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Russian Banking

On the last day of 1991 the Soviet Union vanished, and the various countries of the former USSR accelerated their ongoing political and economic transformation. One result is that the title of this *Weekly Letter* is no longer an oxymoron. Indeed, the Russian banking system stands out among sectors of the Russian economy for its high degree of privatization, its market orientation, and its rapid adoption of Western technology and management methods.

But partly because of its rapid development, the Russian banking sector is fragile. This point was emphasized during August 1995 when the Russian interbank credit and payments system froze, precipitating calls for central bank intervention and government action. This *Letter* describes the emergence of a private banking system in Russia, provides insight into banking's current state, and discusses the critical issues Russian banking still faces.

A brief history

During the Soviet era the Russian banking system, such as it was, consisted of branches of the central bank (the Gosbank), and functioned primarily as an accounting network for the annual central plan. Credits were transferred on the books of the Gosbank to account for flows of physical production and inputs between state-owned enterprises. Firms paid wages in cash provided by the Gosbank; workers paid cash for purchases and deposited the excess "under the mattress" or in the Gosbank's savings bank section, called Sberbank. In 1987, under *perestroika*, the Gosbank was split into several specialized banks for different sectors of the economy, with each bank still centrally controlled. Beginning in 1988, a few commercial banks began operating, although their legal foundation remained vague.

Formal banking legislation was passed in late 1990, and a licensing and regulatory process was put in place. After the breakup of the Soviet Union, the former specialized banks were partially or totally privatized through the issuance of shares to the public, although in some cases (notably Sberbank) the government retained some degree of control. What remained of the old Gosbank within Russia became the new Central Bank of the Russian Federation (or CBR).

Industry structure

Establishment of new banks has been rapid; there are now more than 2500 commercial banks in Russia. Sberbank is in a category by itself; its branch network is immense (roughly 30,000 offices, compared to about 5500 for the rest of the banking system), and it is by far the largest holder of personal deposits. The rest of the Russian commercial banking industry divides into three segments. One segment arose early in the transition process: Large industrial enterprises, needing a mechanism to make and receive payments and needing access to credit, established their own banks. Since these banks are owned and controlled by their one major customer, they are like treasury departments of the associated industrial firms. A second segment of the industry sprang up when the specialized arms of the former Gosbank were privatized. Many regional branches of the specialized banks have themselves become independent commercial banks, about 750 in all. The third segment of the industry consists of a large number of completely new commercial banks, some quite small, including many of the most progressive. It is hard to get precise figures on the various types of banks, but this third segment probably accounts for about two-thirds of the total number.

A small number of U.S. and other foreign banks now operate in Russia, although primarily to service their existing international clients. In the other direction, Russian banks are just starting to apply for entry into U.S. banking markets.

Supervision and regulation

A new central banking law, signed by President Yeltsin in April 1995, specifies the duties of the CBR as Russia's bank supervisor. The CBR licenses new banks, supervises existing banks, and can impose penalties or revoke banking licenses when appropriate.

The CBR has been criticized as lax in its efforts to close troubled banks; many poorly capitalized and even insolvent banks remain open. Following some clarification of the CBR's powers, the pace of closures has increased: 65 banks were closed in 1994, and an additional 71 during the first six months of 1995. However, some observers believe that many more Russian banks are insolvent. Part of the problem is simply knowing which banks are the bad ones. The CBR has been hiring and training examiners, or inspectors as they are called in Russia, but real competency will come only with time.

Russian banks must meet various regulatory standards: liquid liabilities cannot exceed liquid assets, large credit exposures cannot exceed 25 percent of a bank's capital, and loans to shareholders of the bank cannot exceed 20 percent of capital. Currently, banks must have capital of at least 1 million ECU (roughly $800,000 at current exchange rates); recent increases in this minimum should help weed out some of the worst banks, and the requirement is due to rise further, to 5 million ECU by 1999. In addition, the CBR measures capital adequacy using standards similar to those developed by the Bank for International Settlements; a bank's equity must equal at least 4 percent of its risk-weighted assets, rising to 8 percent by 1999.

Russia has no formal deposit insurance system. The Russian Federation explicitly guarantees deposits in the Sberbank. Deposits in other commercial banks have been uninsured since the discontinuation of a guarantee fund maintained by the CBR, although several versions of a deposit insurance act have drifted through parts of the Russian legislative system.

The business of banking in Russia

The activities of an institution call a "bank" in Russia differ from those of a typical U.S. bank. Intermediation, or the transformation of deposits into loans, is much less important. A sizable part of the lending Russian banks do is to each other: over 25 percent of aggregate bank assets are plowed into the interbank market. Loans to nonbank customers have increased recently, to about 45 percent of total bank assets, but are still far less than the 60 percent figure typical for the U.S. These loans predominantly finance inventories and receivables, and are very short term; loans for capital investment or housing are virtually nonexistent. Deposits amount to only 35 percent of assets on average, compared to 60 percent in the U.S., and (outside of Sberbank) most are business deposits; in fact, the new Central Bank Law requires that total personal deposits not exceed a bank's own capital.

Banks are heavily involved in foreign currency dealings, both as brokers to earn fees, and as traders to attempt to earn speculative profits from exchange rate movements. They also provide payments services for business enterprises, although there are no checking accounts in Russia. Russian enterprises use third party transfers, carried out by commercial banks, to make interfirm payments. It takes an inordinate amount of time to clear these transfers, although new private and central bank electronic clearing systems now are being introduced.

Beyond these activities, banks are active investors in real estate and nonbank securities, including common shares. Thus, Russian banks are "universal banks," with powers more like those of European banks than those of U.S. banks. Until recently a certain amount of centrally directed credit also flowed through the banking system, primarily to former state-owned enterprises, and banks earned a fixed spread for acting as the conduit. However, such credit programs appear to have ceased.

Crisis and aftermath

The August 1995 paralysis of the banking system was caused largely by the practices of Russian bankers, likely aggravated by a change in monetary policy in early 1995. Previously, monetary policy had a "stop-go" character, with slow monetary growth and low inflation during the first half of each year, followed by rapid monetary growth and high inflation in the second half. Annual inflation rates in excess of 1000 percent had two effects on banking. One was that credit analysis was not emphasized: the real value of loans became so small so fast that principal repayment was irrelevant, as long as borrowers continued to pay interest. The second effect of rapid inflation was that banks with foreign exchange licenses profited by positioning against the ruble, betting correctly that the currency would depreciate against foreign currencies.

But significant monetary tightening was introduced in early 1995. Banks' reserve requirements went up and money growth slowed; annualized inflation fell from 700 percent in January to 70 percent in August, and the ruble began to appreciate on exchange markets. As welcome as

these developments were to the Russian economy, many banks suffered. Previously profitable foreign currency positions became losers, higher required reserves meant forgone interest, and default by marginal borrowers became likely as loan principal no longer was trivialized by inflation. With no sign of the usual monetary policy reversal, suspicions grew that the condition of some banks was tenuous. A lack of truthful, publicly available financial information made it impossible to tell strong banks from weak. The banks themselves became nervous about their large exposures in the interbank market; the crisis erupted as banks, with no good way to judge counterparty risk, reacted to mild signs of illiquidity by simply refusing to transact.

The banking crisis may stimulate two changes for the better. First, banks may be pushed to abandon speculation and take up the hard work of analyzing credit risk and making loans. Currently, the banking sector is stunted: the ratio of banking industry assets to GDP is only 0.17 in Russia, compared to 1.3 in the EC (or 0.75 in the United States). With powers like those of banks in the EC, Russian banks may eventually play a similar role in the economy, and assets may reach a similar relationship to GDP. Russia desperately needs the investment finance that a deeper, more mature banking sector could supply.

A second positive result of the crisis may be consolidation. Russia has too little banking, but also too many banks: the 2500 banks currently average only about $20 million in assets, compared to $300 million in the U.S. or $3 billion in the EC. Similar banking arises in other transitional economies have been followed by consolidation, which may increase the efficiency of the banking system. If a "fully banked" Russia had the same 1.3 ratio of banking sector assets to GDP found in the EC, it could support 150 EC-sized or 1500 U.S.-sized banks.

Deeper problems

But while the immediate crisis may be the catalyst for such changes, it will not solve deeper problems that are retarding the development of a healthy banking system. Russia lacks the "financial infrastructure" that would let its banks provide credit effectively. One problem is information: unreliable or false financial information raises the risks facing lenders and obstructs the flow of capital through the banking system. A second, perhaps more significant problem is contract enforcement. Property rights are ill-defined, the legal status of collateral is unclear, and Russia still does not have laws governing such things as the order of claims in bankruptcies. Traditional banking is difficult under these handicaps.

Of course, if disclosure problems and a hazy legal structure make banking difficult, they make corporate governance through market mechanisms nearly impossible. With some basic improvements in the financial infrastructure, large universal banks might be the ideal way to resolve the conflicts that arise between debtholders and shareholders, or between insiders and outsiders, in the wildly imperfect Russian capital markets. An offsetting concern is that it might be hard to make large universal banks smaller and narrower at some later stage of Russia's financial development.

Conclusion

An efficient, well-functioning banking system is crucial for a peaceful transition to a new order in Russia. Four years ago, Russia had no bankers, at least in the Western sense of the word. Today, Russians are eagerly adopting many Western practices, but cultural change is slow.

One danger is that attempts to "solve" the August crisis in the banking system might reverse the macroeconomic gains Russia has made recently. Over the near term, consolidation in the banking system may lead to fewer and larger Russian banks, but more fundamental improvements to laws governing contract enforcement and information disclosure will be far more important. Without changes in the financial infrastructure, banks will continue to be restricted in their ability to help the Russian economy grow.

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