

# **BANKING SYSTEM RESTRUCTURING IN RUSSIA**

by

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## **I. INTRODUCTION**

Following the outbreak of the banking crisis in August 1998, the World Bank and the Fund sought to assist the Russian authorities to address the immediate consequences of the crisis and develop an appropriate strategic approach to bank restructuring. These efforts were hampered by the authorities' lack of meaningful financial data on the banking system, their unwillingness to treat with sufficient seriousness other data generated by the World Bank's FIDP project, and initially by disagreements with the international institutions about the causes of the crisis and the appropriate pace of reforms. Efforts during the first year, therefore, focused on establishing the enabling framework for banking system restructuring while work was carried out on determining the underlying financial condition of the banks.

While progress was made on a number of fronts, the overall results of the first year of bank restructuring were mixed. Progress was made in establishing an appropriate enabling environment. The legal framework for effective bank restructuring was largely established but additional amendments to the existing legal structure are needed to enhance the laws' effectiveness. Progress was also made in establishing the necessary institutional framework for bank restructuring. However, the use of this framework has been tentative and the court system has proven to be an impediment to rapid action. Thus, results have been limited. Consolidation of the banking system lags and, recently, a number of setbacks have occurred.

This paper describes briefly the background to the banking crisis and the results of the first year of restructuring efforts. It then turns to the reform agenda that remains for the immediate future. It emphasizes the need to elaborate a fully comprehensive medium-term strategy for bank restructuring.

## **II. PRE-CRISIS DEVELOPMENTS**

Immediately following the collapse of the Soviet Union, the CBR followed a liberal policy of bank licensing and the number of banks increased dramatically. At that time, the banking system consisted of only five state-owned banks: the Gosbank and four specialized

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\*The views expressed in this paper are those of the author(s) and do not necessarily represent those of the IMF or World Bank, or policies of these institutions.

banks. By 1997, 1,675 banks had been licensed. These banks had almost 39,000 branches, 90 percent of which were branches of the savings bank, Sberbank.

In 1993, the supervisory authority was established in the CBR to supervise the rapidly growing banking system. The formal regulatory structure, created with the advice of both international consultants and international organizations, was broadly consistent with practice in western countries. Prudential regulations were developed for the key areas, including capital adequacy, lending activities, minimum liquidity, concentration, and exchange risks.

Although successful in establishing a formal framework for supervision, supervisory practices suffered from a series of limitations. First, accounting norms differed from international accounting standards. Russian accounting practices were not aimed at providing information about the true financial conditions of banks but were little more than bookkeeping practices. Off-site analysis was based on unreliable data and focused excessively on compliance rather than on analysis of risks and the actual financial conditions of the banks. Second, on-site examinations were relatively infrequent and focused on verifying the banks' statistical reports. No judgements were made about the true value or risk of particular assets or the quality of management. The "loans-for-shares" privatization scheme provided an incentive to banks to develop lending to connected parties. Finally, supervisors made insufficient use of existing powers to require changes in unsafe practices and lacked insight into how to make real improvements in bank safety and soundness.

Based on published data, the banking system at the end of 1997 was highly capitalized and sound. Capital of the top 200 banks amounted to 16 percent of unweighted assets and both the largest 100 and the small and medium banks had capital ratios of 15 percent and 26 percent, respectively.<sup>1</sup> Virtually all banks in the system were reported to meet the supervisory regulations as prescribed by the CBR.

These figures vastly overstated the financial health of the banking system. Furthermore, between 1989 and 1996, the banks' business environment deteriorated because of the unstable macroeconomic conditions. As a result, the profitability of the corporate sector was weak and banks had difficulties identifying reliable and profitable borrowers. These conditions were aggravated by both nontransparent corporate accounting standards and weaknesses in the legal system, which made enforcement of loan contracts difficult. Banks responded to these risks by following a combination of three strategies. The first was to concentrate their lending in related borrowers, where more information about the true conditions of the enterprises was known and where the bank had some possibility of having loans repaid. The second was to concentrate their portfolio in government securities. These securities generated significant interest income, carried zero risk weights in the calculation of the prudential norms, and were extremely flexible financial instruments. Under such circumstance, the supervisors treated banks with heavy investments in such securities as

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<sup>1</sup> Detailed balance sheet data are published quarterly on the 200 largest banks by Interfax.

following appropriately risk-averse practices. The third was to engage in speculative foreign exchange dealings, counting on the continued stability of the ruble.

### **III. THE AUGUST 1998 CRISIS AND ITS IMPACT**

In August 1998, Russia suffered a collapse in private sector confidence. This collapse reflected the combination of both internal and external factors. Private sector confidence was weakened when the Duma failed to support an IMF loan agreement reached in July 1998. Similarly, key domestic producers, particularly in the energy sector, voiced their opposition to increases in their tax liabilities. The impact of these developments was compounded by the contagion effects from the Asian crisis and the effects of falling oil prices on Russia's export earnings. As a result, pressures in the exchange market increased. The government faced difficulties in placing government securities in the market and an acceleration in capital outflow.

In the face of these developments, the authorities adopted a series of measures, including a widening of the exchange rate bands and an effective devaluation of the ruble, suspension of payments on domestic government securities, and introduction of controls on capital flows. While addressing the immediate crisis, these measures resulted in a serious disruption in the payment system and a collapse of the domestic banking system. Severe liquidity shortages emerged as banks were unable to make payments or obtain needed liquidity through the usual channels such as the sale on the open market of a portion of their portfolio of government securities.

### **IV. THE INITIAL RESPONSE TO THE BANKING CRISIS**

The Russian authorities and the Fund/Bank team had different understandings of the causes of the crisis and, therefore, had differing policy prescriptions. The authorities argued that the banking crisis, which followed the default on the GKO and the depreciation of the exchange rate, was caused by bank illiquidity rather than bank insolvency. The loss of a large portion of the liquid assets of the banking system, not surprisingly, resulted in a severe disruption of banking services. This interpretation was supported by the generally positive prudential reports from commercial banks, which were based on Russian accounting standards. As described above, Russian data on compliance with prudential regulations suggested that the banking system was highly capitalized.

Based on this interpretation, the initial response of the government was to provide additional liquidity to the banks. The CBR sharply reduced reserve requirements and extended emergency liquidity support to the banking system. In addition, a moratorium on debt payments and settlement of outstanding forward foreign exchange contracts was announced. Concerned about a possible depositor run, the CBR permitted depositors to shift deposits from a number of large, Moscow-based banks to Sberbank.

The Fund and the World Bank had a different interpretation of the banking crisis. While acknowledging the severe liquidity constraints facing the banking system, they considered it likely that the banks were also seriously insolvent. Given the rapid growth of the banking system seen since 1989, some consolidation of the banking system was considered necessary.

With a view to resolving these differences in views, the authorities agreed to focus their initial efforts in three areas. First, better information was needed on the state of the banking system. Accordingly, it was agreed to conduct due diligence reviews of the financial condition of 18 large, mostly Moscow-based, banks using western accounting standards. These banks represented approximately 50 percent of assets of the privately-owned banking system. Banks found to be insolvent and nonviable would be closed and liquidated or, if judged to be of systemic importance, would be candidates for state-assisted restructuring. Second, establishment of an adequate legal framework was necessary to allow banking system rehabilitation. In particular, a bank bankruptcy law and a bank restructuring law were needed, as well as necessary amendments in related laws. Third, an appropriate institutional framework was needed that would include both a strengthening of the supervisory capacity of the CBR and establishment of an institution to oversee the rehabilitation of viable but undercapitalized banks.

The Bank and the Fund were not the only donors involved in Russia. Other multilateral donors as well as a number of bilateral donors indicated an interest in assisting in the restructuring efforts. To that end, the CBR established an Inter-Agency Coordinating Committee on the Restructuring of the Banking System (IACC). The IACC met for the first time in March 1999 and then again in June 1999 and in December 1999. The IACC, as well as the working groups formed under the IACC, provided both a forum for technical discussions between the Russian authorities and international experts on a wide range of issues and a means for coordinating the technical assistance on offer from the donor community.

## **V. RESULTS OF THE FIRST YEAR**

The results of the first year were decidedly mixed. Important progress was achieved in establishing an appropriate legislative framework, although some amendments are still needed to make the laws fully effective, and it remains to “test” some of the more novel legal concepts in the courts, which may give rise to the need for further amendments. Enforcing the new laws is a separate matter where little progress has yet occurred. Progress was also made in establishing the institutional framework. Progress on consolidating the banking system, however, was disappointing. Efforts to identify insolvent banks were slow and efforts to close and liquidate deeply insolvent and nonviable banks were resisted on a variety of fronts.

### **A. Establishment of a Legal Framework**

The legal framework for bank restructuring needed to be strengthened in two areas. First, bank bankruptcy was covered under the general bankruptcy legislation, which was slow and gave considerable authority to the bank owners. In addition, no legislation existed governing the restructuring of banking institutions. The Russian authorities, supported by the joint Fund/Bank team, developed legislation in both areas. As a result, the Bank Bankruptcy Law was signed into law in March 1999 and the Bank Restructuring Law was passed into law in June 1999.

While both laws resulted in improvements in the legal framework for bank restructuring, additional amendments were needed to further strengthen the authorities' ability to deal with insolvent banks. Specifically, amendments to the Law on Bank Bankruptcy, the general Law on Bankruptcy, the Law on Banks and Banking Activity, the Law on the Central Bank, and the Civil Code were required in order to (1) include a capital adequacy criterion as criterion for determining insolvency; (2) require the mandatory write-down of banks' charter capital to reflect actual value; (3) allow for early regulatory control of a bank's operations when it begins to fail; and (4) strengthen licensing requirements as regards "fit and proper" criteria to restrict the scope of former owners and managers and failed banks to participate in new banks. Although suitable amendments were drafted by the authorities, the Duma did not consider them prior to its dissolution. It is expected that the new Duma will soon consider these amendments.

## **B. Establishment of an Appropriate Institutional Framework**

Important institutional changes were made to deal with the banking crisis. First, the Bank Restructuring Agency (ARCO) was established. Second, the CBR consolidated its supervision functions and has begun to reform its supervisory regulations. Finally, progress was made in beginning the process of shifting the commercial banking system from Russian accounting standards to international accounting standards (IAS).

ARCO was established in November 1998 and took its first measures to become operational in January 1999. Its staffing was quickly initiated and full operational guidelines were approved by ARCO's Board. Before enactment of the Bank Restructuring Law, ARCO was limited to facilitating the restructuring of banks on a voluntary basis, which severely restricted its ability to undertake difficult restructuring measures or penalize shareholders and managers of failed banks. In that capacity, it assumed responsibility for 14 regional banks. Following passage of the restructuring law, ARCO moved to the more difficult task of restructuring large and insolvent banks. In that phase, it has taken responsibility for six additional banks.

In the early phase of operations, ARCO has made progress in restructuring regional banks that voluntarily submitted to ARCO oversight. Consolidation and restructuring of the banking system in the Kamorovo region, as well as the streamlining and strengthening of some medium-sized Moscow-based banks, was undertaken. Progress in dealing with the large Moscow-based banks, on the other hand, has proven to be far more difficult and less effective. First, the delays in the approval of the restructuring law, as well as the authorities'

unwillingness to use existing powers aggressively, provided a window for asset-stripping in many of the insolvent banks. For example, a number of those banks either purchased bank shells or licensed new banks and transferred the bulk of the performing assets to the new banks. Even after the passage of the Bank Restructuring Law, ARCO was slow to deal with the large and politically connected banks. In part, this reflected a lack of political will on the part of the authorities; in part, a lack of consensus on how these large banks should be treated; and, in part, the limited financial resources for bank restructuring.

One reflection of a lack of political will is the difficulty that ARCO has had in closing and liquidating insolvent and nonviable banks. Promstroibank was determined to be nonviable and was to be closed. Although the CBR withdrew its banking license and the courts supported the action, the government has recently decreed that Promstroibank be rehabilitated by ARCO. Similarly, SBS-Agro has been closed but its assets and liabilities will be transferred to two newly created state banks (the Rehabilitation Bank and an Agricultural Bank). It is unclear how the state banks will be able to effectively manage the assets of SBS-Agro and whether the creation of new state-owned banks is the least cost solution.

Institutional modifications were also initiated in the CBR. In 1998, the departments responsible for on-site and off-site supervision, as well as the departments responsible for licensing of banks and bank auditors, and for bank rehabilitation, were consolidated under a single Deputy Chairman. Furthermore, a high-level committee was established to ensure that the CBR's supervisory efforts were fully coordinated. Both the supervisory and regulatory regulations were reviewed under the aegis of the IACC. Resulting improvements in the regulatory framework have focused on three principal areas: strengthening loan-loss provisioning, strengthening licensing procedures, and supervision on a consolidated basis.

Accounting practices of the banks limited the CBR's ability to evaluate the soundness of banking activity in Russia. The introduction of full IAS accounting should strengthen the CBR's supervisory ability. Accordingly, the authorities agreed to introduce IAS accounting for the CBR by end-2000 and in commercial banks by end-2001.

### **C. Consolidation of the Banking System**

One of the most important priorities for the CBR was to determine the true state of the financial system. Using financial support from the World Bank, the CBR conducted due diligence reviews of 18 large Moscow-based banks, representing almost 50 percent of the assets of the privately-owned banking system.<sup>2</sup> The reviews found that, given stringent assumptions about the value and collectibility of securities and outstanding loans, nearly all of the banks were deeply insolvent. Fifteen of the 18 banks had negative net worth. Several

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<sup>2</sup> The reviews were conducted according to a common set of internationally accepted practices and uniform assumptions to ensure consistency among bank reviews.

of these banks had leverage ratios in excess of minus 400 percent. Only three banks had positive capital.

The insolvency of the banking system was caused by several factors, the most important of which was growth of the nonperforming loan portfolio. Loan-loss provisions required by the audits accounted for 34 percent of the net charges to capital. Foreign exchange and translation losses accounted for 28 percent of the charges to capital and losses on government debt accounted for 13 percent.<sup>3</sup> Moreover, the financial reviews revealed that many of the 18 banks followed exceptionally risky practices. Many banks were not as well capitalized as reported in their financial statements. Many had excessive lending to related counterparties or to shareholders where loan servicing was not enforced. The reporting by banks was frequently inaccurate and incomplete, limiting the ability of the supervisory authorities to identify on a timely basis unsafe and unsound banking practices. Finally, banks relied on speculative sources of income, including foreign exchange trading, as well as significant short-term borrowing from foreign banks to fund domestic clients. This practice exposed the banks to exchange rate risk and, to the extent that the banks lent dollar-denominated loans to clients without dollar income, it exposed the banks to heightened credit risk. In summary, the financial reviews pointed to an underlying systemic insolvency, which was brought to light by the impact of the August 1998 crisis on bank liquidity.

In negotiations with both the Fund and the World Bank, an agreement was reached to de-license immediately at least six of the banks for which due diligence reviews had been collected. However, concern about the consequences of large-scale bank closure slowed progress. By December 1999, two banks were declared bankrupt (Menatep and Promstroj), but bankruptcy proceedings were under way only for one (Menatep). One license revocation had been overruled (Uneximbank) and the bankruptcy proceedings were under way for the remaining three. The rest either entered into a voluntary restructuring agreement with ARCO or have continued to operate under enhanced supervisory oversight by the CBR.

The CBR has moved somewhat more aggressively against smaller, regional banks with financial problems than against the largest banks. During 1999, the CBR withdrew the licenses of [more than 20] banks and ARCO has initiated the restructuring of three major regional banks. Even in the cases of the smaller banks, however, the pace of consolidation was slower in 1999 than in previous years.

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<sup>3</sup> The CBR requested the auditors to calculate solvency levels on the basis of a less conservative provisioning assumption and under the assumption that losses from foreign exchange forward contracts have a limited impact on the financial condition of the banks. Under this alternative scenario, the negative net worth of the eighteen banks fell by half. However, all banks that were classified as insolvent under the first scenario were also classified as insolvent under the second.

## VI. LESSONS FROM THE EXPERIENCE TO DATE

As described above, progress in bank restructuring in Russia has been mixed. There has been progress in establishing the enabling environment for bank restructuring but the authorities have failed to use it with full effectiveness. As a result, the banking system remains weak and does not play a significant role in financial intermediation.

One important element that has restrained progress has been the absence within the government, and within the country more generally, of a consensus on how the banking system should evolve. This has meant that a fully comprehensive medium-term strategy has not yet been developed. Fundamental choices must be made but, if they are to have lasting significance, Russians—not foreign advisors—must make them. For example:

- The role of public versus private banking remains unresolved. Of particular importance in that debate is the role of Sberbank in Russia's financial system. Given the size of Sberbank and the role it plays in mobilizing household deposits, decisions must be made concerning the appropriate organization and functioning of the bank as a necessary first step in developing a framework for banking sector reform. Absent a "level playing field" for private- and state-owned banks, privately-owned banks have little prospect of long-term survival.
- The role of national versus regional banking remains an unresolved issue. While the provision of banking services to the Russian provinces is a priority to the authorities, it is not yet clear if such services should be provided by regional banks or by regional branches of national banks.
- An additional question to be determined as part of the medium-term strategy is whether banks should be limited to traditional banking practices or be permitted to conduct investment banking.
- The role of domestic and foreign-owned banks must be decided.

However, while the lack of a consensus on these important issues clearly impedes the elaboration of a fully comprehensive banking system development and reform program, other important elements of a comprehensive strategy can be identified and agreed. Moreover, these elements will be common to whatever fully articulated strategy ultimately does emerge. Work in implementing these elements should go forward without delay.

The experience since the August 1998 crisis reveals important lessons about these common elements:

- Adoption of full international accounting standards and transparent dissemination of financial information. The misleading impression of strength in the banking system



prior to August 1998 underscores the need for strengthening financial accounting and transparency.

- A stronger supervisory framework for banks, to be achieved in particular through simplification of regulation, improved on-site inspection, use of consolidated financial accounts and consolidated supervision for financial groups, and more vigorous use of enforcement powers.
- Reform of the court system such that regulatory decisions can be implemented fully and enforced quickly.
- Better laws regarding collateral possession and seizure, strengthened bankruptcy procedures, etc., such that banks have a means for enforcing loan contracts and thereby limiting the buildup in the future of nonperforming loans.
- Consolidation of the banking system through the application of firm exit policies to unprofitable banks. Slow progress in corporate restructuring has meant that there is only a very limited amount of profitable lending business for banks and too many banks competing to provide it. Absent a suitable balance between the amount of profitable lending opportunities and the number of banks, banks are driven to engage in risky, speculative business which makes the system vulnerable to future crisis. The risks can be offset only through a strong political commitment to reduce the number of banks for the overall good of the banking system as a whole.

## **VII. THE REFORM PROGRAM FOR 2000**

In order to maintain forward progress in banking system restructuring and reform until agreement on fundamental issues can be reached, the Fund/Bank team proposed an Action Plan to be followed during 2000. The Plan builds on the lessons learned from the experience since the crisis began in 1998. The intention is to continue reforms in critical areas already begun and, at the same time, build the necessary understandings to allow development of a longer-term strategic approach to bank restructuring in Russia.

The Action Plan is organized into three strategic areas: (1) continued consolidation of the banking sector; (2) creation of a small number of viable core banks; and (3) establishment of a competitive and transparent environment for banking. The agenda for 2000 is ambitious and requires concerted efforts on the part of the authorities to implement. However, if progress can be made in these areas, the authorities will be in a position to accelerate the restructuring of a banking system in a way that is consistent with their medium-term objectives.

## **A. Continued Consolidation of the Banking Sector**

Efforts to continue consolidation of the banking sector must continue and accelerate in 2000. Three key priorities can be identified in this area.

First, the CBR should continue efforts to close and liquidate banks identified as nonviable and insolvent by the due diligence reviews. While the CBR has withdrawn the licenses of six banks, four cases have been challenged in the courts, and one has been reversed by the government.

A second priority is to support the efforts of ARCO to restructure banks under its management. ARCO must require restructuring plans for the banks that are based on consistent assumptions concerning future macroeconomic and sectoral developments. Those plans must be reviewed and modified as necessary. As part of the plan, ARCO should evaluate the management and shareholders of the banks in line with the recently revised criteria defining “fit and proper” characteristics of managers and shareholders. ARCO must also begin to implement transparent and regular reporting of its activities. It should report on the sources and uses of funds and on the disposition of banks under its management. The decision to establish a new agricultural bank and use the Rehabilitation Bank for the management of SBS-Agro assets should be carefully reviewed. If the authorities finally decided on that approach, ARCO should carefully review the operations of those banks, ensuring that they do not pose a threat to fiscal stability.

The third step in the consolidation of the banking system is to conduct both the financial and the operational review of Sberbank. The terms of reference for the financial review have been agreed on and discussions on the operational review have begun. The analysis of Sberbank’s operations is a critical input into the design of a medium-term strategy for banking sector restructuring. Once completed, a similar exercise would be needed for the remaining state banks, Vneshtorgbank and Vneshekonombank.

## **B. Creation of a Core Banking Sector**

A key strategic goal is to create a small number of viable and prudently run banks that could eventually constitute Russia’s core banking sector. In this context, efforts should be made to design and implement a program aimed at strengthening the operational and financial performance of a group of viable banks. The CBR should evaluate each bank’s financial condition, the quality of bank management and shareholders, and the viability of the bank’s financial and operational restructuring plans. The CBR should closely monitor the performance of such banks, standing ready to intervene when necessary to ensure that they follow safe and sound banking practices. For banks not meeting these criteria, the CBR should actively seek resolution of the banks. Either they should be merged with other, more viable banks or the CBR should withdraw their license and begin bankruptcy proceedings.

An important supportive element of this effort should be restrictions of the licensing of new local banks. Limiting the entry of new banks will help to establish “franchise” value

for existing banks. In addition, this would limit the ability of current shareholders to strip-performing assets from existing, insolvent banks and transfer them into newly established banks, as was the practice in 1999.

Participation of foreign banks in the Russian market could sharply increase competitive pressures and introduce new skills. Foreign banks may be reluctant to enter the market, given the developments in 1999. However, the CBR is advised to identify and remove any existing barriers to entry of foreign banks. Such barriers might include legislative or regulatory restrictions or limits on repatriation of earnings.

### **C. Establishment of a Competitive Banking Environment**

The measures to strengthen the competitive environment should continue over the remainder of year. To that end, the amendments to both the Bank Bankruptcy Law and the Bank Restructuring Law, discussed above, should be enacted. The amendments are critical to strengthening the authority of the CBR and ARCO.

Similarly, efforts to strengthen the supervisory and regulatory environment should be continued. Regulations on asset classification, provisioning, and consolidated supervision have been drafted and should be approved. Equally importantly, these regulations should be enforced. The CBR's supervisory framework has been strengthened and largely meets international standards. The implementation of this framework, however, remains weak. The CBR has the authority and the ability to identify and halt unsafe and unsound banking practices. It now needs the commitment to enforce these regulations.

Measures are also needed to improve the transparency of bank operations. Accounting practices should be brought into line with international standards. To this end, the phased implementation of a revised chart of accounts consistent with IAS is planned. Pilot banks should be selected to test the revised framework and ensure that the chart of accounts is fully integrated into the management accounting and information system.

### **D. Implementation**

The program described is ambitious and, to be successfully implemented, requires consistent and sustained efforts on the part of all participants. The CBR and ARCO should closely cooperate in establishing priorities and a plan for its implementation. As it is implemented, the CBR and ARCO should seek to determine the longer-term objectives of banking system restructuring, as described earlier in this paper. There is clearly a need to gain broad social commitment to the strategic medium-term objectives and to reaffirm support for the initial measures contained in the Action Plan. The Inter-Agency Coordinating Committee (IACC), under the chairmanship of the CBR, could be an important vehicle for developing necessary consensus on these objectives.