Bad rap on Russian banking?

PHOTOGRAPHS BY ED BLOUNT

Russian regulators and bankers address reports of renewed bank failures and explain how the latest crisis was actually part of a weeding out process

Since the collapse of the Soviet Union, the Russian people have been trying to make capitalism work. Yet, with virtually no business experience or even an inherited legal infrastructure for the protection of property rights, most capitalist enterprises have struggled to find their way in a hostile world. Perhaps as ongoing fallout from the Cold War, Russian commercial failings have usually been viewed by westerners, not merely as growing pains, but as collateral evidence of chaos and deceit.

With only a few recent exceptions, the financial press tends to ignore the booming Russian economy and writes more often of the intrigues of "the Russian mob" and the sophistication of "Russian

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PREVIOUS PAGE: Impressively ornamented headquarters of the Russian Central Bank, Moscow.

Internet scams," as well as the "chaotic" Russian banking system. Indeed, to the average reader, the Russian banking system always seems to be just a half step from The Next Crisis.

Russians have come to understand that good banking—and a good banking reputation—are as necessary to long-term economic success as the formation of durable enterprises. Furthermore, they now appreciate that stable banks rely on a stable national reputation, and vice versa, in ways not always apparent to bankers operating in developed market systems. This recognition grew, according to Russian bank regulators, as they took up the notion of adopting the reformed Basel capital accord (Basel II) as their means to both ends: a better reputation, plus a more stable and efficient banking system.

"Right now," says Andrei Kozlov, first deputy chairman, Central Bank of the Russian Federation, "we are in line with nearly 95% of all recommendations made by the Basel Committee. Our goal is to be in exact conformity, always.

"However, one of our problems is very low transparency of ownership in the banking system. Often, there may be five or six intermediaries separating the bank and its beneficial owner." The inherent opacity of post-Soviet property rights makes it extraordinarily difficult to adopt the consolidated reporting requirements of Basel II. "Initially, banks are becoming more transparent to us," says Kozlov. "But it's a difficult process."

At present, the law does not require full reporting of the ownership structure of banks. Koslov says that the goal of the central bank is to provide transparency to the point of the owner's identity as a government, individual, or public company. The same rules will be applied to foreign-owned banks.

Foreign bankers welcomed

It is generally understood that Russian bankers are eager to participate in the privatization programs of many former Soviet allies in the eastern European transitional market economies. Russian bankers believe their credibility in other markets will be easier to establish if they are certifiably in compliance with international bank solvency standards. At the same time, their government officials believe that Basel II compliance will help to foster a stable environment in the Russian market itself, partly by encouraging solid foreign banks to partner with Russian correspondents.

In late October, Russian Prime Minister Mikhail Fradkov told an audience at an international conference that he believed foreign bank competitors were an important part of the establishment of a modern banking system. Restoration of wide-scale banking linkages, regulators know, will not be easy until they can first restore the reputation of their banks. After the 1998 sovereign bond default that ended with the Long Term Capital Management debacle, many foreign bankers equated Russian credits with smallpox. And for many, that view will likely continue in the near term. To illustrate, one writer at a western credit rating agency, instead of praising Russian banking reform, recently cited the adoption of a depositors' safety net as a desperate government measure proving that the banking system had again fallen into a state of crisis.

This is wrong, according to Andrei Kozlov, who explains that the safety net legislation was enacted by the Russian Duma in 2002 to take effect in 2003, after being under discussion by regulators for nearly ten years. It was not an emergency measure.

"The banking system is in a state of change," he says, "with deposit insurance legislation at the core of the reform."

The truth about the onset of last year's banking disturbances, according to Russians, is far more prosaic than dramatic, though the story includes a web of irony and unintended consequences. In a long story cut short, it seems that the law directing the central bank to evaluate and certify private banks for inclusion in the safety net (with a fifteen basis point quarterly charge on insured deposits) was also responsible for the 2004 crisis of confidence in banking, as Russians describe their most recent disturbance. That is, the central bank's revocation, in one of its first safety-net examinations, of several banking licenses, after finding evidence of money laundering, was incorrectly taken by outsiders as the first in a new wave of bank failures. When government officials confirmed that several other banks were also under investigation, depositors rushed to transfer their assets to the state savings bank. An alarming newspaper report then prompted a run on other banks, creating a liquidity squeeze throughout the entire banking system.

An unintended, ironic consequence of the adoption of Basel II by Russian bank regulators, or at least its *method* of adoption, was the near-collapse and impaired image of the very banking system it was intended to protect. As another unintended consequence, the government's share of the Russian banking market grew substantially, exacerbating foreign observers' fears that government ownership of seized banks, when added to the existing dominance of the state savings bank, would strangle private banking in Russia.

Stages of banking development

Fears about Russian banking seem inevitable, given the hostility of even their own media. The Russian federal government's 2003 seizure of the largest corporate entity in Russia, the Yukos oil company, and subsequent jailing of its chairman, is widely being interpreted in Russia less as a normal, corrective phase of the market development process than more darkly as another heavy bootstep along a cobbled road that will lead to government apparatchiks manipulating the economy indirectly through financial and industrial pawns.

When such a system of industrial control was tried in the nineteen-thirties by Europeans recoiling from the bank failures of The Great Depression, it was called Fascism. "That's a word that people are now starting to use," said a senior correspondent for *Kommersant*, one of Russia's largest private newspapers, to a group of visiting U.S. financial writers.

Whether Russian banking regresses to a semi-soviet state or advances to become a true engine of economic growth will likely depend on whether its leaders, in both the private and official sectors, can first convince their own people and media that the banks are safe for depositors; that bankers will make loans on fair terms; and that their government will allow private banks to operate without unnecessary interference.

"We have passed through all stages of development," says First Deputy Chairman Kozlov. Going forward, he says, "The government intends to reduce its role in the market for private deposits."

Still, it's apparent that not everyone is convinced that the plan is on track, if the banking system's experiences in 2004 are a guide. Adoption of the principles of Basel II, while a positive move, will probably not be the silver bullet that kills the skepticism of generations of cash-under-the-mattress savers in Russian society, not to mention the legions of critics in global financial circles. Fortunately for Russia, there are some eloquent spokesmen in their banking system who have taken up the challenge of convincing the skeptics.

Myth and reality

"There are a lot of myths in the world about Russian banks being involved in dubious activities," says Garegin A. Tosunyan, president of the Association of Russian Bankers. "Don't believe them. After 1998, the banking system improved significantly. A new generation has come to the top of the management structure. Now the vast majority of the banks are working with the long-term in view," Tosunyan continues. "They are thinking about capitalization and, while the general level of capitalization is still quite low, they are working on improvements."

According to Tosunyan, there is much room for growth of the banking system. Very few banks have capitalization levels of more than $1 billion. There are fewer than 100 banks with more than $100 million in their own capital, but many with at least $5 million. For regional banks in Russia, according to Tosunyan, that's a significant value.

"The capitalization problems of regional manufacturing concerns are actually more acute than for their banks," according to Tosunyan. Russian Banking Association members' main concerns at present are to improve the quality of their services. "The central bank set up that task, so they are very actively involved in solving that problem. They've actually been *too* involved in its solution," he complains, "because a lot of new requirements have been set up in a very short time. One of those very important tasks is providing more transparency about the chain of ownership."

Barriers to Basel

Standing in the way of Basel II are cultural, as well as technical challenges, according to Tosunyan.

"A lot of the Basel II changes are quite difficult to implement in Russia because lenders are not prepared to be *that* transparent and *that* efficient, in terms of banking efficiencies as understood abroad. For that reason, it's difficult to improve risk management in the banks themselves without also raising the level of lending. We have to work with the Central Bank to help define their directives and instructions, or else we won't have enough money for compliance. At the same time, if we take into account the lack of capitalization and the deficiency of financial resources in the Russian market, it also means we have to intensify the development of the bank funding markets. And yet, using the strictest requirements of Basel II, we would have to narrow the area for banks' activities. We have to find a sort of 'golden mean,' a middle ground, where we can implement the requirements of Basel II without damaging the achievements already made by Russian banks."

Starting in 2005, banks will be required for the first time to publish annual reports prepared in conformity with international accounting standards. The central bank will itself publish insured banks' reports on its own website. That will be helpful to depositors, investors and joint venturers. To protect the banks themselves, as their consumer loan operations begin to grow, TransUnion and Experian are said to be investigating the creation of credit bureau services in Russia. That will also generate the statistics that will be needed for the more advanced implementations of Basel II. More help will also be required from lawmakers.

"Unfortunately for bankers," says Kozlov, "the bankruptcy law is not that efficient. Amendments made in 2002 were a big step forward, but not everything that was needed. There will be further changes in the near future, designed primarily to safeguard the interests of creditors. For example, the law covering the liquidation of failed banks was amended this past summer. In the past, bankruptcies were handled by private companies. A new government agency, like the FDIC, was authorized by the law to take over this function at the end of November."

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— Andrei Kozlov, first deputy chairman, Central Bank of the Russian Federation

Negotiating the plan

Since this necessary foundation for credit and operational risk management will take time, might it not be easier for

Russian banks to first adopt the market risk rules of Basel?

"Yes, it would be more appropriate to start with the market and then move toward the bank," says Tosunyan. "The problem is that we are not sufficiently prepared for managing credit risk. What is more, the Institute of Credit History is only now being created with support from the Russian Banking Association."

Increased capitalization presents a further challenge for Russian banks.

"There is a call for banking capital to be above $5 million, but that is clearly taken out of the Russian context. The RBA is quite actively involved in the development of the system of deposit insurance. That law was passed last December. It is a very painful process."

According to the central bank, the examination process was started with the banks most likely to pass, although there were no public reports of the number of banks on the "expected pass" list. That's not accidental, according to Tosunyan.

"The RBA asked the central bank *not* to disclose any forecast numbers, because talk about banking inadequacies creates a sense of instability in the Russian market. We believe that most banks will pass the examination, although perhaps not on the first pass. If we take a rational approach, we feel that the standards are quite sensible. But they should not be pushed in 'leaps.' Neither should they be enforced in parallel with many other new demands. They should not be linked to the insurance system, for which the requirements should be increased only very gradually. A great number of market participants could adapt to a gradual process, but not to an accelerated process. The best idea is to do one thing at a time. If we demand too much at once, it creates an unhealthy market.

And is the central bank willing to be flexible?

"For the time being, yes. But there were difficulties last May. One of those sprang from confusion over the expectations of the central bank. When it became apparent that the reaction of the market was quite nervous, we came to an agreement that the process of increasing the requirements should be done more smoothly. If it comes down to the process of removing certain licenses, it should be done without unnecessary publicity. Meanwhile, nine banks lost their licenses since January 2004. That was a justified measure, although most of those banks were already out of operation before being shut down. By the end of this year, quite a few banks will be taken into the insurance system. By the 27th of March, 2005, the vast majority of banks will submit applications to the insurance system. Most of those will pass."

And is the central bank actually trying to force consolidation?

"Yes, such ideas are on the agenda of the central bank. It is not something that they openly advertise. From that perspective, the banking association is trying to clarify the wishes of the central bank. The RBA initiates bills and legal initiatives which would simplify the process of merging. The RBA did manage to convince the central bank that not all banks should have minimum 5 million euros in capital by 2006. Quite a few small banks away from Moscow are quite efficient and should not be shut down, just because their absolute level of capital is too low. In this particular area, the banking association was able to compromise with the central bank. The compromise has two sides: first, no one should disturb the process of merging if it comes naturally and, second, there should be no pushing to get banks merged or consolidated if they don't desire that."

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— Garegin A. Tosunyan, president of the Association of Russian Bankers

Shared ideals for capital reform

Many global bankers have come to view Basel II as an opportunity to gain a competitive advantage, as well as to improve the state of risk management in the banking system. With better risk management policies than their peers, those bankers expect to reduce their regulatory capital charges and, assuming economic capital follows suit, to advance their bank's performance in the league tables by improving their return on capital.

To banking supervisors, this adds a positive incentive to the inherent value of improved risk management in their banking systems. Surprisingly, the eventual benefits may be greatest, not in the developed countries which initiated the Basel reforms, but in the transitional market economies where banking reform is a highly desirable, but often unattainable, goal.

Russian bank regulators appear to be embracing the Basel reforms wholeheartedly, to assign a seal of legitimacy not just to their banks, but also to the entire financial system. It is hoped that will enable stabilization, which will itself lead to an expansion of the underlying market economy. But it won't be easy. Stay tuned. *BJ*