Evolution of the Commercial Banking System in Russia

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Abstract: We undertook an institutional analysis of commercial banks in Russia. After the failed experiment with private financial intermediation in the 1990s Russia migrated towards a banking system consisting of three, rather than two, tiers and featuring core institutions controlled by the state directly or indirectly. This evolution is consistent with this country's historical pattern of financial intermediation. It is also in line with recent trends in the real sector of the economy where public ownership has rebound over the past decade. The core state-controlled banks have evolved into hybrid institutions performing two various sets of functions, those of a regular commercial bank and a policy bank. We found a similar evolution in China but not in transition economies of Central Europe. Institutional matrix theory suggests that in non-market economies centralized finance and credit allocation is the dominant institutional form while private banking activity is a complementary one.

Keywords: Russia; banks; state; institutions; institutional matrix

JEL Classification Codes: B40, G21, P50

By the early 2000s, Russia has had its share of experimenting with private financial intermediation. While contributing to massive reallocation of industrial assets to new owners and to initial accumulation of wealth, privately-owned banks remained a factor of major macroeconomic instability while they consuming a disproportionate share of national income and requiring public support. Privately-owned banks were underperforming as financial intermediaries, their lending rates were prohibitively expensive for real sector borrowers due to low efficiency, fat interest margins, and high cost of funding. The latter was a product of missing trust on behalf of the private sector. Private banks were evidently incapable of supporting Russia's growth. In 1998 several largest private sector banks failed due to poor risk management, incompetence and fraud.

State-owned banks may step in to fill the void left by private financial intermediaries, in line with the "development theory" of government banking (La Porta, López-de-Silanes and Shleifer, 2002). In the early 1990s the market share of state-controlled banks in Russia was quickly eroded and hit the bottom in 1998 but then went into a continuous rise. It is now commonplace that during financial crises the government often has intervene in the economy and in particular the banking sector, and the most recent crisis of 2008 caused government interventions in dozens of countries. In Russia, by contrast, expansion of the public sector of the banking industry was only partly attributable to anti-crisis policies because it started a few years *before* the recent crisis. By the beginning of 2012 the combined market share of banks directly or indirectly controlled by the state reached 56 percent (Fig.1).

Russia remains an underbanked economy despite an impressive number of licensed banks (around 950). Penetration ratios remain relatively low, and banks contribute very modestly to economic and social development, in particular to the financing of investment needs of non-financial enterprises.

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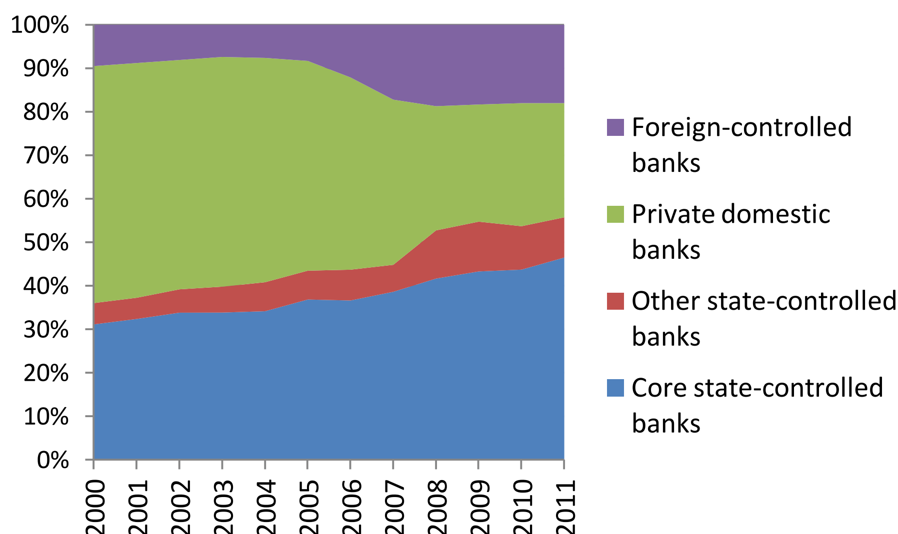

Figure 1: Combined market shares of Russian banks by form of ownership, end of respective year

Source: own calculations; bank data; Central Bank of Russia

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Core state-controlled banks*	31,3	32.5	33.9	34.0	34.2	36.9	36.7	38.7	41.7	43.3	43.7	46.5
Other state-controlled banks	4.9	4.9	5.4	6.0	6.7	6.6	7.1	6.2	11.1	11.4	10.0	9.2
Private domestic banks	54.6	54.1	52.8	52.9	51.6	48.2	44.2	37.9	28.5	26.9	28.3	26.2
Foreign-controlled banks	9.5	8.8	8.1	7.4	7.6	8.3	12.1	17.2	18.7	18.3	18.0	18.0
Total	100	100	100	100	100	100	100	100	100	100	100	100

* Sberbank, VTB Group (VTB, VTB24, since 2011 Bank Moskvy and Transkreditbank), and Rosselkhozbank

According to Russian official statistics, over the period of 1999-2010 the share of bank loans among all sources of investment into fixed assets did not exceed 12 percent, whereas companies have been using for investment mostly their own funds, budgetary funds, mutual borrowings and other sources (Table 1).

Table 1: Fixed capital investment in Russia by source of financing, percent of total

	1995	2000	2005	2007	2008	2009	2010	2011
Own funds	49.0	47.5	44.5	40.4	39.5	37.1	41.0	42.7
External funds, of which	51.0	52.5	55.5	59.6	60.5	62.9	59.0	57.3
Bank credits	…	2.9	8.1	10.4	11.8	10.3	9.0	7.7
of which foreign bank credits	…	0.6	1.0	1.7	3.0	3.2	2.3	1.5
Borrowed funds of other organizations	…	7.2	5.9	7.1	6.2	7.4	6.1	5.0
Budget funds	21.8	22.0	20.4	21.5	20.9	21.9	19.5	18.8
Other sources	…	15.6	20.6	20.1	21.2	23.0	24.1	25.6

Source: Rosstat, www.gks.ru/bgd/regl/b12_12/IssWWW.exe/stg/d02/24-04.htm

The swing of the ownership structure from a complete state monopoly on banking to a highly dispersed and mainly private financial sector and then back to state control took less than 20 years. This swiftness and the fact that it was actively steered by the state might suggest that it

went contrary to a natural evolution. On the other hand, one can argue that by recreating a centralized system of credit allocation Russia actually returned to a solid historical pattern. Stand-alone privately-owned banks have never dominated the financial industry. State-owned and funded institutions were at the core of the financial system prior to 1917. In the early 1920s, private finance re-emerged briefly during the NEP (new economic policy) period, only to give way again to a very high degree of centralization and state ownership.

On the macro level, the architecture of the modern Russian banking system includes three tiers while legally there should exist just two. Apart from the central bank and the ordinary commercial banks, there is an additional tier consisting of core state-controlled banks. *Sberbank*, *VTB* and *Rosselkhozbank* became "national champions" of the public sector thanks to financial support and assistance from the state (IMF 2011). In turn, banks in the intermediate tier are expect to play a special role in the monetary policy transmission, to channel public funds to other commercial banks and to set target prices for bank products of social significance. Fungáčová and Weill (2012) find that state-controlled banks make a valuable contribution to liquidity creation in Russia, including at times of macroeconomic instability and general liquidity squeeze.

The market share of "national champions" increases through organic growth as well as takeovers of other institutions, both public and private, that are financed with public funds. "National champions" and their respective subsidiary banks now control 46.5 percent of Russia's total bank assets and are active in every segment of the market (Vernikov 2012). The emergence of several state-controlled market leaders has increased concentration on the [relatively dispersed] Russian market. If state-controlled banks are looked at as stand-alone entities, then the combined share of top 5 market players is in the range of 50 to 58 percent, varying across market segments. If one consolidates the market shares of core state-controlled banks with those of their offspring, then the share of top 5 players increases to 59 to 65 percent. Measured through Herfindahl-Hirschman index, however, concentration would grow more tangibly, from 0.27 for corporate deposits to 0.47 for household deposits which is close to a monopoly situation (Vernikov 2012). So far this has not caused overly negative effects for the competitiveness of the Russian banking market (Anzoátegui, Martínez Pería and Melecky 2012), although a significant "cherry-picking" (selection of the best and most reliable customers) does take place and pushes smaller banks into riskier market segments.

Contrary to what is usually argued in the literature on economic transition, in the Russian context the state-controlled banks do not necessarily lag behind private banks in terms of financial or operational efficiency. This is suggested by Karas, Schoors and Weill (2010) and receives factual proof in official bank disclosure. By 2012, state-controlled banks were displaying higher returns on assets and on equity than those of other market participants (Table 2).

If financial reports of Russian banks are to be considered credible, then figures in Tab.2 might suggest that in Russia the core state-controlled banks have become "normal" market players guided aiming at maximization of profits and efficiency. That is true only to an extent. Along with "regular" commercial banking all "national champions" engage in kinds of economic activity that would be more natural to development banks. These institutions are employed for policy and program lending on behalf of the state. They might even be used to implement social programs and special assignments such as geopolitical goals of the government. In some instances these banks have acted as investment vehicles of the government or even hedge funds; they acquire non-core assets and hold them on the balance sheet. Both *Sberbank* and *VTB* are assigned important roles in financing infrastructural projects or projects related to APEC summit, Olympic games, soccer world cup, etc. *Rosselkhozbank* is systematically used to finance agricultural projects. Commercial viability and business case of those loans are unclear, but state support offsets any arising problems with non-performing loans, liquidity or capital (in-) adequacy.

Table 2: Financial efficiency of Russian banks

	Return on assets (ROA)			Return on equity (ROE)		
	2009	2010	2011	2009	2010	2011
All banks	0.7	1.9	2.4	4.9	12.5	17.6
State-controlled banks*	**0.7**	**2.4**	**2.8**	**4.3**	**14.8**	**20.6**
Foreign-controlled banks	1.1	2.1	2.4	8.3	14.5	17.4
Big privately-held banks	0.4	1.1	1.7	3.2	8.4	14.2
Small and medium banks, Moscow	1.2	1.4	1.5	5.2	6.7	8.0
Small and medium banks, other regions	1.1	1.5	1.7	6.2	9.8	10.4

* Central Bank of Russia's definition
Source: CBR 2012, p.28.

There is nothing fundamentally wrong in that state-owned banks engage in policy lending, especially if it yields positive financial results as we see. Real sector financing in the Russian Federation is based predominantly on the institutional model of "state as investor". Despite all the mess in the classification of ownership types by the official statistics, the Russian state is now estimated to own around one-half of all industrial assets. It remains the single largest investor in the national economy, including innovation and R&D where the share of public funds was 66.5 percent in 2010 (Russian Innovative Index, 2011, p. 31: Kirdina 2010). Neither the stock market nor private financial intermediaries have proven willing nor capable of financing these purposes. The network of development institutions in Russia remains weak. The main development bank (*Vneshekononbank*) can be involved in a large-scale government project alongside one or two state-controlled "commercial" banks (*VTB* or *Sberbank*) playing essentially the same role and sharing similar risks.

The weakness of this model might be its impreciseness. Core state-controlled banks pursue two conflicting missions at the same time: maximization of profit and capitalization for their shareholders *and* maximization of social benefit as understood by the government. These banks have evolved into a kind of hybrid institutions that combine under one roof the elements of a commercial bank and a development bank, even if their respective charters do not provide for such ambiguity. These banks have thousands of minority private shareholders, including foreign ones, and are regulated by the Central Bank of Russia according to standard criteria designed for genuine commercial banks.

One more aspect of evolution undergone by Russia's leading banks is gradual replacement of direct state ownership and control by indirect control. According to our estimate, more than one-quarter of all bank assets within the public sector are not controlled by the state only indirectly if at all (Vernikov 2012). The building of corporate pyramids has become widespread in the public sector. Such arrangements separate the ultimate beneficiary (the state) from downstream assets by several layers of corporate bureaucracy embodied in intermediary entities. While presumably adding to efficiency and flexibility, corporate pyramids greatly enhance opportunities for expropriation of public assets by insiders, be it top managers of the downstream banks or the civil

servants assigned to monitor and supervise a given sector or company. Low transparency and accountability feature public sector banks, and incidence of corruption is high.

A search for international benchmarks for the Russian banking system suggests increasing divergence from the transition path followed by quite a few countries in Central, Eastern and Southeastern Europe. For example, in most of those countries the banking industry mostly comprises foreign-controlled players. The share of state-owned banks stands under 20 percent whereas Russia's is at least three times that (Fig.2).

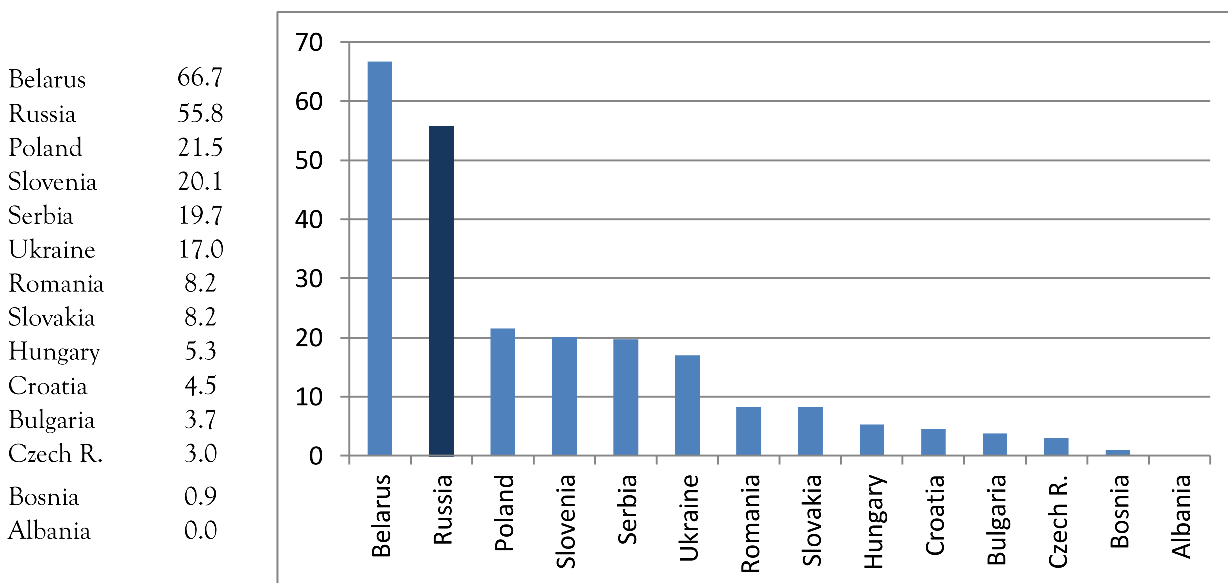

Figure 2: Market share of state-owned banks in European post-communist countries, percent, by 01.01.2012

Source: Raiffeisen 2012; for Russia - own calculations based on bank data

At the same time we find a growing convergence with the system of commercial banks in China in terms of macro-structure and institutional setup. Below are some elements of similarity:

- Both banking systems have more than two tiers. Russia has its core state-controlled banks, and China has the top 5 "large commercial banks" named somewhat similarly (Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank, and Bank of Communications) that dominate every segment of the banking market (CBRC 2011; bank data). Both countries may have inherited this system from the *spetsbanki* (specialized state-owned banks) that existed in the late Soviet Union in the second half of 1980s;
- Market concentration is moderate if state-controlled banks are considered on a stand-alone basis, and high if their market shares are consolidated;
- The state is yielding some space to minority shareholders while maintaining ultimate control; not a single large state-owned bank has been truly privatized (Lin and Zhang 2009);
- Core state-controlled banks try to combine commercial lending with policy lending and even development finance on behalf of the respective government;
- Loan quality is an acute problem in both countries, not fully reflected in official statistics (Podpiera 2006; Berger, Hasan and Zhou 2009).

Structural and institutional dissimilarities exist too:

- China has fewer commercial banks than Russia (250 vs. 950), and many of those banks have vast branch networks, although the number of banks grows in China and declines in Russia. In China banks co-exist with several other types of financial intermediaries active in different tiers of the economy including rural areas;

- In China all market participants, regardless of their form of ownership, lend and price their services according to guidelines and directives received from the government. Implementing the 12th 5-year plan is a priority task for all;
- The breakdown of bank liabilities and assets is more natural in China, with greater reliance on domestic savings and productive investments;
- China has set up a separate bank supervisor, whereas the Russian Central Bank remains in charge of bank supervision that intensifies the conflict of interest (monetary policy – control of the largest bank – supervision over all banks);
- In China development banks and policy banks are stronger and more diverse (China Development Bank, Export-Import Bank of China and Agricultural Development Bank of China);
- Unlike Russia, China has no explicit government insurance of household deposits;
- Foreign-controlled banks do not enjoy national treatment in China, unlike in Russia. Foreign bank penetration in China is much lower. At the same time, China allows foreign bank branches and Russia does not.

Neither the similarity between Russia and China nor the dissimilarity between Russia and Central European countries are accidental. They reflect different institutional dynamics inherent to two fundamentally different types of societies (Polanyi 1957; Polanyi 1977; Rosefielde 2008). According to the theory of institutional matrix, China and Russia might both belong to the same type of non-market economies (X-type) based on centralized redistribution of all resources including finance (Kirdina and Sandstrom 2010; Kirdina 2012). Such economies presume a central role of the state in industry as well as in the financial system. If so, then the shape of the banking industry must be coherent with the rest of the economy. Within the paradigm of institutional matrix, the prevailing dominant type of the matrix (either X or Y) is invariable and cannot be switched. Institutional consistency is a key to sustainable functioning of the system which presumes a sustainable proportion between the dominant institutional forms (state-controlled banks and centralized credit reallocation) and complementary ones (private banking, both domestic and foreign). An attempt to renounce the predominant matrix by leaving finance to private initiative (like in Russia in the 1990s) is futile and can destabilize the economy and finance alike.

From the viewpoint of institutional consistency China seems to have fared better than Russia, if one judges by the outcomes. Russia has repeatedly swung the balance too far in favor of non-core institutions that could not cope with the challenge. It is not the first time in Russia's history that private financial institutions fail to deliver. The comeback of state-owned banks in Russia was thus predictable. That makes one wonder whether the official plans to privatize core state-owned banks (*VTB*, *Sberbank* and *Rosselkhozbank*) will make more good or harm. Divestment from those banks is not driven by efficiency consideration nor by fiscal constraints, but ideology (and maybe by vested interest). In the absence of reliable private banks and development financiers the government will soon have to recreate its investment vehicles in order to support its various needs in the infrastructure and other sectors. The privatized "national champions" will remain too big to fail and will always require public backing and funding regardless.

An institution that might seem redundant within the given institutional setup is *deposit insurance*. This institution was imported into Russia under strong pressure from international experts and under the assumption that it is a must-have for everyone. We now refrain from discussing whether deposit insurance generates more benefit or harm through moral hazard in Western countries. But in Russia where 62 percent of household savings are concentrated in state-controlled banks it duplicates the liability of the state: first as owner of those banks, and then as guarantor of private deposits in those banks. Deposit insurance has generated all kind of wrong incentives for the smaller private banks (who raise expensive deposits to gamble on risky assets)

and for the people who no longer care about the quality of the bank. The competition it has enhanced is evidently counterproductive. China is a notable exception to the list of countries with explicit deposit insurance scheme. Pragmatism and consistency have once again served China well. Russian policy makers and experts have remained notably mute about this fact, although they have praised Chinese approaches to other subjects that were more in line with the Russian political agenda.

Conclusions

Over the past 20 years or so the Russian banking system has swung from a full state monopoly to a highly dispersed and mainly private financial sector and then back to state control. As different from authors who believe that the recent trend disrupts a natural evolution, we tend to think that it was the failed experiment with predominantly private financial intermediation that went against Russia's historical tradition. Development economics fails to explain it; the theory of institutional matrix can. Under the latter paradigm, the proportion between public and private banks must remain consistent with the underlying set of fundamental institutions that shape Russian economy and society.

The other important elements of the evolution of Russian banks have been the emergence of three "national champions" in the public sector, a blend of commercial banking and policy lending under the same roof, and replacement of direct state ownership and control by indirect control.

Core state-owned banks, along with the development bank, have undertaken to finance government policies and projects. Rephrasing Schumpeter who suggests that banks are a development phenomenon only if a command force does not drive socio-economic process (1934), we can argue that in Russia (as well as in China) some banks become a development phenomenon by representing the command force that drives socio-economic process.

If our hypothesis regarding the institutional dynamics of the Russian economy is correct, it might have policy implications with regard to banks. The system ought to become more consistent, with a clearer definition between commercial and policy banking and a better balance between public property and private initiative.

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