## Analysis

# The Russian Banking Industry after the 2008–2009 Financial Crisis – What Next?

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### Abstract

Although the Russian banking sector is relatively small by international standards, it is growing rapidly. The sector is highly fragmented, with the large number of small banks complicating oversight and limiting interbank trust. At the same time, state banks dominate the industry. The Russian financial system suffered greatly during the 2008–9 international crisis because it is highly dependent on the price of oil and the international financial markets. The current financial crisis most likely will not alter the makeup of the sector, but continued tightness in international money markets could ultimately hinder Russian growth.


### Small but Growing

The Russian banking sector has grown extremely rapidly in recent years. In 2001 domestic lending was equal to 14 percent of GDP. By the end of 2008, the ratio had risen to 35 percent. At the beginning of 2001 the combined sector balance sheet was equal to approximately 32 percent of GDP, but over the next few years this figure grew, reaching over 68 percent in 2008. Despite this impressive expansion, Russia still trails not only the developed economies but also its counterparts in Central and Eastern Europe in the level of financial intermediation (see Figure 1 on p. 5). The Russian banking sector remains small relative to the size of economy.

Banking sector growth has been associated with longer loan periods, increased confidence in the ruble and a multiplication of borrowing opportunities for Russian households. During the impressive growth years of the 2000s, Russian banks increasingly began to resemble the banks everywhere in emerging economies. Russian banks, by and large, receive retail deposits, give credit both to households and enterprises, engage in fairly standard operations on capital markets, issue bonds and, in some cases, even participate in international loan syndications. The Russian ruble 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.

### The Structure of the Russian Banking Sector

#### *Too Many Small Banks*

Despite the slow decline in the number of banks since the peak of 2,500 in 1994, there are still a large number of banks registered in Russia. At the end of 2009, the Bank of Russia reported the number of banks to be 1,058. 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 over the rest of the country. 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 much of a nationwide branch network.

The fragmentation of the sector causes difficulties in supervision and 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 more form than substance. Moreover, reporting is still based on the Russian accounting standards, which in many respects differ from the International Financial Reporting Standards (IFRS). The objective of implementing the Basel II recommendations on banking laws and regulations has been declared, but how this is to be achieved remains 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 governing the minimal amount of capital banks must hold entered into force on January 1, 2010. This legislation requires banks to have capital of at least RUB 90 million (RUB 180 million from 2012). Banks seem to have adjusted to this requirement since at the beginning of 2010 there were only 22 banks with capital lower than the minimal requirement. Thus, the consolidation of the banking sector remains a task to be dealt with in the future.

### *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 share of the three largest state-controlled banks (Sberbank, VTB Group and Rosselkhosbank) in total banking sector assets increased from 30 percent in 1998 to 35 percent 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 percent to 45 percent 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) estimated the share of state-controlled banks in total banking sector assets to be 57 percent in July 2009. The increase in state holdings is, however, not necessarily bad for efficiency in Russia. A recent study found 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 bank penetration in Russia has been low, but is increasing. The share of foreign-owned banks in the total assets of the Russian banking sector increased from 8 percent in 2002 to almost 20 percent in 2008. There are no binding legal barriers to foreign bank entry, but the low foreign bank penetration can partly be explained by the legal and regulatory environment which is only slowly beginning to resemble that of many other emerging economies. 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 2010). This trend 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 from going bankrupt. However, macroeconomic stability combined with the new deposit insurance system reduced their competitive advantage. On the other hand, foreign-owned banks gained in market power. This shift 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.

### Dependence on Foreign Money

The years of growth saw Russian banks become stronger, and, on average, highly capitalized and exceedingly profitable. In addition, the Russian banking sector had very little involvement with the financial instruments that triggered the international financial crisis. Why, then, did the crisis hit the Russian banking sector so 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.[1]

During the past decade, 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 rapidly and the loans are relatively short-term (see Figure 2 on p. 6). Only a third (37 percent) 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. This means the banking system is very open and, as became clear in autumn 2008, dependent on the risk-taking propensity of foreign financial institutions. In autumn 2008 the supply of foreign refinancing dried up and the interbank ruble interest rates doubled in a matter of months. The collapse in the world market price of oil together with the strengthening dollar destroyed market confidence in the ruble.

Concern over the future exchange rate finally paralyzed the Russian financial markets. The banks did not want to lend in rubles, while borrowers no longer dared to borrow in foreign currency. A substantial share of the banks' ruble liquidity was exchanged for foreign currency. Russia drifted into a step-by-step devaluation, as a result of which the currency depreciated approximately 30 percent against the dollar-euro basket between November 2008 and February 2009.

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 central bank proved sufficient and there have been no significant bank failures. 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

1 For a fuller discussion, see Solanko, 2009.

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

worked without problems. Taken together, the measures promised to secure the operations of the banking system amount to approximately 10 percent of GDP.[3]

## Future Outlook

In recent months, since the return of oil to USD 60–80 a barrel, the ruble has 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 the state railroad monopoly RZD and the state oil pipeline monopoly Transneft leading the way (Fungacova and Kurronen, 2010). But bank lending is still declining in real terms.

So far solvency has not been a problem at the level of the banking system as a whole. Many of the smaller banks (which typically have high capitalization ratios) may stomach a fairly large share of their possible loan losses by eating up their own capital and retained earnings. The government has made clear that it will recapitalize the banks in its ownership if needed.

Since the banks currently have ample liquidity, 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 slow growth on the other side of bank 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.

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 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.

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 Central Europe. As elsewhere, 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 rumors. 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 if the large Russian corporations also 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 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.

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