will pay the deceived depositors from Kuzbass).

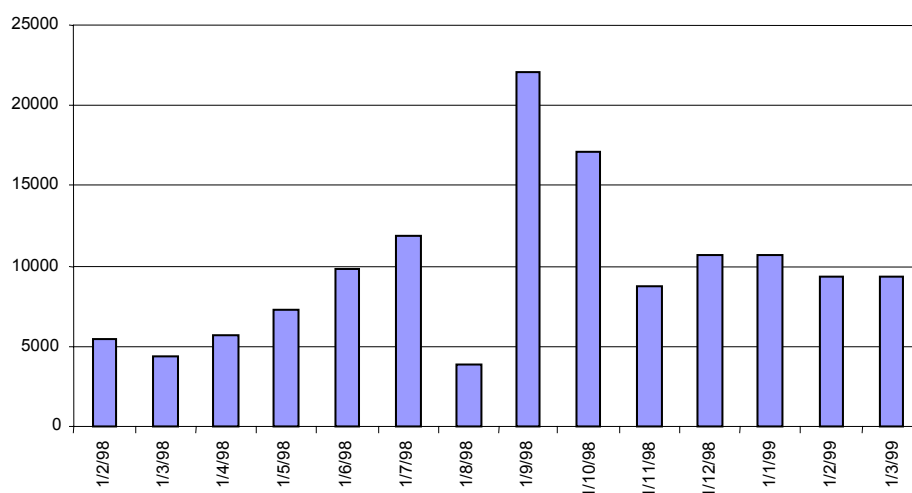
## The policy of 'Stabilisation Loans'

In early September, President Boris Yeltsin and the Duma elected Viktor Gerashchenko as the head of the Central Bank. The move was welcomed by local bankers but dreaded by some Western economists.<sup>32</sup> As a first move, Gerashchenko decided to allow a debt swap in which many bank debts were mutually offset and others were paid out of the banks' mandatory reserves. These decisions partially reduced the lack of liquidity banks were facing. However, they allowed commercial banks to shrink their reserves.

In the meanwhile, the Central Bank had begun issuing banks overnight loans at low interest rates, which was another way to pump liquidity into banks (Figure 2.1). The Central Bank was lending at an interest rate of 40 percent (below market rate), accepting treasury bills as collateral for these loans. In normal times, overnights are loans meant to be repaid the day after they are issued and are used by banks to settle urgent debts among themselves. After the crisis, the interbank credit market collapsed due to the lack of liquidity and confidence. Banks could no longer repay overnight loans the following day and the Central Bank had to roll over these short-term credits repeatedly.<sup>33</sup>

In early November 1998, Viktor Gerashchenko revealed the amount of credits provided by the CBR. The CBR had injected 46 bn roubles into the financial system: approximately 35 billion of this amount was the cost of the government guarantee for the repayment of all deposits frozen at insolvent banks. The CBR had also provided 11 bn roubles in direct financial injections into the largest banks in the form of short-term 'stabilisation' loans (Table 2.1).

Figure 2.1 Outstanding Credits of the CBR to resident credit institutions (mln roubles)



Source: Bulletin of Banking Statistics, CBR

<sup>32</sup> Viktor Gerashchenko was a Soviet-era banker who ran the central bank between 1992-94. Yeltsin cut short his previous term as governor in October 1994 after the rouble suffered its worst post-Soviet one-day plunge. Respected at home as a professional who understood Russia's messy finances, Gerashchenko was seen in the West as being too lax with monetary controls.

<sup>33</sup> *Moscow Times*, 09-Oct-1998, 'Central Bank Tries New Loan Scheme'.

Table 2.1 CBR Assistance to the Banks

Type of Assistance	Amount
CBR guarantee on retail savings at insolvent banks	RUR 35 bn
Short-term and stabilisation loans to commercial banks	RUR 11 bn
TOTAL	RUR 46 bn

Source: The CBR, Troika Dialog estimates

Gerashchenko also announced that 17 banks had immediately received long-term loans from the CBR. These banks were SBS-Agro, Most Bank, Bank of Moscow, Bank Vozrozhdenie, Mosbiznesbank, and Moscow Industrial Bank, Inkombank, Sberbank and nine other regional banks. Such injections, however, failed to shield Inkombank and SBS-Agro from liquidity problems. Despite CBR support, problem banks were not able to regain client confidence (Table 2.2).

Gerashchenko did not mention Sberbank among the banks receiving assistance, despite the fact that the bank significantly benefited from the Central Bank's support. Sberbank rebounded within a few months after the August debacle, largely thanks to liquidity infusions by the Central Bank that were estimated to have totalled 30 billion roubles.<sup>34</sup> Sberbank partly avoided losses related to rouble devaluation, thanks to its significant investments in USD resources just before the rouble crash in August. Nevertheless, the bank experienced a deterioration of its profitability and liquidity due to the freezing of the GKO market and the outflow of retail deposits. The major portion of this outflow was financed by CBR loans. The CBR provided the bank with short-term loans for covering gaps in the bank's cash flows and financing Sberbank's payments on retail deposits. Thus, the resources of Sberbank became significantly dependent on the CBR as well as on the Pension Fund. By January 1999 over 48% of retail deposits at Sberbank consisted of pension accounts. The timely payment of pensions became crucially important for the maintenance of the stable short-term resources of the bank.<sup>35</sup>

Table 2.2 Long term CBR Loans to Commercial Banks, RUR mln

Bank	Amount
Sberbank	9,000
Most-Bank	900
Moscow Industrial Bank	400
SBS-Agro	1,600
Vozrozhdenie	350
Mosbiznesbank	1,000
Inkombank	1,000
Bank of Moscow	1,000
Regional banks (nine)	500

Source: Toika Dialog (1999), Reuters and Troika Dialog estimates

<sup>34</sup> *Brunswick Warburg, Daily News Review*, 06 Nov 1998

<sup>35</sup> Troika Dialog (January 1999)

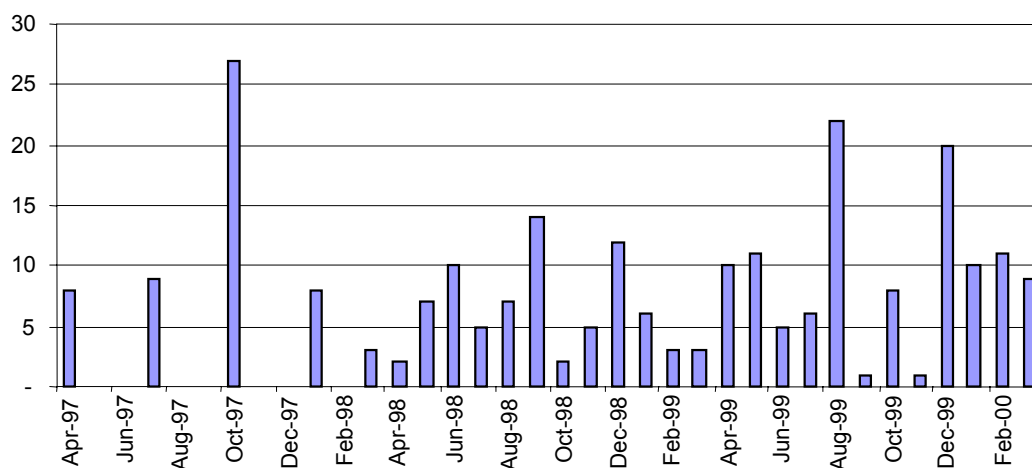


## Restructuring

In Russia banking sector restructuring encountered several difficulties since its beginning. The major obstacle was the conflict of political interests among the involved parties: bank owners, the Central Bank, the Duma and the government. The government had good incentives to restructure the banking system, both since it needed tools for implementing industrial policy and because banking reform was a main condition for further IMF financing. But at the same time, the Duma intended to remove some regulatory functions from the CBR and to obtain some control over cash flows in the country by regulating procedures for reorganising banks.

By March 1999 the CBR –the only institution that had the right to intervene in banks' operations and to close them down - hardly used its powers to deal with problem banks (Figure 2.2). In the period between the end of August 1998 and the end of March 1999, the Central Bank withdrew approximately 88 licences for violations of banking laws and CBR regulations, which was 46 less than in the same period a year before. This was despite the fact that many banks had left their creditors stranded. The total number of banking licences recalled in 1998 was 229, which was 105 lower than in the previous year. The CBR justified itself by blaming Russian accounting standards, which allowed troubled banks to manipulate their books to meet CBR capital requirements. The lack of restructuring in the Russian banking sector is particularly stark compared with the sharp increase in bank closures in other markets that have experienced banking sector meltdowns. While other banking sectors responded to crisis by closing down 20-40% of their banks (from a much lower base than Russia's), the Russian banking sector saw just a 12% decline in the total number of institutions over the year following its collapse in August 1998.<sup>36</sup>

Figure 2.2 Number of Bank Licences withdrawn each month by the CBR for violations of banking laws and CBR regulations



Source: Bulletin of Banking Statistics, CBR

<sup>36</sup> Renaissance Capital, (Oct 2001).

## ARKO

The experience of countries that have suffered a banking crisis shows that an independent agency heading up the restructuring process could improve the chances of success. In countries like Chile and Mexico, such an agency intervened in the operations of problem banks, seized their shares, restructured their operations, dealt with their debts and then re-sold them. In other countries, central banks have taken on a similar role, although the conflict of interest, which is unavoidable when the bank supervisor becomes the owner of some of them, is not at all helpful in the process of bank restructuring. Such hands-on restructuring was the goal of Russian policy makers when ARKO – the Agency for the Restructuring of Credit Organisations - was officially founded by the Russian government in the first quarter of 1999.

ARKO's capital was supposed to be supplied half by the state and half by the CBR. But this plan had to be changed when the Duma rejected the amendment to the law 'On the Central Bank of Russia' that allowed the CBR to be an ARKO shareholder. In the end, however, although the government owned 100% of ARKO's share capital, the Central Bank obtained de facto control over the Agency. Moreover, the head of the CBR, Victor Gerashchenko, was appointed chairman of ARKO's board of directors and former Deputy Chairman of the CBR, Alexander Turbanov, was appointed its general director. Nevertheless, ARKO proved relatively weak from the start. Its RUR 10 bn capital was very limited, considering its mission. At the time, the amount of money necessary to patch the holes in the 18 largest banks in Russia was estimated at over RUR 100 bn. A second, still more critical flaw was that ARKO lacked the right to close down inefficient banks and was even powerless to interfere with the operations of banks against the will of their managers and owners.<sup>37</sup>

Starting in autumn 1998, the Kremlin and parliament members tried to hammer out a bank-restructuring bill. The first version of the bill, which was expected to regulate arbitration and bankruptcy proceedings, was put before the State Duma, the lower house of parliament, in late 1998. Months were spent on idle debates in the parliament between the deputies and the presidential administration, which offered and lobbied hard for its own version of the law. It took eight months to pass the bill into law.

In the meanwhile, on February 25, 1999 the Law on the Insolvency (Bankruptcy) of Credit Institutions was passed, specifically regulating bankruptcies and the liquidation of financial institutions. Until then, credit institutions did not have any bankruptcy regulation. The new law correctly defined a bankrupt bank and set out bankruptcy procedures but it poorly defended creditor rights. In short, it protected controlling shareholders at the expense of less influential creditors. The new law did not prevent at all asset stripping and other non-transparent manoeuvres. After the passage of the law, at least half of the top ten banks moved their business to newly established bridge banks in violation of creditor rights. According to the new law, creditors at problem banks could not prevent asset stripping until the CBR had revoked the banks' licences and a court had declared the banks insolvent. Even if the CBR brought a bank under its temporary administration, the administrators had to agree all significant deals (exceeding 5% of the bank's total assets) with the bank's owners, not creditors.<sup>38</sup>

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<sup>37</sup> Russian Economic Trends (March 1999).

<sup>38</sup> Troika Dialog, (May 1999)

Finally, in July 1999 President Yeltsin signed the 'Law on the Restructuring of Credit Organisations'. In order to qualify for restructuring under the law, a bank had to meet some size criteria that prioritised large banks.<sup>39</sup>

The new law also reaffirmed the role of ARKO.<sup>40</sup> Prior to the law, ARKO lacked the power to impose restructuring on broken banks and was even used for other means. By June 1999 ARKO had already spent a quarter of its capital buying up 'off-market' government bonds designed to shore up Russia's yawning budget deficit. The bonds were part of an emission sold as part of a government strategy to fill in its budget shortfall. By then ARKO had only picked out a few small troubled banks that were willing to be helped. Since its foundation, ARKO's board of directors had approved restructuring plans for a few banks of the Voronoezh and Kemerovo regions.<sup>41</sup> Only at the end of June, when the approval of the law on restructuring was getting closer, did ARKO decide to rescue major banks like Rossiisky Kredit and Promstroibank.<sup>42</sup> In a surprise move, ARKO also announced that it would extend a 1 billion-ruble (USD 41 million) credit line to up-and-running giant Alfa Bank to finance its expansion into the regions. With its limited founding capital, the loan to Alfa Bank tied up ARKO's funds meant for rescuing struggling banks.<sup>43</sup> ARKO's move to invest in the relatively unscathed Alfa Bank as a way to restore regional payment systems saw the agency step beyond its original mission.

<sup>39</sup> The four criteria were (*Russian Economic Trends*, June 1999):

- The bank holds no less than 1% of all deposits of Russian citizens in commercial banks;
- It accounts for no less than 1% of all credits extended to firms by credit organisations in Russia (not including credits to other banks);
- It holds no less than 20% of all deposits of Russian citizens in its region;
- It accounts for no less than 20% of all bank assets in its region.

<sup>40</sup> Specifically it was designed to:

Ensure that banks are directed to ARKO only by the CBR based on established criteria.

- Give ARKO the power to evaluate the feasibility of restructuring projects and refuse to restructure hopeless banks.
- Ensure that the claims of shareholders on a bank are written down and control is seized by ARKO if shareholders do not contribute additional capital.
- Grant ARKO powers to reverse past transactions that infringed the rights of bank creditors.
- Require temporary administrators to remain in a bank from the time of its referral to ARKO or the withdrawal of its licence until the time when the bank is restructured or a receivership manager is appointed to it.
- Allow ARKO to be a receivership manager for banks under its control.
- Introduce capital insolvency as a ground for bank bankruptcy.

<sup>41</sup> Namely: Vozroshdenie (12<sup>th</sup> largest in the country), Russian People's Credit Bank (RNKB) (56<sup>th</sup>), Viatka-bank (183<sup>rd</sup>), Khovansky (189<sup>th</sup>), Cheliabinsk Commercial Real Estate Bank (191<sup>st</sup>) and Eurasian Bank for Economic Development (not in the top 200). Of these, only one (Vozroshdenie) satisfied one of the national criteria listed in the law. In the Kemerovo region Kuzbassprombank, Kuzbassotsbank and Kuzbassugolbank had been rescued. Finally, AvtoVAZ bank in Tolyatti and Investbank in Kaliningrad had received some assistance.

<sup>42</sup> *Moscow Times*, 22-Jun-1999, 'ARKO Picks 2 Major Banks to Rescue'. *Nezavisimaya Gazeta*, 25-Jun-1999, 'Арко Занялось Банками Федерального Значения: Агентство начало санировать Промстройбанк и Российский кредит' (Arko Has Considered Banks Of Federal Importance: the Agency began to sanitize Promstroybank and Rossiiskii Kredit).

<sup>43</sup> *Moscow Times*, 24-Jun-1999, 'ARKO Asks Government for Funds'.

## Examples of Asset Stripping and 'Bridge Banks'

Despite the legislative efforts and the foundation of ARKO, the Russian bank restructuring was an example of the feeble safeguarding of the rights of minority shareholders and creditors. Russian banks were in fact an excellent case study in dramatic corporate governance abuse. Problem banks routinely engaged in asset stripping in the process of restructuring their debts. The process of bankruptcy and liquidation of insolvent banks protected insiders but exposed outsiders to massive losses. Such problems were exacerbated by weak bankruptcy legislation and a lack of bank liquidation history. Controlling shareholders nearly always triumphed over minority shareholders and creditors.<sup>44</sup>

The weaknesses of bankruptcy procedures and the ineffectiveness of CBR monitoring, already emphasised by the bankruptcy proceedings at Tokobank, were unpleasantly confirmed. As we have seen, since the beginning of the crisis the CBR, instead of punishing bankrupt banks for their excessive risk exposure, rather treated them with a very soft hand with kid gloves. This eradicated any residual confidence of the public in the banking sector and created incentives for future moral hazard.<sup>45</sup> The head of the Central Bank, Viktor Gerashchenko, once admitted: 'Banks were burned by state bonds and by bankrupting them we punish them a second time'. He did, however, have a realistic view of the Russian situation. Once he said that the system by which banks were declared bankrupt was permeated by criminal structures. He added: 'foreign creditors would often fare better by dealing directly with ailing banks than going through the official arbitration manager, who would probably have paid for the job. To become an arbitration manager, people pay huge money. And often it works out worse for a creditor with an arbitration manager than with the previous owner'.<sup>46</sup>

To provide some concrete examples of corporate governance abuses, in this section we consider four case stories. We start from the never-ending bankruptcy of Inkombank, in which the CBR effectively imposed bankruptcy regulations. However, the liquidation procedure of Inkombank took three years and left most creditors disappointed. The following story regards the rescue of SBS-Agro, which was an example of the costs that Russian taxpayers had to bear - often in vain - to support the ailing financial system. In the case of SBS-Agro, public money was spent to keep alive an inefficient credit institution that could not be scrapped because it was 'too big to fail'. The next two stories are about the restructuring of Oneximbank and Bank Menatep. Both of them serviced very influential financial-industrial groups. Both were able to move their core businesses to so-called 'bridge banks', new credit institutions controlled by the shareholders of the old banks and run by the same managers.<sup>47</sup> The assets of the bankrupt bank were transferred to the bridgebank and liabilities were left behind. Several large banks such as SBS-Agro, Oneximbank and Rossiisky Kredit are beginning to form new banks working parallel to the old structures.<sup>48</sup> Rossiisky Kredit created a bridge bank, Impeksbank, to allow it to keep working with its clients. Menatep-St. Petersburg took over Menatep's 46 Moscow branches and acquired several of its sister's regional offices. Oneximbank formed Rosbank and used it together with BaltOneximbank to transfer the assets Oneximbank's assets. SBS-Agro became part of the Soyuz Group, and started up a new bank - the First Mutual Credit Society - to handle its choicest accounts.

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<sup>44</sup> Troika Dialog, (May 1999)

<sup>45</sup> On the risks of bailouts for moral hazard, see Cordella and Levy-Yeyati (1999).

<sup>46</sup> Reuters, 13-Jul-1999.

<sup>47</sup> Troika Dialog, (May 1999)

<sup>48</sup> Reuters, 03-Mar-1999

## The never-ending bankruptcy of Inkombank

Inkombank (the Moscow Innovation-Commercial Bank) was founded by Vladimir Vinogradov in 1988 and was one of the so-called 'zero banks', created primarily by Party-affiliated bodies, spetsbanks and other non-productive organisations in the latter years of Perestroika. Inkombank received its first capital with the support of Leonid Albakin, then Deputy Prime Minister, and Vitalii Groshev, rector of the Plekhanov Institute for Economics and would-be chairman of Inkombank's supervisory council. By January 1996, Inkombank had become the fifth largest bank in Russia in total assets and was listed by the CIA among 10 of the largest 25 banks linked to organised crime. Inkombank became head of one of the major bank-led Financial-Industrial Groups, having increased its influence in the real sector. Inkombank's retail network comprised more than 120 outlets and held stakes in almost thirty enterprises ranging from metallurgy, aircraft and pipes to confectionery.<sup>49</sup>

At the beginning of July 1998 the international rating agency Standard & Poor's cut the credit ratings of six Russian banks, saying the renewed market turbulence in Russia had increased the risk of a systemic crisis. Inkombank was on the list together with SBS-Agro Bank, Rossiisky Kredit Bank and Alfa Bank.<sup>50</sup> Inkombank incurred a total loss of USD 355 million, one of the largest incurred by a private Russian bank.<sup>51</sup> The rating agency Fitch-IBCA said Inkombank had balance sheet foreign liabilities of USD 600 to 700 million, but affirmed that the bank's overall debt to foreign and domestic creditors was difficult to assess because its obligations under rouble forward contracts were not reflected in the balance.<sup>52</sup>

From late 1998 until the conclusive bankruptcy of February 2000, there was a long series of attempts to save the bank from its dire destiny.<sup>53</sup> Due to the CBR's procrastination over revoking the bank's licence, Inkombank succeeded in setting off its liabilities to key clients against their debts on loans extended by the bank, often at significant discounts that mostly benefited the bank's managers. Additionally, some Inkombank creditors used the time allowed by the CBR to make advance tax payments from their frozen accounts with the bank, thereby offsetting the money they lost with it. According to the Amendments to the Federal Law on the Basic Structure of the Tax System passed in November 1998, the receipt by a bank of a client's instruction to pay taxes qualified as a tax payment even if the money never reached the government's accounts. Because of these transactions, the bank could meet its liabilities to its key domestic creditors and controlling shareholders at the expense of retail depositors, foreign creditors and the federal budget.

At the beginning of September 1998, the CBR was capable of imposing a temporary administration on the bank. However, Inkombank successfully appealed to a Moscow district court to have it removed. When the ruling decision came from a Moscow Arbitration Court declaring it bankrupt, Inkombank chairman Vladimir Groshev fought to the end to keep the bank alive. At that stage the bank had repaid only 1.5 bn roubles (USD 52 million) to individual creditors with a further 4.6 bn roubles still owed. The state and the CBR had a credit of 6 bn roubles and companies and banks another 32 bn.<sup>54</sup>

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<sup>49</sup> Johnson (2000)

<sup>50</sup> Reuters, 10-Jul-1998

<sup>51</sup> Interfax, 18-Mar-1999

<sup>52</sup> Itar-Tass, 10-Nov-1998

<sup>53</sup> Itar-Tass, 10-Nov-1998, 11-Nov-1998, Reuters, 08-Feb-1999, 17-Feb-1999, Interfax, 18-Mar-1999, 03-Jun-1999, 02-Feb-2000

<sup>54</sup> Reuters, 02-Feb-2000

In July 2000 Inkombank finally decided to give some money back to individual depositors; however, it restricted payments to a mere 600 hundred of them. All the others would be paid at the rouble/dollar exchange rate valid at the time of the licence withdrawal, i.e. 16.33 RUR/USD. A Moscow Arbitration Court argued that according to the bankruptcy law, Inkombank was supposed to pay at the exchange rate valid at the time of the bankruptcy declaration, i.e. 28.55 RUR/USD. To buy time, the bank decided to appeal the decision of the court and moved its only valuable assets, i.e., its retail network, into the hands of Guta-Bank, which acquired 80 of Inkombank's offices throughout Russia.<sup>55</sup>

### Too-big-to fail: SBS-Agro

SBS-Agro was Russia's second biggest retail bank before the crisis, second only to Sberbank. SBS-Agro specialised in loans to the agricultural sector, where it enjoyed a monopoly position with an important retail network, comprised of more than 1,500 branches.<sup>56</sup> The bank was in trouble already before the crisis, which hit it severely. SBS-Agro was heavily exposed on rouble/dollar forward contracts before the 1998 devaluation and had issued USD 250 million worth of Eurobonds. Due to foreign loans and retail deposits, the bank found it impossible to remain liquid after the rouble devaluation.<sup>57</sup>

At the time of the crisis, the head of the bank, Alexander Smolensky, admitted in September 1998 that the bank owed more than USD 1 billion to non-residents, including USD 162 million in non-serviced margin calls. By November, SBS-Agro had the sector's lowest capital adequacy and liquidity, with cash comprising just 1% of the bank's assets (sector average = 10%).<sup>58</sup>

Despite this appalling performance, the bank was perceived as one of systemic importance and the possibility of catastrophic social effects for over 1.2 mln SBS-Agro retail depositors in the event of the bank's bankruptcy prevented any liquidation procedures against it.<sup>59</sup> Furthermore, the government used SBS-Agro for the distribution of budget subsidies to the agricultural sector.<sup>60</sup> Therefore, despite the difficult financial situation, the CBR decided to acquire a controlling stake in SBS-Agro in exchange for over RUR 1.6 bn in stabilisation loans issued to the bank, whose negative capital in September 1998 was estimated to be RUR 32.3 bn.<sup>61</sup>

At the end of July 1999, the Russian Central Bank decided to introduce a temporary administration for SBS-Agro. Central Bank deputy chairman Georgy Luntovsky was appointed head of the temporary administration and SBS-Agro received another 400 million-rouble (USD 16 million) Central Bank loan.<sup>62</sup> At the beginning of November 1999, SBS-Agro, the negative capital of which had fallen to RUR 60 bn, was brought under the direct management of ARKO.<sup>63</sup> In January 2000 the government declared SBS-Agro bankrupt, and announced the imminent creation of a new state-owned agricultural bank with an old name, Rossel'khozbank (Russian Agricultural Bank). Despite the fact that the law on the

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<sup>55</sup> Kommersant-Dengi, 26-Jul-2000

<sup>56</sup> Schoors (1999)

<sup>57</sup> Interfax, 28-Aug-1998

<sup>58</sup> Reuters, 08-Jul-1999

<sup>59</sup> Troika Dialog (June 1999)

<sup>60</sup> Troika Dialog (Jan 1999)

<sup>61</sup> Eggenberger (1999)

<sup>62</sup> Reuters, 10-Aug-1999

<sup>63</sup> Russian Economic Trends (2000)

bankruptcy of banks prevented managers of bankrupt banks from holding a management position in another bank, Juri Trushin, former director of Agroprombank and SBS-Agro, was chosen to head the new agricultural bank.<sup>64</sup>

In February 2001 an 'amicable agreement' on the bankruptcy of the bank was reached but most depositors were angry about the accord due to its extremely unfavourable conditions. To ease the tension, ARKO decided to please selected depositors (old people and invalids) by paying out part of their money. However, the number of people who got their money back amounted to a mere 500 out of 35 000 individual depositors still waiting for a total sum of 5.2 billion roubles.<sup>65</sup>

In the first half of 2001 ARKO approved an ultimate intervention in SBS-Agro, spending one more billion roubles.<sup>66</sup> Practically all this fresh money was used to pay individual depositors at SBS-Agro and for the preparation of judicial actions on a number of doubtful transactions, revealed in an investigation by the auditing company.<sup>67</sup>

## Oneximbank fades into BaltOneximbank and Rosbank

Oneximbank was founded in 1993 by Vladimir Potanin, who already played a leading role in MFK bank, which he had created in 1992 in cooperation with Sberbank, Vneshekonombank, IBEC and Interros. The latter was a foreign trade company that Potanin formed in March 1990 using his connections at the USSR Ministry of Foreign Affairs, where he had worked before striking out on his own. By January 1996, Oneximbank had become the fourth and MFK the eighth largest Russian banks according to assets and at the beginning of 1998 Oneximbank was on the surface a very solid credit institution.<sup>68</sup> Until August, Oneximbank's management maintained an aggressive attitude, which materialised in the acquisition of a controlling stake in the troubled Unikombank.<sup>69</sup>

The first negative sign came from Fitch-IBCA, which correctly anticipated the fragility of the bank –accentuated by the potential strain on its capital, asset quality and performance due to the acquisition of Unikombank.<sup>70</sup> Oneximbank had been among the largest holders of government securities since 1997 and had 15% of its liabilities in foreign debt,

<sup>64</sup> Schoors (1999)

<sup>65</sup> *Kommersant-Daily*, 08-May-2001, 'АРКО платит вкладчикам 'СБС-Агро' за молчание на суде (ARKO pays depositors of SBS- Agro for silence in court).

<sup>66</sup> ARKO had to sell the shares it held in five restructured banks in order to raise money for the rescue. The sale provided ARKO with 660 mln roubles that were added to another 375 mln roubles obtained from selling Rossel'khozbank to the government.

<sup>67</sup> ARKO had hired KPMG as an auditor in 2000. Together with the agency itself, Rosbank and MFK-Securities, KPMG conducted financial investigations into SBS-Agro transactions. *Vedomosti*, 19-Jul-2001, 'В СБС-Агро вложат 1 млрд руб' (SBS-Agro receives 1 billion RUR).

<sup>68</sup> From the beginning, Oneximbank operated as an official agent of the Russian government for servicing Russia's foreign trade operations. The biggest export enterprises in Russia became shareholders and clients of the bank. In a few years, Potanin managed to transform Interros/Oneximbank into one of the most powerful Financial Industrial Groups, with over 30 enterprises. Its sectors of investment included oil (fifth-largest oil firm, Sidanko), petrochemicals, shipping, metallurgy (Norilsk Nickel), railways, export trade, real estate and media (*Izvestiia*; *Ekspert*, *Komsomolskaia Pravda*). Potanin felt the need to form bank branches in those regions where his bank-led Interros group had acquired enterprises. For this reason Oneximbank moved into Irkutsk and Saratov when it invested in Sidanko Oil. And after the 1996 Presidential elections, Yeltsin named Vladimir Potanin to the post of First Deputy Prime Minister in charge of economic affairs. Johnson (2000), Reuters, 25-Aug-1998.

<sup>69</sup> Reuters, 08-Jul-1998, 03-Aug-98

<sup>70</sup> Reuters, 16-Jul-1998

totalling USD 557.9 million.<sup>71</sup> Oneximbank had a notional USD 1.9 bn in outstanding rouble/dollar forward contracts, divided between dollar contracts to foreigners and rouble contracts from Russian banks. Onexim's liquidity further deteriorated after U.S. investment banks began to freeze Oneximbank's accounts in order to retrieve outstandings on forward contracts while many clients had stopped sending export revenues to the bank's correspondent accounts.<sup>72</sup> Financial adviser Fleming UCB, after Onexim defaulted on its Eurobond issues in February 1999, estimated the bank's total foreign and domestic debt exposure at around USD 2.0 bn. On July 1 1999 the CBR withdrew Onexim's licence.<sup>73</sup>

Just after the crisis, the first reaction of Oneximbank's management was to declare a merger with MFK, Menatep and Most Bank, to create a new entity called Rosbank.<sup>74</sup> The merger received full approval by the CBR, but never took place. In fact, as the bankers realised the extent of each other's debts, they dropped the idea.<sup>75</sup> Rosbank, however, came into being and together with BaltOneximbank— Onexim's subsidiary bank in St Petersburg— was used as a 'bridge bank'. Rosbank and BaltOneximbank received most of Onexim's assets, its employees and almost 90 percent of its clients.<sup>76</sup>

At the same time, talks about debt restructuring began.<sup>77</sup> Onexim's creditors made serious efforts to postpone the bankruptcy proceedings and obtain an amicable liquidation with the management. The CBR supported this process of conciliation between the two parts and Central Bank chairman Viktor Gerashchenko assured that Onexim would have got back its operating licence in case a successful agreement with its creditors had been reached.<sup>78</sup>

In November an accord was finally reached. Onexim won creditors' approval to restructure over USD 1 bn in debts with an up-front cash payment of USD 105 mln and an issue of USD 130 mln in 12-year Eurobonds by Rosbank. 'The order on the withdrawal of the operating licence of Oneximbank has been suspended' Gerashchenko told reporters. 'A court will take a decision on the bank's future based on an amicable agreement,' he added.<sup>79</sup> The Onexim spokeswoman said that once the bank got its licence back and bankruptcy proceedings were halted, it would merge with Rosbank as already approved by creditors. The merger was a key point of the whole accord. Rosbank would take formal responsibility for Onexim debts and as part of the restructuring, bonds would be issued offering holders the option to buy Rosbank shares.<sup>80</sup>

In July 2000, a USD 2.2 bn debt deal was reached. In September came the long expected merger of Onexim with Rosbank, with the latter taking full responsibility for the

<sup>71</sup> Johnson (2000), p.210

<sup>72</sup> Reuters, 07-Oct-1998

<sup>73</sup> Interfax, 03-Feb-1999, Reuters, 27-May-1999, 05-Jul-1999

<sup>74</sup> Interfax, 25-Aug-1998, 11-Sep-1998, 01-Oct-1998, 19-Nov-1998, Itar-Tass, 25-Aug-1998, Reuters, 25-Aug-1998, 26-Aug-1998, *The Economist*, 29-Aug-1998, 'Three's company: a shaky rouble shakes Russia's banks'.

<sup>75</sup> At the same time the National Reserve Bank, Inkombank, Avtobank, Mezkhkombank and Alfa Bank also declared a merger that never took place. Only Mosbiznesbank and Bank of Moscow actually merged.

<sup>76</sup> In a news conference in early November, Potanin said Oneximbank was now many times smaller than it had been, but that the bank had no intention of selling its 51% stake in Norilsk Nickel since it was a strategic enterprise that needed careful attention. Brunswick Warburg, Daily News Review, 06-Nov-1998

<sup>77</sup> Prime-Tass, 29-Jun-1999, 08-Jul-1999

<sup>78</sup> Reuters, 09-Sep-1999, 01-Nov-1999

<sup>79</sup> Interfax, 22-Nov-1999

<sup>80</sup> Reuters, 22-Nov-1999, 23-Nov-1999, *Financial Times*, 24-Nov-1999, 'Court Clears way for bank rescue: Russia Oneximbank bankruptcy halted to allow settlement with creditors',



former's debts.<sup>81</sup> The restructure plan eventually worked out, but it was only the first voluntary restructuring to end positively.

## Bank Menatep and Rosprom group

Bank Menatep historically operated as the settlement and financial centre for the Rosprom group. The group included important companies like Yukos and Apatit, as well as some chemical and construction companies. On the eve of the financial crisis, Menatep was heavily exposed to foreign exchange risk. While its GKO portfolio accounted for just 4% of assets, the overall foreign debt of the bank (leaving aside the USD 90 mln on currency forwards) exceeded 25% of liabilities. Thus half of the bank's loan portfolio was financed by short-term borrowings from foreign banks.

Moreover, the bank had a scarcely diversified loan portfolio and its credit positions were exposed to grave risks. Yukos, the bank's main borrower, had overdue debts to creditors in excess of USD 100 mln, which seriously reduced its ability to service the loans received from Menatep. As a result of Yukos' difficult financial situation, Menatep was forced to default on the repayment of a USD 136 mln foreign loan. To reassure its creditors, Menatep then used a 15% stake of Yukos shares as collateral for the defaulted loan.

Given the trouble lying ahead, Menatep escaped its creditors by moving its business and branch network to its subsidiary, Menatep St Petersburg.<sup>82</sup> By May 1999, all 46 of Menatep's Moscow branches were owned and operated by Menatep St Petersburg. Menatep St Petersburg was then sold back to Rosprom members, Menatep's main shareholders.

In September 1999 creditors finally voted for Menatep's bankruptcy, which however, encountered several obstacles. The bank's temporary manager, Alexei Karmanov, declared that assets of the bank had been hidden in accounts abroad and that they were very difficult to trace at that stage. Karmanov also accused Menatep officials of denying the temporary administration access to information about its funds in foreign banks. Then, a truck transporting financial documents belonging to Bank Menatep crashed off a bridge into the Volga River and all documents went lost, further complicating Karmanov's attempts to throw some light on Menatep accounts.<sup>83</sup> Later, even further problems occurred and investigations have been conducted related to Menatep bank.<sup>84</sup>

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<sup>81</sup> Interfax, 17-Jan-2000, 03-Feb-2000, Reuters, 10-Apr-2000, 03-Jul-2000

<sup>82</sup> *Moscow Times*, 17-Nov-1998

<sup>83</sup> *Ekonomika i Zhizn'*, 10-Mar-2001, 'Менатеп Прощается с Вкладчиками' (Menatep Says Goodbye to Depositors).

<sup>84</sup> *Rossiyskaya Gazeta*, 22-Sep-1999, 'Khodorkovsky To Testify Before Us Congress'. *Moscow Times*, 24-Aug-1999, 'Dart Team Dismisses Avisma's Charge of Money Laundering'.

### 3 The Evolution of the Banking Sector after the Crisis: 2000-2001

#### Recent Trends

Since the August crisis, the Russian banking system has grown in terms of assets, equity, loans and deposits.<sup>85</sup> These developments have proceeded alongside the general economic recovery of the country. However, the Russian banking sector remains very small, by a number of parameters. One of the ironies of the 1998 banking sector meltdown was that it had little impact on the real economy, as there was, and still is, little connection between the former and the latter. However, the corollary of the relatively low level of development of the sector, that banking sector development is not important, is forcefully negated by the close linkages between economic growth and banking sector development.

Banking assets amount to only ca. 30% of GDP compared to more than 100% in developed countries. Furthermore, the Economic Development and Trade Ministry estimates that only 3 percent to 5 percent of investment financing in the country is from banks, compared to 15 percent to 30 percent in many other countries. Data shows that while investment picked up between October 1999 and April 2000, bank lending began to increase only by mid-2000. Similarly, the deposits-to-GDP ratio, at 10%, is well below international comparables.<sup>86</sup> Consequently, the banking sector is not linking the need for capital in small- and medium-sized companies, which drive growth in other transition economies, to the large amount of existing capital generated by the large natural resource exporters. Small- and medium-sized businesses account for roughly 60 percent of the economy in Central and East European countries, but for only 30 percent in Russia.

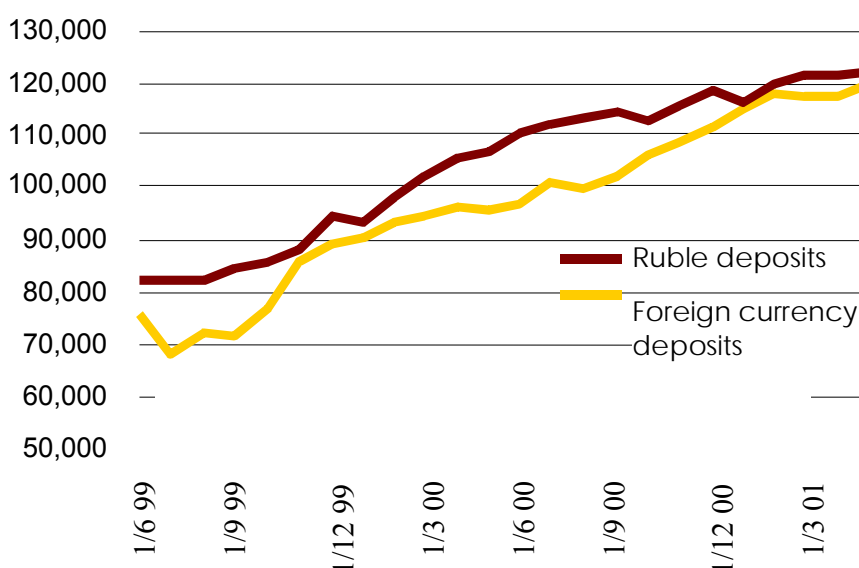
Along with economic recovery, the volume of deposits has increased (Figure 3.1). But overall public trust in banks remains low and still further assets remain outside the domestic financial system. This deprives private banks of long-term financial resources and hinders development of lending activity, as modernisation projects require loans with a maturity of at least 3-5 years. At the same time, lending remains a surprisingly low 40% of assets, whereas before the crisis it represented at least 50%. One reason is that the main corporate shareholders want banks to ensure transactions and liquidity (i.e. play the role of a treasury). For this reason, the share of liquid assets (cash, correspondent accounts at the CBR and foreign banks) jumped from 20% of assets in 1998 to 40% in 2000.

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<sup>85</sup> According to a rating of Eastern Europe's largest banks in 2001, conducted by S&P, Russian banks lead in terms of profitability, capital adequacy and size of equity. State owned Sberbank and Vneshtorgbank (VTB) took first and second place in the latter category (\$2.5 bln and \$1.86 bln, respectively). There are several reasons behind this result. Russian banks still benefit from high interest spreads between cost of resources and returns on loans. And the majority of Russian banks benefit from the recovery in prices on government debt in 2001. The majority of Russian banks maintain excessive capital, with an average capital/asset ratio of 15.2% (reaching 30% at VTB). And of course, Russia is the largest economy and largest market in Eastern Europe. *Russia Market Daily*, Troika Dialog, 21-Oct-2002.

<sup>86</sup> Alfa Bank, (Dec 2001).

Figure 3.1 Total deposits in rouble and foreign currencies  
(mln rubles, dec-97 prices)



Source: Bulletin of Banking Statistics, CBR

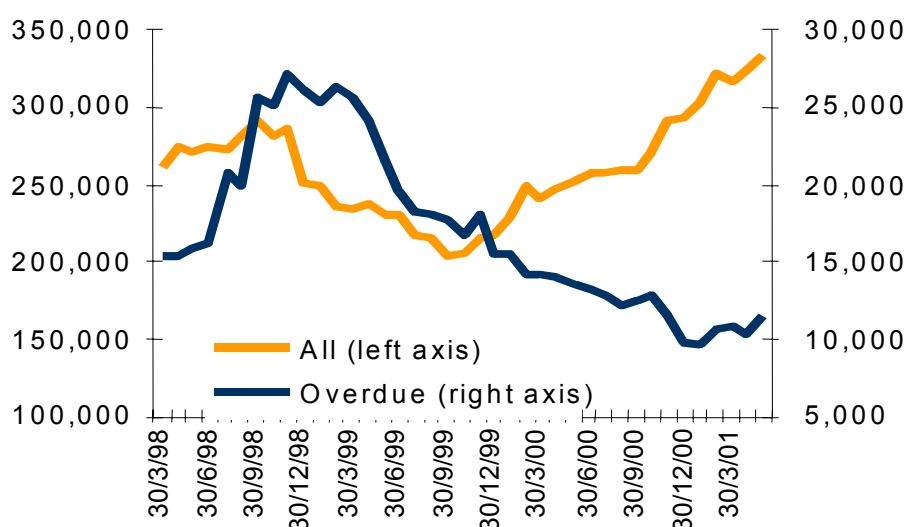
The volume of loans extended to the real sector has gradually increased with decreasing overdue loans (Figure 3.2). Large banks in particular have witnessed a significant credit growth (Figure 3.3).<sup>87</sup> In general, an increase in the volume of assets and capital goes along with greater portfolio diversification. However, in the case of Russian banks it is rather the opposite. Recent figures show that banks have extremely concentrated portfolios.<sup>88</sup> The ten most important borrowers hold half of the credit portfolio and almost 30% of all assets of the average Russian bank. It is often the case that a few key corporate clients dominate the credit institutions they borrow money from. As size gets bigger, the share of the ten largest credits diminishes, albeit very gradually. In the smallest banks the ten largest credits amount to 80% of the loan portfolio; in medium-sized banks their share reduces to 55-65%; and in large banks it averages 45%. As assets increase, credits are largely replaced by investments in bonds, reserves at the Central Bank.

It is useful to study the ratio of concentrated credit to a bank's own capital. The largest banks are relatively more exposed, with the largest credit accounting on average for 31.5% of the bank's capital. This figure violates the norm (N6) established by the CBR that requires a maximum of 25%. An increase in the capital of banks hardly ever leads to more risk diversification.

<sup>87</sup> However, it must be taken into account that these figures are relatively inflated, as they include high levels of related-party lending - which might not represent true market-driven intermediation. Quantifying the actual level of related-party lending is virtually impossible, however, given the prevailing non-transparency and the complexity of legal structures that are designed to prevent the identification of related parties. Under Russian legislation, banks are allowed to lend only 20% of total capital to related parties, a level which in theory would be comparable to international norms.

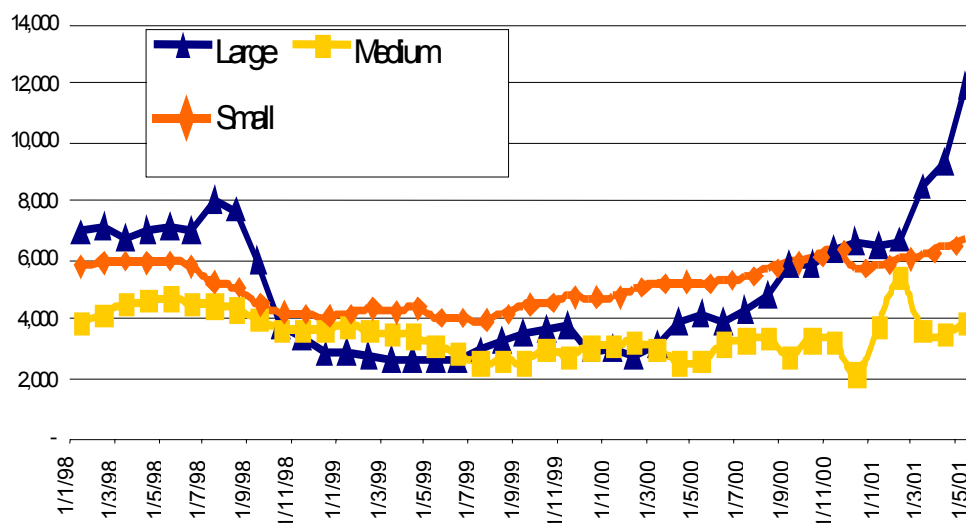
<sup>88</sup> Expert, 17-Sept-2001

Figure 3.2 Total vs overdue credits (mln roubles, dec-97 prices)



Source: Bulletin of Banking Statistics, CBR

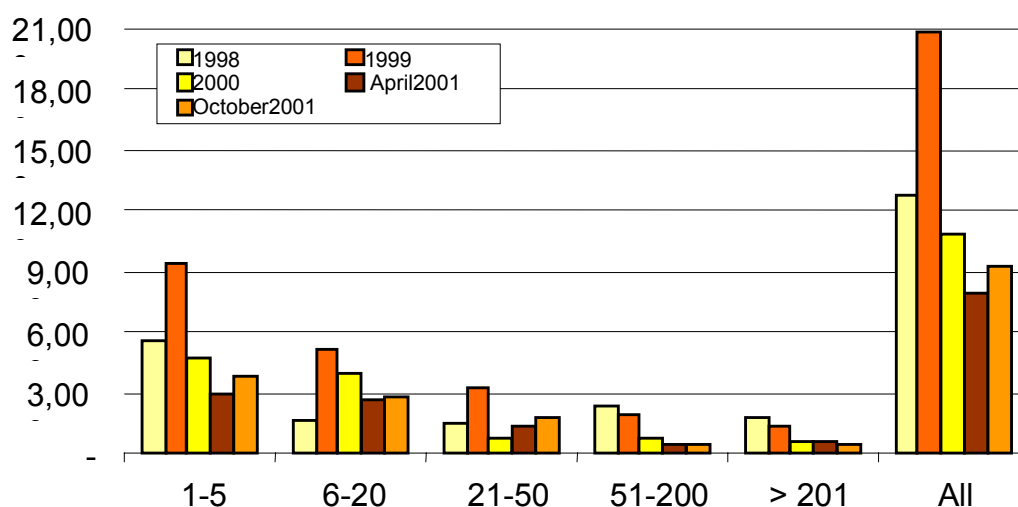
Figure 3.3 Credits extended to individuals: banks grouped by size



Source: Bulletin of Banking Statistics, CBR

The bad loans in the Russian banking sector stand at just 3.4% of total loans, down from 14.4% from post-crisis highs (Figures 3.2 and 3.4, according to the CBR). However, credit quality assessments by Russian banks - and by Sberbank, which accounts for roughly 30% of total loans, in particular – can be too relaxed. Russian banks have perfected the practice of ‘evergreening’, that is, concealing non-performing loans by making a fresh loan to cover the repayment.

Figure 3.4 Overdue corporate credits (mln roubles, dec-97 prices)



Source: Bulletin of Banking Statistics

The risk of a rise in non-performing loans is particularly relevant for economies tied to commodity prices, as large increases in defaults follow a reduction in commodity prices because lenders eager to throw money at the most liquid segment of the economy do not properly account for the impact of a slowdown. (Interestingly, the total volume of loans extended to the oil, gas and chemicals sector by Sberbank increased by 78% in 2000.) Of course, a slowdown in economic growth and commodity prices can also expose how banks account for their loans.

Summing up, Russian banks nowadays are apparently less vulnerable than in 1998. Devaluation exposure is low, as their foreign-currency assets on average exceed their foreign currency liabilities. They also lack exposure to liquidity risk, as the interbank market remains weak and their state bond portfolios represent only 15% of banking assets (Figure 3.5).<sup>89</sup> Finally, the share of non-performing loans is very low. But the high concentration of risk (also deriving from related-party lending), the adverse selection of borrowers and the portfolio concentration in few sectors, stress the persistent vulnerability of the Russian banking sector.<sup>90</sup>

<sup>89</sup> Alfa Bank (Dec 2001).

<sup>90</sup> See Tompson (2001).

Figure 3.5 Bank Investment in Government Securities  
(mln roubles, Dec-97 prices)



Source: Bulletin of Banking Statistics, CBR

## Market Structure

Structurally the Russian banking system still suffers from three major problems. First, the dominant role played by state-owned banks, both in terms of volume of activity and number of branches across the country. Second, the existence of a large number of bank-like institutions and 'ghost' banks. Third, the tiny size of the majority of banks.

### The consolidation of state banks

One of the most marked consequences of the 1998 financial crash has been the relative loss of power of some of the old bank 'oligarchs'. Moreover, the rescue enfeebled the position of private bankers as it stressed their dependence on the government.<sup>91</sup> Probably the most important winners of the crisis were state-owned banks. As shown in Table 3.1, nowadays state-owned banks dominate Russia's banking sector. Whereas before the crisis Sberbank and Vneshtorgbank – both belonging to the state – together controlled around 20% of banking assets, their share currently totals around 30%. Gazprombank, the fourth-largest bank, can also hardly be called private, as it is controlled by the state gas monopoly Gazprom.<sup>92</sup>

<sup>91</sup> Tompson (2001).

<sup>92</sup> Alongside state-owned banks, over the last couple of years, a handful of 'new' players have come to the fore. Often, their power comes from the large financial-industrial groups that stand behind the bank, rather than from the bank itself. This is the case for Rosbank, Doveritelni i Investizionni Bank and Sobinbank, which are respectively linked to Interros, Rosprom and Lukoil. In other cases, however, a bank leads the group, like Alfa Bank with Alfa Group and MDM Bank with MDM group. A case apart are the banks connected to Moscow government, like Bank of Moscow, Moscow Industrial Bank and Mostroieconombank.

Table 3.1 Top Russian Banks as of October 1, 2001, USD mln

	Assets	% of total assets	Deposits	% of total deposits	Capital adequacy ratio
Sberbank	24,711	25	15,057	75.0	11.4
Vneshtorgbank	4,525	5	172	0.9	82.0
Moscow Industrial Bank	3,355	3	9	0.0	35.4
Gazprombank	3,340	3	274	1.4	13.6
Alfa Bank	3,118	3	346	1.7	27.2
Moscow International Bank	2,953	3	150	0.7	12.5
Surgutneftegazbank	2,652	3	65	0.3	5.9
Bank of Moscow	1,930	2	198	1.0	13.3
Rosbank	1,789	2	151	0.8	15.1
TIB	1,649	2	37	0.2	12.6
MDM Bank	1,224	1	33	0.2	13.0

Source: Interfax, Alfa Bank estimates

The position of Sberbank relative to its competitors in the retail sector was strengthened by the financial crash. As the rest of the nation's banking system collapsed in the wake of the 1998 August crisis, Sberbank was able to acquire more control over the retail market. The main reason for the increasing strength of Sberbank was the outflow of deposits from commercial banks soon after the crisis. Up to USD 500 mln was transferred to Sberbank from Rossiisky Kredit, Menatep, SBS Agro and Oneximbank – see Part 2. Furthermore, the absence of any form of deposit insurance makes it difficult for Russian commercial banks to compete with the state-owned savings bank Sberbank in the retail market, given that Sberbank deposits are guaranteed by the state.

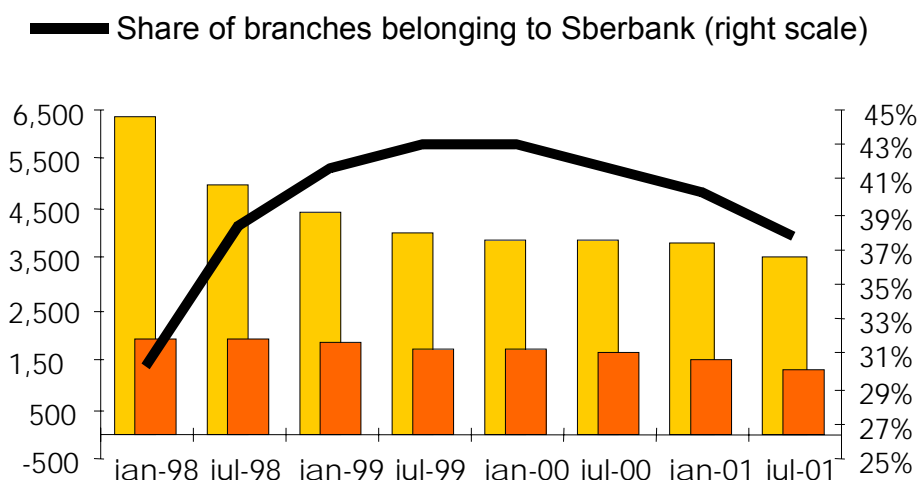
The stronghold of Sberbank remains in household deposits, which account for the largest share of total deposits (Figure 3.6 and 3.7). Its market share among Russian residents had grown to 75.1% (90% of the rouble-deposit market) by April 1, 2001, leaving its closest competitors far behind with less than 2 percent each (Table 3.1).<sup>93</sup> In addition, Sberbank continues to benefit from an increase in pension accounts. The State Pension Fund transfers up to 40% of its USD 1.5 bln in monthly payments directly to accounts at Sberbank. Pensioners comprise 60% of Sberbank's individual deposits. This monopoly allows it to attract deposits at below-market rates, thus harming the ability of commercial banks to attract private clients. Also, the difference between interest rates offered by commercial banks and Sberbank allows the latter to earn around USD 100 mln annually.<sup>94</sup>

<sup>93</sup> Sberbank's dominance on the market for foreign-currency deposits, however, is not as comprehensive – the bank controls only 50% of this segment. This provides hope for private commercial banks that when trust in the banking sector is restored, at least part of the USD 30 bln currently held 'under mattresses' will flow to them in the form of deposits.

<sup>94</sup> In the last few years Sberbank has come several times into the spotlight of the media for problems of corporate governance. In October 1999 Sberbank tried to fend off World Bank and International Monetary Fund demands to investigate its finances. A World Bank-supervised probe into the finances of Sberbank was one of the conditions for the release of the USD 640-million IMF loan tranche. But the release of the loan continued to be delayed, as the dense fog around Sberbank's financial situation was all but clear. PricewaterhouseCoopers wrote in its 1998 auditing report about the slamming opacity of the bank. 'The audit ... significantly differs from audits prepared in accordance with international accounting standards'.

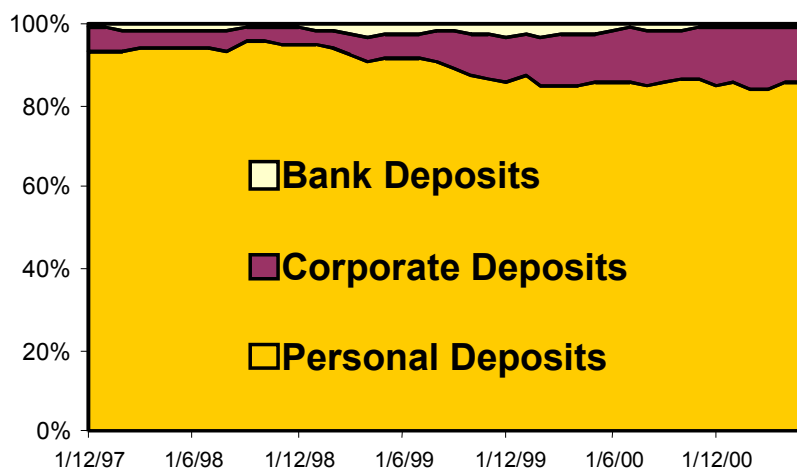
Sberbank's board voted at the end of December 2000 to issue 5 million shares in order to raise USD 135 million and improve its capital adequacy ratio. The share emission diluted minority shareholders' stakes by 36 per cent, allowing the Central Bank to increase its ownership by 1.2 per cent to 63 per cent of voting stock. A month later Sberbank said it wanted another 10 million share issue. The changes gave Sberbank's supervisory board the opportunity to increase the bank's charter by 150 percent at any time, thus further

Figure 3.6 Total vs Sberbank Branches



Source: Bulletin of Banking Statistics, CBR

Figure 3.7 Total Deposits divided by type



Source: Bulletin of Banking Statistics, CBR

diluting minority shares. Led by Hermitage Capital Partners, minority shareholders of Sberbank brought a suit against the Central Bank of Russia and Sberbank to the Moscow Arbitration Court, requesting decisions made by the Supervisory Council of Sberbank and the Central Bank to be declared illegal. In the end, the Russian parliament approved amendments to the Joint-Stock Company Law that introduced the concept of pre-emptive rights to protect minority shareholders from dilutive share issues. Vadim Kleiner, Director of Research at Hermitage, gained a seat at the Sberbank’s Board of Directors and effectively blocked any further dilution of minority shareholders. *Moscow Times*, 15-Feb-2001, 'Shareholders' Champions Fall Out'. *Pravda*, 25-Apr-2001, 'Minority shareholders of Sberbank bring suit against Central Bank and Sberbank.'



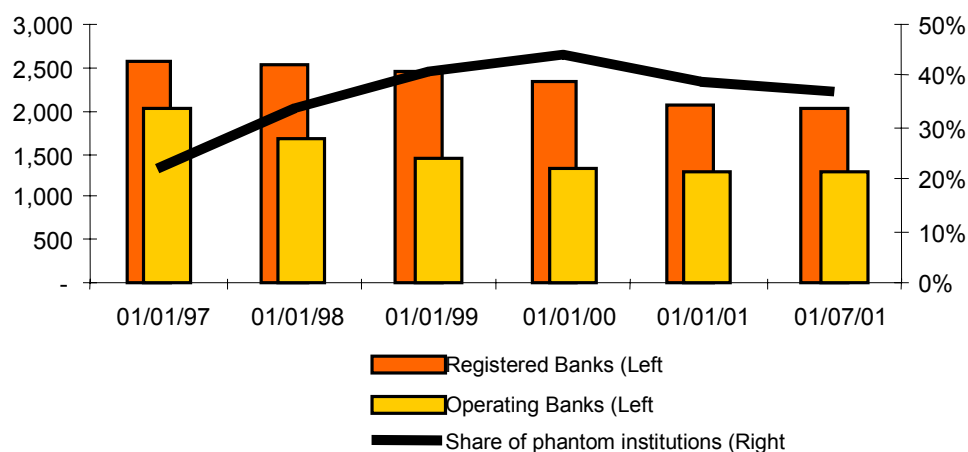
## Pocket and ghost banks

A significant number of Russian banks do not operate as normal credit institutions, but rather act as treasuries for financial-industrial groups (FIGs) and large corporations. Instead of providing intermediation services to the general public, they are privately used to redistribute capital within the industrial conglomerate. These services could in theory be supplied, at a greatly reduced cost and with a significantly lower cost of capital, by a specialised contractor. Indeed, in most markets, companies do not create their own banks to take care of simple banking matters: they use a bank that has the institutional infrastructure, personnel, experience, and expertise to provide the same core services as Russia's pocket banks do, but far more efficiently and for less money.

What prevents Russian FIGs from trusting specialised service providers (i.e., unrelated banks)? There are four major explanations. The first is risk perception, both from the point of view of corporate and bank managers. The difficulties in gathering information about counterparts, worsened by the lack of financial transparency, induces banks and firms to prefer related parties. Second, there is a generally poor understanding of the cost of capital, and the continued widespread belief in corporate Russia that vertical integration is a worthy aim in itself.<sup>95</sup> Third, for many enterprises, borrowing from private commercial banks entails an obligation to disclose sensitive financial information. Very often, this is considered dangerous: if an enterprise is very profitable or potentially attractive, shareholders of the lending bank may seek to purchase the company's shares and replace current management. Thus good enterprises tend to set up their own banks and avoid borrowing from banks for as long as possible.

A different set of problems is related to the existence of a significant number of 'ghost' banks. Through the years the CBR has been slow in cancelling those credit institutions that, despite being registered, are not actually operating. As shown in Figure 3.8, the number of phantom institutions as a percentage of all registered banks is significant, and reached its peak at the beginning of 2000.

Figure 3.8 Banks registered vs active banks



Source: CBR

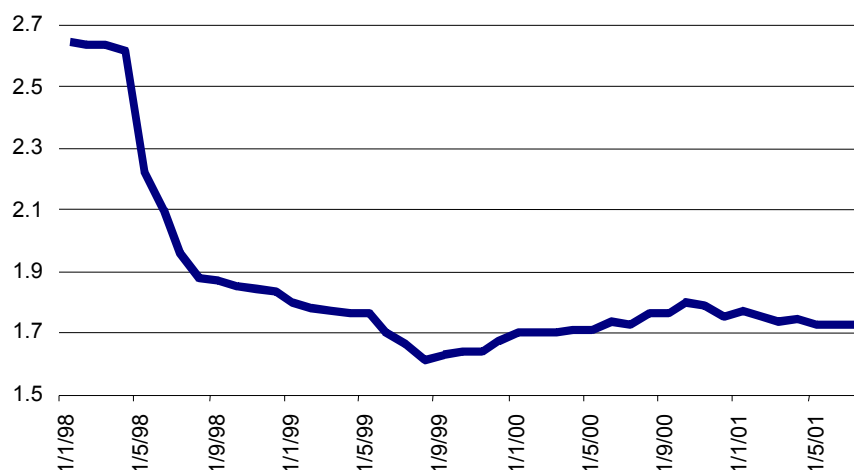
<sup>95</sup> Indeed, more recently the managers of a number of large financial-industrial groups that control pocket banks are slowly recognising that investment in their core businesses yields far greater returns than do funds allocated to their bank-like institutions. Renaissance Capital (Oct 2001)

## Tiny institutions

The large number of banks that continue to operate in Russia underscores how little restructuring of any substance has taken place since the August 1998 financial crisis, and that market dynamics have little to do with the sector. Most banks in Russia are too small to be economically viable as standalone institutions, and, as explained above, are not banks in the normal sense of the word. They exist because they serve as a means to ends to which financial intermediation is incidental. Figures 3.9 and 3.10 clearly depict this phenomenon and the insignificance of small banks. The 20 largest credit institutions have more assets than all the remaining 1300. Since the crisis, larger banks have become relatively more important. Hopefully this trend will gradually force into bankruptcy or mergers a large number of these tiny institutions.

Sberbank's ubiquity remains a discouraging barrier to forming a competing retail bank. Developing a retail network requires big investments, such as setting up branch offices, training staff and installing security. To recoup the investment, banks must attract a large number of depositors. However, the pool of Russians who have sufficient earning power and confidence in banks remains shallow. The tendency of Russians to withdraw their money soon after it hits their account also makes it difficult for banks to develop long-term investment strategies. Russians save only 11 percent of their disposable income.<sup>96</sup>

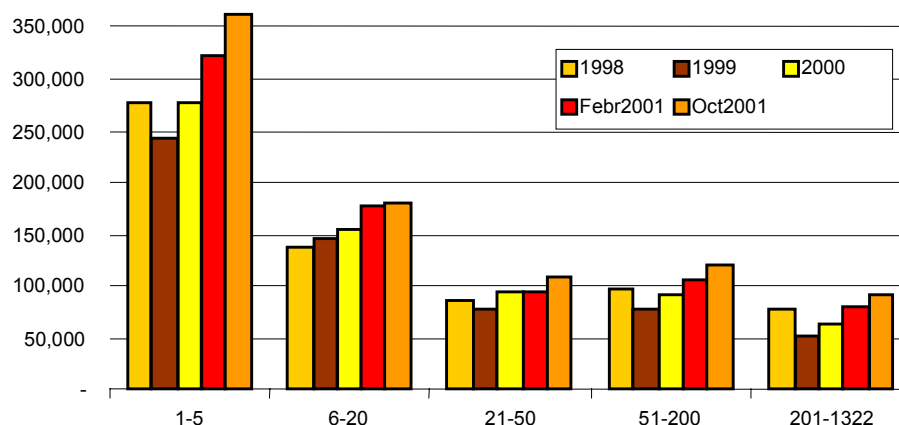
Figure 3.9 Average of Branches per Bank (excluding Sberbank)



Source: Bulletin of Banking Statistics, CBR

<sup>96</sup> *Moscow Times*, 26-Jun-2001, 'Retail Banks Struggle Under Sberbank Shadow'.

Figure 3.10 Total Assets, Banks grouped by size (mln rubles, dec-97 prices)



Source: Bulletin of Banking Statistics, CBR

## The Reform Agenda

There has been little progress over the past three years by the government in bringing about comprehensive and real change in the Russian banking sector. In the very narrow terms of the passage of banking sector reform legislation, progress has been solid in recent months. A large portion of the banking sector reforms that the Putin government laid out in the Gref reform programme in July 2000, which has formed the backbone of the government's reform efforts, has in fact been passed. These changes include requirements for increased transparency by banks; broadened power for regulators to monitor the activities of banks and bank-holding companies; measures against money laundering; and efforts to increase the accountability of bank founders for their institutions. Additionally, on September 27, 2001, the Cabinet signed off on a banking sector development strategy document that was the joint product of the input of the government, the CBR, and the Russian Union of Industrialists and Entrepreneurs, among others, and that establishes the agenda for banking sector reform.

The main proposals dealing with legislative improvement and bank monitoring continued the trend established by the IMF. The key points of the reform agenda are to: 1. attract foreign investment; 2. demarcate credit deposit organisations vs. banks; 3. create credit institutions to boost lending by improving borrower transparency and by reducing the risks associated with lending; 4. increase control over licensing; 5. cut the tax rate for banks; and 6. make term deposits more secure. For the most part, the programme and the previously enunciated plans of the Duma are sensible. However, the overall agenda for banking sector reform does not go far enough and is reflective of the CBR's go-slow approach to banking sector reform, which has meant that no significant change has been implemented over the past several years. Any serious banking reform has to be preceded by addressing the following broad themes: judicial reform, corporate transparency, creditor protection, a new bankruptcy code, the strengthening of property rights and tax reform.<sup>97</sup>

<sup>97</sup> For specific studies on the problems of the Russian economy, see Hellman (2000), Commander (1998), Carlin (2000), Pissarides (2000), Johnson (1999), Popova (1998), Buiters (2000) and Korhonen (1997). For a more general analysis of juridical and institutional problems in Russia and in the other transition economies,

## Conclusions

The 1998 financial meltdown brought to public attention the vulnerability of Russia's banking sector, which emerged from the crisis severely stressed. The Russian government and the CBR acted in a timely manner in setting up a basic intervention plan for the rapid restoration of solvency. Unfortunately, these measures were not followed by a correction of the real problems behind the crisis. As a result, the Russian authorities failed to exploit a unique chance to carry out significant reforms in the financial sector. Although, on the surface, contemporary Russia's banking sector appears to have fully recovered from the crisis, a deeper inspection reveals that many of the flaws that afflicted Russian banks before 1998 are still present.

The banking sector in Russia can still be characterised as fundamentally non-market in nature, including weak competition, conflicts of interest, a lack of sound sector regulation, and low levels of transparency. Most importantly, bank intermediation remains low by international standards. Due to little portfolio diversification, banks are exposed to high credit risk.

The Russian banking rescue achieved a 'reactive' rather than a strategic restructuring of the sector. The 'first phase' of the rescue, which primarily consisted of restoring liquidity, was not followed by other far-reaching reforms, ie a 'second phase'. The 'first phase' of the rescue, in the second half of 1998 and the early months of 1999, was quite successful. The measures taken by the government in the immediate aftermath of the crisis were essential 'first aid', which succeeded in restoring minimum operating conditions for the financial sector. Russian authorities correctly realised that a single bank can fail without national repercussions, but when a large proportion of the deposits in the national banking system are involved, the problem becomes systemic and paralysis threatens the economy.

Nevertheless, in restoring financial normality, the Central Bank allowed for a high degree of forbearance towards large problem banks, and only few licences were cancelled. Applying the too-big-to-fail principle, Sberbank and SBS-Agro were bailed out with so-called 'stabilisation loans'. Several other big banks –such as Oneximbank, Bank Menatep and Rossiisky Kredit- were able to protect their assets through 'bridge banks', thus depriving creditors of their rights. Few banks, such as Inkombank, were actually closed down, but those bankruptcies that did occur were long and painful for creditors and depositors alike.

A special agency for restructuring credit organizations (ARKO) was founded and two important pieces of legislation were passed (the Law on Restructuring and the Law on the Bankruptcy of Credit Organizations). However, hardly any change was imposed. ARKO, due to little initial capital, proved incapable of managing the badly needed restructuring of large banks. ARKO did a decent job on the tiny sliver of banking sector restructuring that it did focus on: the selling of a small number of nominally restructured bank-like institutions (albeit at times to entities linked to the previous owners). However, ARKO barely scratched the surface of the banking sector.

We can therefore conclude that Russian authorities failed to exploit the unprecedented 'window of opportunity' offered by the crisis: a mistake that could have negative consequences for the future development not only of Russia's banking sector, but also of Russia's economy in a wider sense.

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see Schankerman (2000), Pistor (2000a, 2000b), Johnson (1999a, 1999b, 1999c), Raiser (1999), Kalmi (1997), EBRD (2001), Bevan (2001), Schnitzer (1999), Sonin (2000), Sprenger (2000), and Guriev (1999).

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