The Russian banking industry after the financial crisis – where to next?

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The current financial crisis is unlikely to dramatically change the structural features of the Russian banking industry. The role of the state in the banking sector will increase rather than decrease after the crisis and the banking sector will continue to be very fragmented. There is a risk that if the large corporations have to turn to the domestic banking sector for finance instead of the international money market, they will crowd out small and medium-sized companies from access to bank finance. This would have a negative impact on economic growth in the long term.

The Russian banking sector has grown extremely rapidly in recent years. In 2001, domestic lending was equal to 14% of GDP. By the end of 2008, the ratio had risen to 35%. Banking sector growth has been accompanied by longer loan periods, increased confidence in the rouble and a multiplication of borrowing opportunities for Russian households. To a large extent, this banking growth has been based on the broader economic growth fuelled by the rising price of oil, on foreign borrowing and on structural reforms in the banking sector.

During the impressive growth years of the 2000s, Russian banks have increasingly begun to resemble the banks everywhere in emerging economies. Russian banks, by and large, receive retail deposits, give credit both to households and to the enterprise sector, engage in fairly standard operations on capital markets, issue bonds and, in some cases, even participate in international loan syndications. The Russian rouble has been freely convertible since 2006 and there are no restrictions on the capital account. Payments flow fairly reliably across Russia's eleven time zones, several foreign banks have found their way into the top 10 banks and, in the big cities, bank cards have even become common.

A deeper investigation of the Russian banking sector, however, reveals a number of structural features uncommon in other emerging economies in Europe. Some of these features help explain why the global financial crisis hit Russian economy so hard. These features may also help us to foresee how the Russian economy, and its banking industry in particular, will emerge from the crisis.

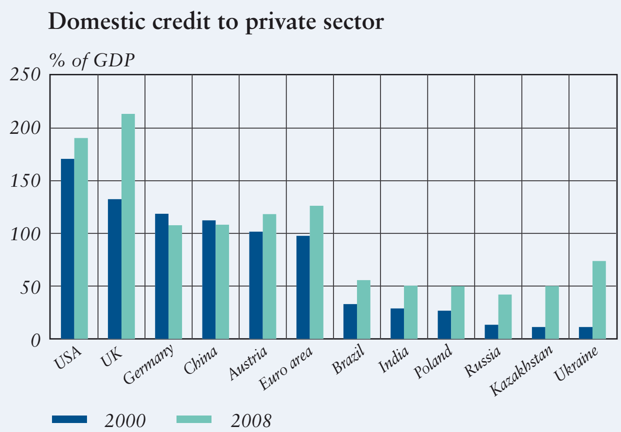
On the structure of the Russian banking sector

Banking sector still relatively young and small

The banking system in Russia started to develop in the course of the transition process at the end of the 1980s. Before that there were no private banks in Russia. A two-tier banking system was introduced in 1987 when the central bank and several state-owned specialized banks began operations. In subsequent years a large number of small banks were established. By the end of 1991 there were already over one thousand credit institutions registered in Russia, and the growth trend continued further thereafter. Since banks were allowed to deal in foreign exchange and could hold corresponding accounts with foreign banks, the activities they engaged in were often not proper banking activities. Consequently, despite its growth, the banking sector played only a limited role in financial intermediation, with domestic credit accounting for only about 10% of GDP.

The 1998 macroeconomic crisis, when the Russian government devalued the rouble and defaulted on its debt, led to insolvency at many large banks and further reduced the trust in domestic banks. Thereafter, even during the years of economic growth, the banks found it hard to regain public trust.[1] In general, Russian households are not accustomed to using banking services and only about one third of them have a bank account. Nevertheless, the recovery from the 1998 crisis, a stable macroeconomic environment and important institutional changes, including introduction of the deposit insurance scheme in 2004, brought about rapid growth in the banking sector in the 2000s. The ratio of bank assets to GDP doubled between 2000 and 2008, to stand at 68% at the end of 2008. The same development pattern holds for bank credit to the private sector, which amounts to more than 40% of GDP. Despite this impressive growth, Russia still trails not only the developed economies, but also its counterparts in Central and Eastern Europe, in the level of financial intermediation (see Chart 1). The Russian banking sector remains small relative to the size of the economy. This indicates considerable scope for further financial deepening, which should also help to augment economic growth.

Chart 1.



Source: World Development Indicators.

Dual financial system

Given the small size of the domestic banking sector, it is hardly surprising that Russian companies do not rely

[1] Altogether more than 2000 banks went into liquidation or otherwise vanished in 1991–2009.

on bank loans to finance their investments. Only about 12% of fixed investments were financed using bank loans in the first half of 2009 (Rosstat, 2009), a figure largely unchanged from a year earlier. A Eurobarometer survey for the same period (Flash Eurobarometer 271, 2009) reports that, despite the financial turmoil, the role of banks is much more important in the European Union, with about a quarter of European companies reporting receipt of a bank loan.

Accessing external sources of finance has been particularly difficult for small and medium-sized enterprises. These companies, unlike the largest, globally operating Russian companies, do not have access to international markets. Moreover, the large Russian oil, gas and metal companies have financing needs that greatly exceed the capacity of the domestic financial system. These corporations are served by the global financial system. Russian banks' participation in the operations of these companies is minimal. This indicates that the duality used in describing the Russian economy in general is also present in the country's financial system. The second part of the dual system is the domestic economy, and it relies on the services provided by Russian banks. Up until the global financial crisis, the large corporations could rely on international markets for their investment finance and generally needed the domestic banking system only for settling their payments. This may well be an additional explanation for the relatively small size of the domestic banking system.

Too many small banks

Despite a slow declining trend in the number of banks in the country since the peak of 2,500 in 1994, there are still a very large number of banks registered in Russia. At the end of the third quarter of 2009, the Bank of Russia reported the number of banks to be 1,074. However, only the 50–70 biggest banks are important to the functioning of the sector as a whole. The remaining 1,000 are mostly small or very small. Of these 1,000 small banks, about half are based in Moscow, with the other half scattered all over the rest of the country. This group of small banks is believed to include a great number of institutions which are effectively pocket-banks of an enterprise group with little if any exposure to retail clients or the interbank markets. A few are merely foreign-exchange offices or accounting centres for their parent companies. Some of the small regional banks are, however, important from a regional perspective. Many remote regions of Russia are served only by the state-owned Sberbank savings bank and a handful of local, regional banks. Only the country's top 20 banks have any nationwide branch network to speak of.

Only the 50–70 biggest banks in Russia are important to the banking sector.

The fragmentation of the sector causes difficulties in supervision and

The large number of banks makes supervision challenging.

a lack of trust within the banking community. The large number of registered banks also makes supervision more challenging, especially with the limited resources available to the authorities. Despite many improvements in recent years, supervision is still considered to be oriented more to form over substance. Moreover, reporting is still based on the Russian accounting standards, which in many respects differ from the IFRS. The objective of implementing Basel II has been declared, but how this is to be achieved is rather unclear. The lack of trust in counterparties is especially clear on the interbank market, which was not functioning properly even before the current financial crisis.

The consolidation of the sector is still the subject of debate. A new law concerning a minimal capital requirement for banks has been approved and should enter into force on January 1, 2010. This requires banks to have capital of at least RUB 90 million (EUR 2 million) (RUB 180 million from 2012) and, unlike previous laws, this requirement is also meant to apply to existing banks. It is, however, unclear if the law will be implemented in full.

State-controlled banks dominate

The Russian banking sector is still predominantly state-controlled. This feature makes it different from the emerging markets in Central and Eastern Europe and more similar to the situation in China. The large state-controlled banks have been significant players in the market throughout the post-Soviet period. The plans to partly privatize the country's top banks, Sberbank and VTB, ended in large IPOs in 2007 that resulted in 40% and 23% of private shareholdings in the two banks, respectively. No further privatization of the large state-owned banks is planned. The share of the three largest state-controlled banks (Sberbank, VTB Group and Rosselkhosbank) in total banking sector assets increased from 30% in 1998 to 35% in 2008. Including the major banks owned by Gazprom (Gazprombank) and by the City of Moscow Government (Bank Moskvy), the share of the five major state-controlled banks grew from 30% to 45% in the ten years to 2008.

As in other countries, the current financial crisis has further increased the state's share of the sector. Vernikov (2009) estimates the share of state-controlled banks in total banking sector assets to be 57% in July 2009. The increase in state holdings is, however, not necessarily bad for efficiency in Russia. A recent study finds that Russian state-controlled banks do not seem to be less efficient than other domestic banks. Foreign banks are, however, the most efficient. (Karas et al., 2010.)

Foreign-owned banks play a minor role

Foreign bank penetration in Russia has been low, albeit increasing. The share of foreign-owned banks in the total assets of the Russian banking sector increased from 8% in 2002 to almost 20% in 2008. There are no binding legal barriers to foreign bank entry, but the low penetration can partly be explained by memories of the 1998 crisis, when many foreign investors incurred huge losses. Also, the legal and regulatory environment in Russia is only slowly beginning to resemble that of many other emerging economies. The number of banks with foreign ownership has increased from 174 in 2000 to 228 at the end of June 2009. Three of the country's top 10 banks are foreign-owned (OECD, 2009).

Despite the high share of state-controlled banks in the banking sector, their market power declined between 2001 and 2007 (Fungacova, Solanko and Weill, 2009). This can be explained by the weakening of their competitive advantage in terms of security. These banks used to have an advantage in collecting deposits, as their ownership status prevented them going bankrupt. However, macroeconomic stability, which considerably reduced financial instability, combined with the deposit insurance scheme to reduce their competitive advantage. On the other hand, foreign-owned banks have gained in market power. This might indicate that, after initially attracting customers with lower prices and better services, foreign-owned banks may have been gradually increasing their prices to become standard banks. Also, with the increasing revenue of Russian companies and households, some of the foreign-owned banks have gradually evolved towards an upmarket niche that allows them to charge higher prices.

How did the financial crisis arrive in the Russian banking system?

The years of growth saw Russian banks become stronger, and on average they have been highly capitalised and exceedingly profitable. In addition, the Russian banking sector had very little involvement in the financial instruments that triggered the international financial crisis. Why, then, did the crisis hit the Russian banking sector so very hard?

There were two basic causes. The Russian economy in general, and the financial sector in particular, are dependent on two external factors: the price of oil and the international financial markets. Fragmentation, low trust, poor supervision and the relatively small share of foreign banks further aggravated the situation.

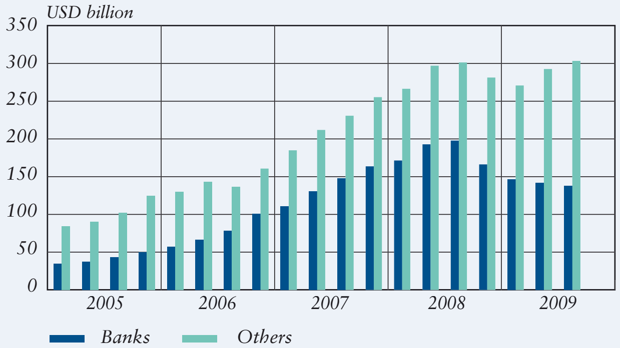
The collapse in the price of oil

The crisis on the financial markets in autumn 2008 also led to a collapse in the world market price of crude oil. In just a couple of months the price of oil fell by 60%, which amplified the decline in share prices in Russia. This, in turn, had two dramatic consequences for the banking industry. In the first place, a number of middle-sized Russian banks had linked a considerable proportion of their assets either directly or indirectly to the stock markets, and the collapse in share prices caused serious liquidity problems for these banks. This simply reinforced the lack of confidence in counterparties and the consequent hoarding of liquidity by financial institutions.

The other shock came from the fact that major corporations which had taken on large amounts of debt in recent years and used their own shares as collateral now found those shares losing a substantial part of their value, leading to margin calls. In addition, the drop in the price of oil, and in consequence also the prices of Russia's other important commodities, meant a contraction in corporate cash flows. The interesting feature here is that the fall in prices should not have had a particularly dramatic impact on corporate earnings if the marginal tax rate on oil exports was truly 90%, as argued by the major oil companies.

Chart 2.

Foreign debt of Russia's private sector



Source: Bank of Russia.

Dependence on foreign money

During the 2000s, a constantly growing share of banking sector growth has been based on borrowing from abroad. Although the stock of foreign borrowing is not particularly large in international comparison, it has grown very rapidly and the loans are relatively short-term (see Chart 2). Only a third (37%) of the USD 140 billion foreign debt of the sector matures after mid-2011.[2] The interbank market, in particular, is highly dependent on foreign money. The Bank of Russia reports that during 2008 some 60% of the total volume of interbank lending involved a foreign counterparty. Furthermore, foreign banks fully dominate interbank lending in foreign currency, with a share of 90% of total foreign currency lending.[3] This means the banking system is very open and, as became clear in autumn 2008,

[2] http://www.cbr.ru/statistics/credit_statistics/print.asp?file=schedule_debt.htm.

[3] http://www.cbr.ru/analytics/fin_r/fin_mark_01-2009.pdf.

dependent on the risk-taking propensity of foreign financial institutions.

The growing foreign borrowing was made particularly attractive by the exchange rate policy pursued by the Bank of Russia. In order to secure macroeconomic stability and domestic price-competitiveness, the nominal value of the rouble was held more or less stable until December 2008, despite pressures to let it rise. As domestic interest rates remained well above the international level, foreign borrowing was very cheap. In autumn 2008 the supply of foreign refinancing dried up and interbank rouble interest rates doubled in a matter of months. The collapse in the world market price of oil together with the strengthening dollar (due to the 'flight to security') destroyed market confidence in the rouble.

Exchange rate pressures

Concern over the future rate of exchange finally paralysed the Russian financial markets. The banks did not want to lend in roubles, while borrowers no longer dared to borrow in foreign currency. A substantial share of the banks' rouble liquidity was exchanged for foreign currency. Presumably, a substantial proportion of the increased domestic liquidity offered by the Bank of Russia also flowed into dollars, further fuelling the pressures for devaluation of the rouble.

In addition, growing uncertainty, increasing payment arrears and the conversion of savings into dollars reduced deposit growth to zero. At the end of 2008, the broad monetary aggregate (M2) also began to contract. The decline in the stock of rouble-denominated deposits at the end of the year actually revealed more about lack of confidence in the exchange rate than in the deposit banks. Russia drifted into a step-by-step devaluation, as a result of which the currency depreciated approximately 30% against the dollar-euro basket between November 2008 and February 2009 (see Chart 3).

However, the step-by-step nature of the devaluation allowed all economic agents to prepare for the depreciation in the exchange rate. Of the banks' corporate loan stock, on average around a quarter of loans

Chart 3.

Rouble exchange rate against the US dollar, the euro and the currency basket

1. EUR 2. Currency basket 3. USD
Source: Bloomberg.

were denominated in foreign currency at the end of 2008, although the variations between banks were considerable. For the thirty largest banks, almost 40% of corporate loans were in foreign currency at the beginning of 2009.

The massive support measures taken by the government and the central bank prevented the collapse of the financial system.

The rapid and massive support measures taken by both the government and the central bank at the end of 2008 prevented the collapse of the financial system. The measures taken by the Bank of Russia proved sufficient and there have been no significant banking bankruptcies. Some smaller institutions were closed and the authorities even took over several banks in order to prevent possible bank runs. The deposit guarantee system has worked without problems. Taken together, the measures promised to secure the operations of the banking system amount to approximately 10% of GDP.[4] The end of January saw the establishment of a new, clearly credible exchange rate.

When will lending revive?

In recent months, since the return of oil to USD 60–80 a barrel, the rouble has rather tended to strengthen slightly. Fuelled by ample liquidity in the domestic banking system and foreign capital inflows, the Russian stock exchange indices have more than doubled from their lows at the end of February 2008. Moreover, the market for domestic corporate bonds has been attracting increasing interest. The monthly volumes of bond emissions have been larger than ever, with RZD (the state railroad monopoly) and Transneft (the state oil pipeline monopoly) leading the way. But bank lending is still declining in real terms.

Loan stock quality in decline

With the most acute phase of the financial crisis now over, the banking system is still hampered by a third source of uncertainty in addition to the uncertainty over the price of oil and the tightness of the international financial markets: namely the quality of the loan stock. Economic collapse and declining real incomes have been reflected in a growth in problem loans and loan rescheduling. The level of non-performing loans recorded by the Bank of Russia is still relatively low at 6%, but there is considerable variation between banks. It is also important to keep in mind that the definition of non-performing loan based on Russian accounting standards only includes the overdue payments, not the whole principal. Moreover, according to international credit rating agencies, the share of non-performing loans has already risen substantially, being at present over 10% of the banks' loan stock. Some Russian observers put the current figure at 20–30% of the total loan stock. These are levels sometimes associated with a full-scale banking crisis.

[4] For an account of the various support measures, see Fidrmuc and Süß (2009).

Recapitalization is the first priority

So far, solvency has not been a problem at the level of the banking system as a whole. On average, the ratio of bank capital to risk-weighted assets has slightly increased during 2009, equalling 20% in September 2009, well above the regulatory minimum of 10%.[5] Many of the smaller banks (which typically have high capitalization ratios) may, in fact, stomach a fairly large share of their possible loan losses by eating their own capital and retained earnings. Nevertheless, on average, the banking sector will need recapitalization before lending can revive.

In this sense, the extensive state-ownership may be a temporary blessing for the Russian economy. Russia's six largest commercial banks, accounting for around 50% of the entire sector balance sheet, are all either directly or indirectly state-owned. These are the systemic banks, vitally important for the functioning of payment systems and interbank markets as well as central in funding the large Russian corporations. During the crisis, the government has resolutely sought to use these banks to carry out its anti-crisis measures and to maintain at least some degree of lending activity in the economy.

The government has made clear it will recapitalize the banks in its ownership if needed. The state development bank, VEB, has been granted direct budget funding to be invested in commercial banks in the form of 10-year subordinated loans. At the time of writing, almost all large private banks had already received VEB funding to bolster their capital adequacy. Uncertainties over economic growth and, hence, over the creditworthiness of potential customers have not eased. Lending, therefore, has yet to resume.

Future growth depends on increasing domestic funding

Since the banks currently have ample liquidity and considerable capital support from the state, lending activities can revive as soon as the uncertainties in the economic environment begin to diminish. In the medium term, however, growth in bank lending may be hampered by very slow growth on the other side of banks' balance sheets. The rapid growth in bank lending experienced in 2001–2007 was based predominantly on foreign funding. Acquiring wholesale funding now on the international markets will be both more expensive and more difficult than during the last five years. Therefore, future banking sector growth will have to rely on increasing domestic funding.

Russian households have traditionally not been eager to place their money in bank accounts. Only a third of them even have a bank account, and negative real interest rates have understandably discouraged

[5] 11% for banks with capital lower than EUR 5 million.

long-term deposits. The experience of the post-Soviet period with high inflation and low trust in the banking system has depressed savings in Russia. Therefore, it is no surprise that household deposits have not been the single most important funding source for the banking sector. With declining real incomes, this will be hard to change. Due to these funding constraints, we cannot expect rapid growth in the Russian banking sector in the immediate years ahead.

State-controlled banking system is here to stay

The banks that have increased their lending amid the crisis are the state-controlled banks. On average, the stock of corporate loans has grown by 2% in nominal terms throughout the first half of 2009 – including rescheduling and bad loans. Thus, the corporate loan stock has declined 6% in real terms this year. The average figure masks the fact that corporate lending has increased primarily in just a couple of the largest state-controlled banks. For the rest of the banking sector, the loan stock has declined by 15%, according to the Russian magazine Bankir.ru. It is, therefore, clear that, overall, the state-controlled banks are increasing their share of the loan markets.

If minimal capital requirements are also applied to existing banks, there may be demands for state-controlled banks or other state-controlled corporations to take over smaller, weak institutions. These possible takeovers and mergers (even though some might just be mergers of small banks) would undoubtedly further increase the share of state control in the Russian banking sector.

The increasing role of the state in the banking industry during the crisis is by no means specific to Russia. Almost all countries hit by the global financial crisis have been forced to take measures that increase the role of the public sector in banking. But contrary to most Western economies, there are not even preliminary talks about an exit strategy. The state is there to stay. And only the future will show us how the co-existence of state and private banks will develop in Russia.

Will the dual financial system survive?

The current financial crisis is unlikely to dramatically change the structural features of the Russian banking industry. The ownership structure will continue to differ from most European countries. As stressed above, the state will increase rather than decrease its share. The major foreign banks will with all likelihood stay in the market, but they will not become the major players in retail banking. The sector will continue to be highly fragmented and prone to rumours. Even though some smaller banks are expected to vanish, Russia will still have a high number of tiny banks that are difficult to control and regulate. But there are substantial uneertainties over the viability of the international portion of Russia's dual financial system.

Past growth in the banking sector was accompanied by even faster growth in foreign borrowing by the large Russian corporate clients. Russian companies became especially large players in international markets for syndicated loans, with the flow of syndicated loans to Russian borrowers in 2006–2007 being larger than to eg Italian or Spanish borrowers. Therefore, both the domestic and the international side of Russia's dual financial system grew rapidly. Now both sides are struggling.

If the large Russian corporations, too, find themselves unable to draw on the international money markets for a prolonged period, they will have to turn to the domestic banking sector for finance. Given that these corporations are large by any measure, this would imply a further scaling down of many investment plans in Russia. The return of the large corporations to the domestic markets could crowd out the small and medium-sized domestic companies from access to bank finance in Russia. This might seriously hamper economic growth in the long term.

Keywords: banking sector, financial system, Russia

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