CHAPTER-IV

PROBLEMS AND PROSPECTS
OF THE RUSSIAN BANKING SYSTEM
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The banking sector in Russia developed furiously during the period from 1992 to the middle of 1998, against a background of decline and then stagnation in the real sector. The banks did not established stable and profitable relations in the financial servicing of enterprises in the real sector of the economy throughout the entire period of reforms, which was an important precondition of the systemic crisis.¹

The flourishing of the banking sector in 1992-94² was based on its receipt of inflationary incomes. In 1995³, the banking sector started to obtain significant incomes by participating in building the ‘pyramid’ of state domestic borrowing. The world investment boom of 1996-97⁴ also brought quite a bit of income to the Russian banking system, but it subsequently played a fateful role. The world financial crisis that started in the middle of 1997 caused the outflow of resources from

² Ibid.
³ Ibid.
⁴ Ibid.

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Russia. The largest Russian banks, which had accumulated about 70 percent of the assets and capital of the banking system and more than 95 percent of the funds of private depositors and had gained access to Western securities and capital markets, ran into insoluble problems as early as the spring of the 1998.5

The Russian banking crisis of 1998 is undoubtedly systemic, and has come to be a most profound upheaval of the country’s banking system and the economy as a whole. Its fundamental difference from the crisis of August 1995 is that it encompassed a majority of the major Russian banks with multiple branches, through which a significant share of the payments turnover, including payments among regions, moved. The 1998 crisis was moreover manifested in the unprofitability of many Russian banks, and the loss by the banking system of a significant portion of its own capital.6

The crisis of 19987 was the result of both financial upheavals outside the Russian banking system (the de facto bankruptcy of the state, the drastic devaluation of the national currency, and the destruction of financial markets) and its own internal structural weaknesses (blunders and mistakes by management, the low level of

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5 Ibid., p.77.
7 Ibid.
capitalisation, the inadequate estimation and regard for risks, and the poor development of direct banking business). The scope of the losses of Russian banks in the second half of 1998 are estimated at 50-60 percent of the capital of the banking system (2-3 percent of GDP).\(^8\)

The most acute manifestations of the crisis (disruptions in the operation of the settlement system and the ‘flight’ of depositors from banks) have been overcome today, and the banking system is in a state of stagnation and a search for ways to survive. Problems of the settlement of relations with foreign domestic creditors, restoration of confidence in the banking system, and its restructuring and recapitalization have moved to the fore.\(^9\)

Since the crisis of 1998, the banking system of Russia has been searching for ways to survive and adapt to the new conditions. Problems of settling their relations with foreign and domestic lenders, restoring the confidence of the population, and restructuring and recapitalizing the banking system have moved to fore. It is full-fledged functioning is being held back owing to the continued existence of a significant number of insolvent banks with negative capital and the

\(^{8}\) Ibid.
\(^{9}\) Ibid., p.6.
extremely slow revocation of licenses from bankrupt banks which are multiplying the losses of society.\textsuperscript{10}

Having achieved some level of stability in the economy after the financial crisis of August 1998\textsuperscript{11}, the Russian authorities gave some attention to the problems of the country's banking sector. This is evident from several statements made during the past few months. Addressing the Russian Banking Association\textsuperscript{12} on April 11, 2001, Prime minister Mikhail Kasyanov said Russia would strengthen its banking system as a part of general effort to promote economic growth. The deputy Prime minister and finance minister, Alexi Kudrin, said the following week that public trust in the banking system in Russia will lie once the Duma (the Russian Parliament) amends laws regulating it. The first Deputy chairperson of the Central Bank of Russia, Tatyana Paramonova said on April 24 that Russian banks invest too small a share of their money in domestic industrial enterprises.\textsuperscript{13}

All this indicates that there is serious concern among policy makers about the state of Russia's banking sector. Even after a decade of the Soviet break-up, Russia had not been able to evolve an efficient banking system to meet the needs of a market economy. To understand

\textsuperscript{12} Ibid.
\textsuperscript{13} Ibid.
the concern of the Russian authorities, it may be worthwhile to look into some of the major issues and problems that the Russian banking sector faces.

At the outset, it is important to note that Russia did not inherit a sound banking system when the USSR disintegrated itself into 15 independent sovereign countries. As Russian economist Kim Iskyan notes, Russia only had 'bank-like' institutions, and not real banks. It appears that there has been no major improvement in this situation since, as Kasyanov comments,

"...We do not have really genuine banks, practically no banks".

The chairman of the Central Bank of Russia (CBR), Viktor Gerashchenko told to the media person when they returned from Washington, where they attended IMF and World Bank meetings, that;

"Russia has no Commercial Banks that are of national importance to the economy."

The Russian banking sector is still weak and consists mainly of financial companies or financial department or big financial groups that suit the interest of borrowers which the financial groups themselves

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14 They are: Russia, Estonia, Lithuania, Belarus, Ukraine, Moldavia, Georgia, Armenia, Azarbaijan, Kazakhstan, Turmenistan, Uzbekistan, Kyrgyzstan & Tajikistan.
16 SWB, SUW/0559, p. WA/6, 16 October 1998.
control. In this sense there is continuity with the Soviet past. Here, it is worth noting that from a handful of State banks existing in the early 1980s in the former USSR, the number of banks increased under Mikhail Gorbachev’s policy of ‘perestroika’ mainly in the form of cooperative banks. The process continued after the Soviet break-up and by 1995 Russia had over 2,600 banks. However, the majority of these are small, single branch banks established by enterprises or cooperative units.

In fact, this uncontrolled and unregulated growth of banking institutions has posed a major challenge to Russian policy makers. During the financial crisis of August 1998, over 1,200 insolvent and problematic banks were wound up, partly due to the policies pursued by Russian government and Central bank of Russia (CBR). It is reported that there are now about 1,380 banks. In the opinion of the Peter Aven, president of Russia’s Alfa Bank, even this number is large and should be reduced to a sixth. On the question of the number of banks, Georgy Luntovsky, deputy chairman of the CBR, has opined that Russia was carried away by the euphoria of setting up commercial banks in the early 1990s. The minimum capital requirement was low and hence a large number of small banks were set up. In the opinion of some Russian economists, there are three categories of banks in Russia.

\[17\] Giddalubhli, n.11, p.2325.
\[18\] Ibid.
-bust, wobbly and healthy. To make a banking sector strong, it is necessary to liquidate small and insolvent banks. While healthy banks should be promoted, wobbly banks that have a fair chance of being competitive should be helped out. However, on the issue of liquidating insolvent banks, there are differences among economists, policymakers and bankers in Russia it is reported that Viktor Gerashchenko, Chairman of the Central Bank of Russia, was not in favour of closing down many small banks. The reason seems to be that there are several small banks that are promoted either by influential political groups, or regional and local administrations, which resist the liquidation of these small banks.\textsuperscript{19}

Apart from solving these procedural problems, what is lacking is the implementation and enforcement of the law on bankruptcy, which was passed in 1999. Above all, there are many shortcomings with regard to court procedures, and Russia’s judicial system is reported to be highly imperfect and Unsatisfactory. For instance there are reports that court decisions regarding the same question are different on different occasions.

Another major problem affecting the Russian banking sector relates to unfair banking practices being followed during the past decade. Taking advantage of the policy of rapid economic liberalisation

\textsuperscript{19} Ibid., P.2326.
pursued by former Deputy Prime minister Egor Gaider in the immediate post-Soviet period, many newly established banks engaged in utilising their resources for speculative activities such as exchanging roubles into dollars or vice versa to earn quick profits. It was reported that a few banks even used money borrowed from the government and the Central Bank of Russia for such transactions.

Moreover, during 1993-98, when the Russian government introduced 'short term bonds' known as the GKO’s, many banks used their resources including state funds for procuring the GKO’s, which yielded high interest rates and hence high return on money. According to reports, many banks including oligarchy banks invested about one-third of their assets in the GKO’s. But when the Russian government declared a moratorium on the encashment of the GKO’s in August 1998, many banks including a few large private banks, became insolvent.20

Lack of trust in a major problem faced by the Russian banking sector. This problem has been highlighted by Marina Chekurova, first deputy director of the state Agency for Restructuring of Credit Organisations (ARCO). She had candidly observed that in Russia ‘depositors don’t trust banks and banks don’t trust borrowers’.21 The

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20 Ibid., p.2327.
21 Ibid.
seriousness and magnitude of this problem can be visualised from the fact that millions of common Russians, who being given hopes of multiplying their money in a short period parked life savings in the newly established banks and financial firms, and lost their hard-earned money when the private banks went bust. As a result, most Russians do not trust the new private banking institutions. They prefer to keep their money in state-owned banks such as the Sberbank, which they consider safe to maintain their deposits.22

The question of trust has assumed importance as many Russian experts have observed that it was not known where banks kept resources. As noted earlier, many private banks were using resources at their disposal for non-banking speculative activities. In turn the banks have their own story to tell about lack of trust. They complain that the borrowing firms and enterprises are also opaque in their financial position which puts banks to considerable disadvantage in lending to firms. This has created a vicious atmosphere in the Russian banking and financial sector.

There is another issue facing some Russian private banks, as they feel discriminated against vis-à-vis State Banks in terms of attracting deposits from the public. At present the Sberbank accounts for about 80 percent of all deposits. The main reason for this is that while deposits in

22 Ibid.
the state-owned banks are guaranteed, those in private banks are not. This is partly the fault of private bankers who, as stated earlier, have often resorted to speculative activities risking the savings and trust of common Russian depositors. As Russia looks ahead towards economic recovery, the private banking sector would like to expand its business.23

Some spokesmen of the banking sector in Russia also feel that they are discriminated against vis-à-vis other sector of the economy in terms of charging high rates of taxes. Rates of tax on the profits earned by banks are as high as 43 percent, compared with tax rates of 20-30 present in the rest of the economy. This high rate of tax seems to be forcing banks to hide their profits by fraudulent accounting methods. To avoid paying high taxes and retain their profits, some Russian banks are reported to be actively involved in money laundering. To track the payment records of 1,500 banks and insurance companies, a ‘tax inspection body’ has been set up by the Russian government with a view to prevent tax evasion. But many Russian economists and oligarchs feel that more than such administrative measures, economic measures such as reduction of tax rates will be more effective.

A major problem affecting the banking sector in Russia is the lack of coordinated efforts among different agencies such the Central Bank of Russia, the Duma and ministry of finance. This also affects the

23 Ibid.
formulation and implementation of the banking reforms in the country. It is alleged that legislation with regard to banking reform proposals are stuck with the Duma for approval for a long time.

The Russian banking sector has been suffering from weak legal infrastructure. Even after nearly a decade of the Soviet break-up, the Russian government has not been able to bring about necessary reforms in the legal and regulatory system. According to many western experts, information about finances of Russian enterprises is generally opaque and is based on flawed Russian banking standards, most of which were developed during the Soviet era. For instance, the protection of creditors provided by ‘collateral and insolvency laws in weak and relies on an inefficient judiciary’. It is observed that approval procedures for loans are stated to be weak affecting the interests of banks. Some western experts have also said that some banks do not conduct proper firm level analysis at all and that moreover published statements of Russian firms can be misleading. Under these conditions, it has become difficult to write enforceable contracts between banks and firms with regard to loans. In view of this, it is necessary to make simultaneous efforts in reforming the banking laws as well as laws pertaining to the enterprise sector. It is not possible to make progress in one without the other.
THE ECONOMIC IMPACT

The problems facing the banking sector have had an impact on the Russian economy. First and foremost, Russia has not been able to attract necessary investment in the economy, as the deputy chairman of the Central Bank of Russia has pointed out.

Russia’s banking problems have also affected foreign investments. There were 1,697 banks operating in Russia on 1st January 1998. But there number is expected to fall sharply.24 According to a report by Pricewaterhouse Coopers, Russia is losing about $10 million a year in terms of foreign direct investment.25 An idea of how Russia compares internationally in terms of foreign direct investment can be had from a report by Standard and Poor’s dated April 26,2001. According to this report, in the year 2000 Russia attracted only about $3 billion in foreign direct investment as against $46 billion by China. In its assessment, besides short comings in the banking and legal system, absence of an IMF cooperation accord and the weakness of the country’s budgetary base are the major reasons making Russia less attractive for foreign investment.

But although Russia badly needs investment to boost economic development, the Russian government has often followed inconsistent
policies with regard to investment. On the one hand, the Prime minister has pledged to treat domestic and foreign investors equally to allay fears about restrictions and discrimination against foreign investors in Russia. The government is also inviting the private sector in the country, including the oligarchs, to invest more money in the economy. But on the other hand, it is reported that the first deputy minister of economic development and trade, Mikhail Dmitriev, has said Russia may invest 25 percent of pension funds abroad to protect the contribution of pensioners in the event of a national crisis. This gives an impression that the Russian government has its own genuine reservations about the investment climate in the country. What adds to this impression is that as reported by the Washington-based ‘Planecon’ institution, Russia had a gross outflow of $3.1 billion as foreign direct investment (FDI) in the year 2000\(^26\), which was double that in 1999. It is therefore necessary for the Russian authorities to give serious attention towards improving investment conditions.

Secondly, there are also reports both in Russia and in the west about the increase in money laundering from Russia to about $25-30 billion in the year 2000, which was 50% higher than that in the previous year. This huge magnitude of money laundering, when Russia needs resources for its own economic development, is an indication that

\(^{26}\) Ibid., 2329.
there are inadequacies in economic reforms and restructuring. Yet the Russian government is reported to be unable to create a special agency to combat the problem of money laundering. In May 2001, Russian president Vladimir Putin said this is a serious problem needing effective measures by the government. He has also promised Russian bankers and businessmen that taxes will be reduced. But possibly due to the prevailing unfavourable conditions, both the US and Germany, the two major investors in Russia, appear to be not keen to increase their investment or to help the Russian government in bailing the country out from its current financial difficulties.

With a view to reforming the banking sector, the Russian government has undertaken some measures, particularly after the financial crisis of August 1998. For instance, the mushrooming of banks has been contained and the number of banks has been reduced by liquidating over 1,000 banks. In March 1999, the ‘Bank Bankruptcy Law’ was passed and in July 1999, the ‘Bank Restructuring Law’ was passed to facilitate changes in banking system. The Russian government has also declared its policy of saving ‘socially important bank’ and an organisation known as ‘Agency for Restructuring Credit Organisation’ (ARCO) has been established. On 22nd November 1998, the Russian Government and the Central Bank made a statement ‘On
the Agency for Restructuring of Credit Organisations (ARCO)\textsuperscript{27} by that law the government of the Russian Federation and the Bank of Russia are guided by the following principles\textsuperscript{28} of the restructuring of the banking system:-

- The priority of the Protection of the interest of individual investors.

- An equal attitude to all creditors, including foreign.

- Openness of the process of the restructuring of the liabilities and assets of banks to creditors, investors and controlling institutions.

- The economic responsibility of partners in a bank manifested in the curtailment of the bank capital in their ownership.

- The involvement of creditors in the control over banks liable for restructuring.

- State support for banks which try to solve their problems independently, which adopt and implement their own programmes of financial recovery.

\textsuperscript{27} SWB. SUW/0565. p.WA/8, 27\textsuperscript{th} November 1998.
\textsuperscript{28} Ibid., p.WA/9.
It is thus evident that the measures undertaken by the Russian government are found to be inadequate to solve the problems of the banking sector. Moreover, several experts say that, most of the policy decisions have remained on paper and that bank restructuring has been slow both in conception and realisation. Apart from this, there are not only shortcomings in banking laws they are also often applied arbitrarily as has been the case with the ‘Bank Bankruptcy Law’. Russian banking expert Kim Iskyan has said that there is a lack of political will to implement painful reforms such as those relating to the closure of insolvent banks. It appears that the Russian banking sector also suffers from the malady of wide gaps between policy statements and their implementation.

NEED FOR GENUINE REFORMS

To overcome the problems facing the banking sector and to enable it to meet the demands of a modern market economy Russia needs genuine banking reforms. In this regard, the most significant and urgent reform measure is the one relating to the ill-suited accounting system, which was inherited from the Soviet era. The Russian authorities have realised the importance of this measure and hence decided to introduce the ‘International Accounting System’ (IAS)\textsuperscript{29} in the banking sector as there is a growing realisation of its need in the

\textsuperscript{29} Gidadhubli, n.11, p.2329.
context of increasing economic ties with western financial institutions and improving the prospects of Russia’s membership of the World Trade Organisation (WTO).

The proposal of introducing IAS has been supported by the Central Bank of Russia since it will give a more accurate idea both to the government and to the CBR as to where a Russian bank stands financially. Pursuing this policy ‘select pilot banks’ are to train bank staff to follow IAS standards. Even as the CBR hopes to implement this new accounting system in the next five years, this task is quite formidable as Russia has over 1,300 banks with over 40,000 staff.

To effectively implement various policy decisions and laws concerning the banking sector, it is necessary to increase the role of regulatory authorities. This is particularly the case with regard to applying bankruptcy and liquidation procedures and introducing shareholder accountability. Oleg Vyugin, the former vice president of investment bank Troika Dialog, has rightly urged that there is a need to create confidence and trust to ensure adequate protection of assets during bankruptcy procedures.\(^{30}\)

For the overall improvement of the economy and the financial sector in particular, there is a need for generating an atmosphere of

\(^{30}\) Ibid.
healthy competition among banks. Some executives of Russian private banks and foreign banks say, that a level playing field should be created for all banks regardless of whether they are state banks or private banks.

There is also a need that state plays an active role in surmounting the consequences of banking crises, participating in the capacity of an organising force and providing financial resources for the solution of the problems of the banking system.\textsuperscript{31} In this direction state can take four major directions for such actions\textsuperscript{32}:-

- Overcoming the crisis of liquidity.
- Strengthening bank oversight.
- Restructuring the banking system; and
- Recapitalizing the banks.

There is an urgent need for greater co-ordination among various agencies such as the CBR, the Duma and the ministry of finance while taking policy decisions affecting the banking sector. Moreover, it is necessary to strictly to implement policy decisions and laws, which needs greater political will. The banking sector should also be relieved

\textsuperscript{31} Aleksashenko, n.6, p.28.
\textsuperscript{32} Ibid.
of its heavy tax burden by introducing a uniform rate of taxes for all
sector of the economy. Table 4.1 shows what is the major problems of
Russian Banking and its possible solutions.

### TABLE-4.1

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<tr>
<th>Problems and its Causes</th>
<th>Possible tools</th>
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| **Insufficiency of bank capital.** | 1. Establishment of individual prudential norms for a fixed period that proceed from an intensive but realistic schedule for increasing the intrinsic funds of the bank.  
2. State acquisition of a percentage of the bank's capital (offer of subordinated credit to it) to restore the amount of capital to a level that would ensure the fulfilment of oversight standards. In order to prevent inflationary effects, the bank uses the funds thus obtained to acquire long-term low-interest state securities. Additional efforts (options) could envision the right of the bank's owners and managers to buy shares before the repayment of the state securities. In the event they refuse to utilise this right, the state sells the share of bank capital that belongs to it. |
| **Current shortage of liquidity.** This is the result either of errors by bank management in monitoring the correspondence of the maturities of assets and liabilities, or of the bank's sale of its liquid assets to meet sharply increased client requirements. In such a case, the bank has long-term stability and assets of good quality that could provide for the | 1. State buyout of working assets with subsequent resale to other banks.  
2. Involvement of banks in whose capital the state share predominates in participation in funding good long-term assets.  
3. Providing credit to maintain liquidity. |
<table>
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<tr>
<th>Insufficiency of current income</th>
<th>Bank involvement in participation in state programs, such as lending to the agro-industrial complex, servicing State Customs Committee accounts, or lending for export deliveries of state companies.</th>
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<td>2. Transfer to bank of servicing of state enterprises and organisations in a given region.</td>
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<td>3. Buyout of a portion of the bank’s branch network, the expenditures for the functioning of which do not conform to the bank’s income in a given region. The branches retain their corresponding ‘regional’ assets therein. The state can later use these branches to merge with banks that it wants to see actively operating in the given region.</td>
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<td>4. Buyout of assets whose workability has dropped sharply.</td>
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<td></td>
<td>5. Direct financial assistance (one-time subsidies, lending at reduced rates, issue of special high-yielding securities for the bank acquire.)</td>
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Bank losses arising as a result of a drastic rise in the value of obligations (exchange rate revaluations, futures operations), or loss of assets (bankruptcy of borrower).

1. Transfer of a portion of the bank’s assets to banks controlled by the state. The obligations of the bank to the bank assuming its obligations to clients must be guaranteed at the same time (the arrangement by which the private deposits were transferred to Sberbank in the fall of 1998).

2. Direct financial assistance (one-time subsidies, lending at reduced rates, issue of special high-yielding securities for the bank to acquire).

Source: Aleksa@shenko, Astapovich, Klepach, Lepetikov. n.6, pp.46-47.
CONCLUSION

After a decade of the Soviet break-up Russia has not been able to
envolve an efficient banking system to meet the needs of market
economy. At the outset Russia did not inherit a sound banking system
when the USSR disintegrated itself into fifteen independent sovereign
countries. The Russian banking sector is still weak and consists mainly
of financial companies of financial department or big financial groups
that suit the interest of borrowers which the financial groups
themselves control. The uncontrolled and unregulated growth of
banking institutions posed challenge to the Russian policy makers.
Russian judicial system was reported to be highly imperfect and
unsatisfactory. Lack of trust was another problem faced by the Russian
banking sector. Apart from these problems the banking sector in Russia
also faced the problem of Co-ordinated efforts among Central Bank
Duma and the ministry of finance.

These problems had an impact on the Russian economy. Russia
could not attract necessary investment in the economy, though it needs
investment to boost economic development.

To reform the banking sector the Russian government has
undertaken some measures, particularly after the financial crisis of
1998 e.g. the mushrooming of banks has been contained. In March
1999, the Bank Bankruptcy Law was passed and in July 1999, the Bank Restructuring Law was passed to facilitate changes in banking system. But most of the policy decisions have remained on paper and that bank restructuring has been slow both in conception and realisation.

To overcome the problems facing the banking sector and to enable it to meet the demands of a modern market economy. Russia needs genuine banking reforms. The Russian authorities have introduced the ‘International Accounting System’ in the banking sector as there is a growing realisation of its need in the context of increasing economic ties with Western financial institutions and improving the prospects of Russia’s membership of the world trade organisation (WTO).

For the overall improvement of the economy and the financial sector in particular, there is a need for generating an atmosphere of healthy competition among banks. There is a urgent need for greater coordination among various agencies such as the CBR, the Duma and the ministry of finance while taking policy decisions affecting the banking sector.