# The Russian Federation
## Commercial Banking

John Litwack

The development of capital markets and commercial banking presents some of the most difficult policy challenges for countries in transition to a market economy. The operation of capital markets in most OECD countries, involving the guaranteeing of relatively long-term contracts under conditions of limited liability and imperfect information, relies on a host of complex institutions that have developed over a long period of time.

In addition to the enforcement of laws affecting contracts, bankruptcy, disclosures, insurance and the rights of creditors and stockholders, these institutions also include business reputations, sophisticated credit-rating systems, frameworks of corporate governance for the disciplining of management, skills for the monitoring and evaluation of specific investment projects, and co-operative agreements for pooling information.

The very nature of economic transition entails a high degree of uncertainty and risk, adding even more difficulties for the creation and effective operation of these institutions. Experience since World War II suggests that commercial banks may be able to play a key role in this process of institutional evolution, even while the stock market remains very weak.

### Striking Dynamism

The growth of commercial banking in the Russian Federation in the 1990s has been dynamic. Russia began economic transition without even the semblance of a banking sector as exists in a market economy. Branches of the state banking monopoly functioned essentially by intermediating financial flows between the state and economic organisations on the basis of administrative directives. In the late 1980s, the branches of the state banking hierarchy were transformed into commercial banks and placed under the direct regulation of the Central Bank. By the mid-1990s, over 2,500 commercial banks were operating throughout the country, most of which were newly created and private.[1]

During the first years of transition, the vibrancy, growth and profitability of commercial banking contrasted sharply with most other branches of the economy. In more recent years, a handful of large Moscow banks have risen to prominence as the most advanced and best capitalised financial institutions in the country, performing on a daily basis complicated operations on financial markets that were completely foreign to Russia only a few years ago.

This rapid growth in commercial banking has been important for the development of capital markets. But it has also created a serious dilemma. It has by far outpaced the evolution of the institutions necessary to support the effective financial intermediation by banks of savings and investment under the 'normal' conditions of a market economy.

The impressive growth of commercial banking during the early years of transition in Russia derived from a very specific and largely transitory regulatory and economic environment. Very lax minimal capital requirements and other prudential regulations made the establishment and operation of new banks quite easy. Negative real interest rates on deposits and refinance credits allowed banks to profit simply by holding a large share of assets in hard currency. Rapid inflation and poor payment discipline provided another important source of bank profits: the delaying of various payments, usually at the expense of the government or state-owned enterprises. Rapid and unstable inflation supported a high demand for the service of foreign currency exchange. Lax foreign-exchange regulations allowed banks to service capital outflows through excessive payments for (possibly fictitious) imports. In addition, a large amount of implicit subsidies in the form of Central Bank credits and other state resources were intermediated by commercial banks during this period. By offering interest rates somewhat higher than the State Savings Bank (Sberbank), many new banks also attracted a larger share of household deposits during this period.

All of these sources of profits for commercial banks have been eliminated or substantially decreased after changes in economic policies and progress in stabilisation (Table). Monetary policy has tightened sharply, and directed credits have been largely discontinued since 1994, as mirrored in the contraction of bank credit in GDP from 34% at the end of 1992 to 10% by 1997. Progress in stabilisation, assisted by much lower inflation and less volatility in exchange rates, has reduced profits from inflation rents, the servicing of currency exchange and speculation. Real interest rates have gone from being highly negative in 1992 and 1993 to being highly positive from the second half of 1994 until the end of 1996. Charter capital requirements and other prudential regulations have been tightened substantially, and are still to be progressively stiffened to meet many of the main Basel standards by 1999. The authorities have also devoted more resources and legislation to monitoring foreign-exchange operations and uncovering capital outflows disguised as current-account bank payments, although this is reportedly still a problem.

These very sharp changes, many of which came in late 1994 and early 1995, placed a

John Litwack works in the Central and Eastern Europe Division of the OECD Economics Department.
E-mail: eco.contact@oecd.org

1. ***OECD Economic Surveys: The Russian Federation***, *OECD Publications, Paris, 1997.*

Table

**The Evolution of Russian Banking, 1992–96**

*as at 31 December, unless otherwise stated*

| | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|
| Number of operating credit organisations[1] | 1,713 | 2,019 | 2,517 | 2,295 | 2,030 |
| Licences withdrawn (number, cumulative) | .. | 13 | 78 | 303 | 592 |
| Charter capital requirement for new banks ($ thousands) | 214.4 | 70.6 | 1,244.7 | 1,291.5 | 3,648.9 |
| Real monthly refinance rate of CBR[2] (%) | −12.2 | −6.9 | 4.4 | 7.6 | 6.5 |
| | | | % of GDP | | |
| Credit from monetary authorities to commercial banks | 15.0 | 5.1 | 2.4 | 1.1 | 0.6 |
| Bank credit to the non-financial sector | 33.6 | 20.4 | 19.6 | 12.0 | 10.0 |
| Interbank credit received | .. | 3.2 | 4.9 | 3.9 | 3.1 |
| Gross assets of the banking sector | 88 | 54 | 56 | 36 | 36 |
| Household deposits | 1.9 | 2.4 | 4.2 | 4.3 | 5.3 |
| Household deposits outside of Sberbank | 0.3 | 0.9 | 1.7 | 1.5 | 1.4 |

.. not available.

1. 1,360 at the end of 1991.

2. Central Bank of Russia; yearly average of real monthly rates; for 1992 February–December (so as to exclude the price jump in January).

Sources: CBR, IMF, OECD

number of banks in immediate financial trouble. Growing liquidity and portfolio problems culminated in the collapse of the interbank loans market in August 1995 on the heels of a chain of defaults. Instead of providing the accommodation that was characteristic of past policies toward distressed commercial banks, the central-bank authorities used the event to signal the seriousness and credibility of the new tougher policy course.

Refinancing was very limited and concentrated only on a few of the larger banks that presented systemic risk. Simultaneously, the Central Bank began to withdraw the banking licenses from many distressed banks, a process that had reduced the number of operating banks to roughly 1,800 by September 1997.

In view of the absence of comprehensive deposit insurance, the large number of bank and other financial failures in recent years reversed the trend toward the attraction of household deposits by other commercial banks away from Sberbank. After rapidly increasing to 41% at the end of 1994, the share of household deposits in other banks than Sberbank fell back to 26% by the end of 1996.

Two years after the crisis on the interbank market, the overall situation in the Russian banking sector remains very difficult. The tough policy course of the Central Bank has nevertheless borne some fruit. Predictions by some of an immediate repetition of the crisis on an even larger scale have not materialised, while the incentives facing the commercial banks, and their behaviour, have changed dramatically. One important indication of this change is the contraction of commercial credit in GDP, which directly reflects more cautious bank policies. Although the share of commercial credit in GDP at the end of 1996 (10%) is quite low even relative to other transition economies, it can be argued that this properly reflects the low degree of institutional development of Russian credit markets. Policies that supported a high share of new commercial credit in GDP under similar institutional conditions in Bulgaria, for example, eventually led to a full-blown financial crisis in 1996 and the virtual collapse of its banking sector.[2] It is notable that, during a time of escalating inter-enterprise and various budgetary arrears in Russia between 1995 and 1997, the reported share of arrears in all commercial credit fell continuously from 43% in October 1994 to under 13% by mid-1997. Problems in accounting and monitoring have led to estimates that the figure might currently be closer to 30%. But in view of the difficulties the Russian economy is facing, the controlling of credit arrears must be considered a success for central-bank policies – at similar stages in economic stabilisation in almost all other transition economies such arrears increased.

How have some Russian commercial banks managed to survive the elimination of most of their earlier sources of profits? They have been channelling a much larger share of their assets into credits and investments in securities (Figure). In January 1995, most of their assets were 'non-working', most of that in hard currency. By two years later commercial credits or investments in securities jumped to 70% of banking assets. With most other sources of profits vanishing, the market for state securities has offered commercial banks a particularly important opportunity for investment. That was especially in 1996, when access to the market by foreigners was highly restricted and interest rates soared, owing partly to a high federal budget deficit and much political uncertainty. The share of bank assets invested in securities grew from 6 to 18% between 1995 and 1997.

## Moscow and Elsewhere

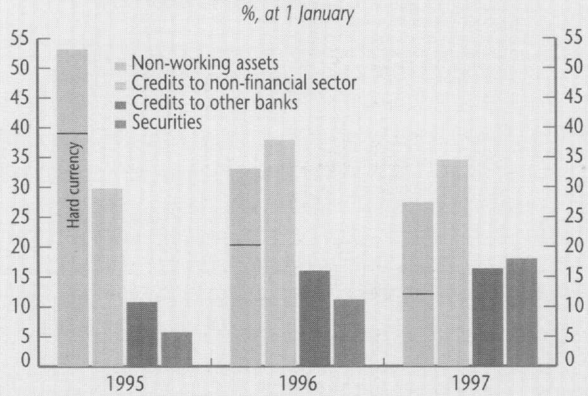
In the last few years a very strong dichotomy has emerged between a handful of rapidly growing large Moscow banks and the rest of the banking sector, most of which has been experiencing increasing financial distress. This process has increased significantly the degree of concentration in the industry, with large Moscow banks accounting for over 70% of assets, close to 80% of credits, and roughly 90% of household deposits by January 1997. These banks are also actively penetrating most regions in the Federation, increasing their shares in, and, in some cases, domination of, regional markets. Some regional governments have adopted policies aimed at protecting their local banks, but financial problems have increasingly pressured most of these governments to abandon such efforts in favour of attracting capital and financial services from Moscow to the region.

The rise of these large Moscow banks has been one of the most prominent features of the Russian economic landscape in the past few years. They operate as universal banks, typically at the centre of extensive financial-industrial groups, and have been the most active players on the emerging market for corporate control. The close relationships that these banks have forged with various government organs have also been a focal point of controversy. Some banks appear to have received privileged access to several privatisation auctions. Several have profited from obtaining the 'authorisation' to participate in state financial programmes, which can involve the holding of budget funds at negligible interest rates or lucrative credit issues with state guarantees.

The government formed in March 1997 announced the goals of reducing or eliminating these special privileges, and eventually transferring all federal finances to the National Treasury. In addition, enhanced political stability and the sequential opening of the state securities market to foreign investors, beginning in the second half of 1996, have driven down interest rates on government bonds dramatically, thereby decreasing the profitability of many banks. Immediately after assuming the position of First Deputy Prime Minister and Minister of Finance, Anatoly Chubais announced, at the Congress of the Association of Russian Banks in April 1997, that banks would no longer be able to survive on the basis of state favours and high yields on state securities: 'For banks there remains only one path: investment in the real sector. Those who are late to realise this will lose, and those who do not realise it will perish financially'.[3]

But success in re-orienting banks toward credits for investment and restructuring depends on more than the elimination of government favours and reduced yields on state securities. Indeed, investment (long-term) credits other than those issued with state guarantees have remained a negligible part (less than 2%) of commercial bank assets throughout the transition period. That not only reflects the presence of other sources of profits but also the very low stage of development of institutions to support the operation of credit markets. Legal protection of the rights of creditors, even in the case of secured loans, remains extremely weak. In addition, enterprises have been predominantly employee-controlled since mass privatisation, and no effective mechanism yet exists for disciplining management or replacing incompetent managers on a large scale.

Figure
**The Structure of Russian Commercial Bank Assets, 1995–97**[1]
*%, at 1 January*




1. Based on a sample of 503 Moscow banks, excluding Sberbank and Vneshekonombank.
Source: Laboratoria Problem Finansovogo Sektora, TsEMI RAN, Moscow

These problems appear to provide some of the motivation for banks to form financial-industrial groups and obtain controlling shares of client firms. Commercial banks are very reluctant to lend to firms that they do not control. The fact that these banks and their group affiliates seek to operate on the basis of special bilateral agreements with various government bodies also derives from the nature of the current business environment in the country. Key economic variables in areas such as taxation, customs duties, trade, and access to transportation remain very unstable and subject to a high degree of discretionary control at various tiers of government. Special bilateral relations with government organs are therefore still widely viewed within Russia as a prerequisite for successful business.

The behaviour of these large Moscow banks can thus be viewed largely as a response to the particular environment of the Russian economy, which continues to suffer from the absence of rule of law. A comprehensive strategy for simultaneously improving the health of the banking sector and reorienting commercial banks toward more involvement in the restructuring process should combine policies aimed at phasing-out state favours with other measures to promote the development and enforcement of economic laws in a few key areas. In particular, the rights of commercial creditors in the event of default should be strengthened, allowing them easier options for seizing collateral or initiating a turnover of enterprise management. This latter option could also facilitate the ability of commercial banks, through debt contracts, to make an important contribution to the establishment of effective corporate governance and combat the problem of insider control.

Several Russian commercial banks are poised to make a potentially important contribution to the development of the Russian economy in the near future. But the nature of this contribution depends a good deal on the success of many overdue reform measures to promote a stable policy environment based on the rule of law, including a strong defence of the rights of creditors. ■

2. ***OECD Economic Surveys: Bulgaria 1996–1997***, *OECD Publications, Paris, 1997.*

3. *Quoted in* ***OECD Economic Surveys: The Russian Federation***.

### OECD Bibliography

OECD Economic Surveys: The Russian Federation, 1997

OECD Economic Surveys: Bulgaria 1996–1997, 1997.