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Evolution of the Banking System in the Russian Context: An Institutional View

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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 rebounded over the past decade. The core state-controlled banks have evolved into hybrid institutions, performing two various sets of functions: those of regular commercial banks and of policy banks. We found a similar evolution in China, but not in the transitional 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 complementary.

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

JEL Classification Codes: B40, G21, P50

By the early 2000s, Russia had had its share of experimenting with private financial intermediation. While contributing to the massive reallocation of industrial assets to new owners and to initial accumulation of wealth, privately-owned banks remained a cause of macroeconomic instability. Simultaneously, they were consuming a disproportionate share of national income and requiring public support. Privately-owned banks were underperforming as financial intermediaries and their lending rates were prohibitively expensive for real sector borrowers due to low efficiency, fat interest margins, and high costs 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 of the largest private-sector banks failed due to poor risk management, incompetence, and fraudulent practices. Generally, state-owned

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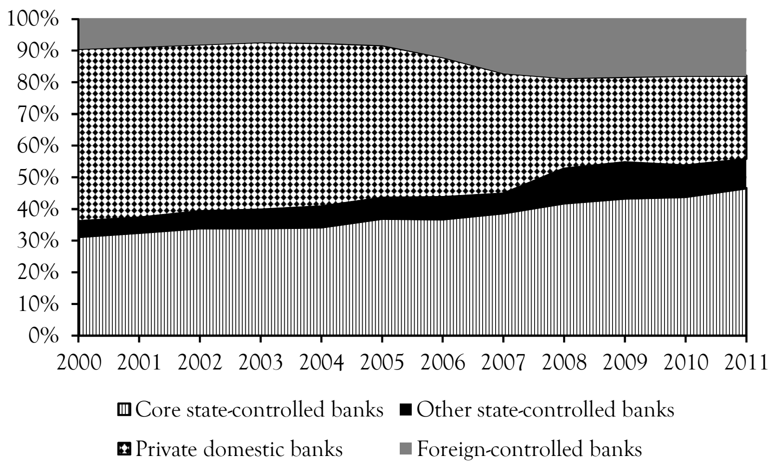
banks would step in to fill the void left by private financial intermediaries in line with the "development theory" of government banking (La Porta, López-de-Silanes and Shleifer 2002).

In the early 1990s, the market share of state-controlled banks in Russia quickly eroded, hitting the bottom in 1998, but then embarked on a continuous rise. It is now a commonplace practice that the government would intervene in the economy during financial crises, particularly in the banking sector. In fact, the most recent crisis of 2008 caused similar 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 since it started several years *before* the recent crisis. By the beginning of 2012, the combined market share of banks that were directly or indirectly controlled by the state reached 56 percent (Figure1).

Figure 1. Combined Market Shares of Russian Banks by Form of Ownership as of End of Respective Year



Sources: Authors' calculations; bank data; Central Bank of Russia

Russia remains an under-banked economy despite an impressive number of licensed banks (approximately 950). Penetration ratios remain relatively low and banks contribute very modestly to economic and social development, particularly to the financing of investment needs of non-financial enterprises. According to Russian official statistics, over the period 1999–2010, the share of bank loans among all sources of investment into fixed assets did not exceed twelve percent. At the same time, companies were using their own capital, budgetary funds, and mutual borrowings for investment (Table 1).

The shift of banking ownership from a complete state monopoly to a highly dispersed and mainly privately-owned financial sector, then back to state control, took less than twenty years. This dramatic change, combined with the fact that the state actively steered it, suggests a process that went contrary to a natural evolution. On the other hand, one may argue that, by recreating a centralized system of credit allocation, Russia only returned to a solid historical pattern. It is true that stand-alone, privately-owned banks have never dominated the financial industry in Russia. State-owned and government-funded institutions had been at the core of the financial system prior to the Russian Revolution of 1917. In the early 1920s, private finance emerged briefly during the NEP (new economic policy) period, but quickly gave way to a new, highly-centralized, and state-owned Soviet banking system.

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:	51.0	52.5	55.5	59.6	60.5	62.9	59.0	57.3
Bank credits,	n/a	2.9	8.1	10.4	11.8	10.3	9.0	7.7
- of which foreign bank credits	- n/a	- 0.6	- 1.0	- 1.7	- 3.0	- 3.2	- 2.3	- 1.5
Borrowed funds of other organizations	n/a	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	n/a	15.6	20.6	20.1	21.2	23.0	24.1	25.6

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

On the macro level, the architecture of the Russian banking system includes three tiers, while legally there should be just two. Apart from the central bank and regular commercial banks, there is a third tier of core state-controlled banks. *Sberbank*, *VTB*, and *Rosselkhozbank* became "national champions" of the public sector due 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. Zuzana Fungáčová and Laurent Weill (2012) find that state-controlled banks make a valuable contribution to liquidity creation in Russia, including in times of macroeconomic instability and general liquidity squeeze.

The market share of "national champions" in Russia increases through organic growth as well as through takeovers of other institutions, public or private, that are financed with public funds. The "national champions" and their respective subsidiary banks today control 46.5 percent of Russia's total bank assets, and they are active in every segment of the market (Vernikov 2012). The emergence of several state-controlled market leaders has increased concentration in the relatively dispersed

Russian market. If state-controlled banks are seen as stand-alone entities, then the combined share of the top five market players would be in the range of 50 to 58 percent, varying across market segments. The consolidated market shares of the core state-controlled banks and their offspring, on the other hand, would increase the share of the top five players to 59-65 percent. However, when measured through the Herfindahl-Hirschman index, results show that concentration would increase tangibly – from 0.27 for corporate deposits to 0.47 for household deposits – to approach a monopoly status (Vernikov 2012). So far, the existing conditions have not had an overly negative effect on the competitiveness of the Russian banking market (Anzoátegui, Martínez Pería and Melecky 2012). But a significant "cherry-picking"– that is, the 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 Alexei Karas, Koen Schoors and Laurent Weill (2010), and indeed receives factual proof in official bank disclosures. As of 2012, state-controlled banks had displayed higher returns on assets and on equity than those of other market participants (Table 2).

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, 28.

If the financial reports of Russian banks are to be considered credible, then the figures in Table 2 might suggest that, in Russia, the core state-controlled banks have become “normal” market players, intent on maximizing profits and efficiency. But that is true only to an extent. Along with “regular” commercial banking, all “national champions” engage in the kind of economic activities 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 for implementing social programs and for special assignments such as geopolitical goals of the government. In some instances, these banks act as investment vehicles for the government or even hedge funds. They acquire non-core assets and hold them on their balance sheets. Both *Sberbank* and *VTB*, for example, are assigned important roles in financing infrastructural projects or projects related to the APEC summit, Olympic games, soccer world cup, and others. *Rosselkhozbank*, on the other hand, is systematically used to finance agricultural projects. While the commercial viability and business end of those loans are unclear, state support would offset any arising problems with non-performing loans, liquidity, or capital (in)adequacy.

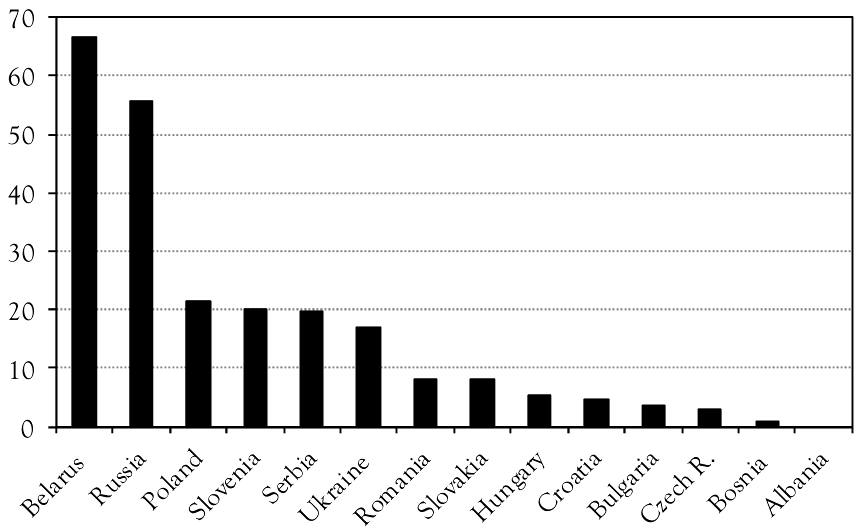
There is nothing fundamentally wrong in the fact that state-owned banks engage in policy lending, especially if it yields positive financial results, as is often the case. Real sector financing in the Russian Federation is based predominantly on the institutional model of “state as investor.” Despite the messy 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 (Kirdina 2010). Neither the stock market, nor private financial intermediaries have proven willing or capable of financing these sectors. But the network of development institutions in Russia remains weak. Nevertheless, the main development bank, *Vneshekononbank,* can get involved in large-scale government projects, alongside one or more of the state-controlled “commercial” banks (such as *VTB* or *Sberbank*), essentially playing the same role and sharing similar risks.

The weakness of this model might be its imprecision more than anything else. Core state-controlled banks pursue two conflicting missions at the same time: (1) maximization of profit and capitalization for their shareholders and (2) maximization of social benefits as understood by the government. These banks have evolved into a kind of hybrid institutions that combine the elements of a commercial and development bank, even when their respective charters do not provide for such dual arrangement. These banks have thousands of private shareholders, including foreigners, and are regulated by the Central Bank of Russia, in accordance with standard criteria designed for commercial banks.

One more aspect of the evolution undergone by some Russia’s leading banks is the 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 controlled by the state only indirectly, if at all (see also 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 they top managers of the downstream banks or civil servants assigned to monitor and supervise a given sector or company. Low transparency and accountability, as well as high incidence corruption, are typical of public sector banks.

A search for international benchmarks for the Russian banking system suggests an 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 twenty percent, whereas Russia's is at least three times that (Figure 2).

Figure 2. Market Share of State-Owned Banks in European Post-Communist Countries as of January 1, 2012 (in Percent)



Source: Raiffeisen 2012; for Russia – authors' 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. Among the elements of similarity between China and Russia's banking systems are the following: First, both banking systems have more than two tiers. Russia has its core state-controlled banks, and China has its top five "large commercial banks," named somewhat similarly (e.g., 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 (bank data:

CBRC 2011). Both countries may have inherited this system from the *spetsbanki* (specialized state-owned banks) that existed in the Soviet Union in the late 1980s.

Second, in both countries, market concentration is moderate when state-controlled banks are considered on a stand-alone basis, and high when their market shares are consolidated. Third, the state is yielding some space to minority shareholders, while maintaining ultimate control. In addition, not a single large state-owned bank has been truly privatized in either country (Lin and Zhang 2009). Fourth, core state-controlled banks in Russia and China try to combine commercial lending with policy lending, and even development finance on behalf of the respective governments. Last, but not least, loan quality is an acute problem in both countries, not fully reflected in official statistics (Berger, Hasan and Zhou 2009; Podpiera 2006).

But a number of structural and institutional differences between Russia and China's banking systems exist, too. First, China has fewer commercial banks than Russia (250 vs. 950). Many of those banks have vast branch networks, although the number of banks is on the rise in China and declines in Russia. In China, banks co-exist with several other types of financial intermediaries that are active in different tiers of the economy, including rural areas. Second, 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. Thus, implementing the twelfth five-year plan is a priority task for all. This is not the case in Russia. Third, the breakdown of bank liabilities and assets is more natural in China, with greater reliance on domestic savings and productive investments. Fourth, 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). Fifth, in China, development banks and policy banks are stronger and more diverse (e.g., China Development Bank, Export-Import Bank of China, and Agricultural Development Bank of China). Sixth, unlike Russia, China has no explicit government insurance of household deposits. Seventh, foreign-controlled banks do not enjoy national treatment in China, unlike in Russia. Foreign bank penetration in China is much less. At the same time, China allows foreign bank branches and Russia does not.

But neither the similarities between Russia and China, nor the differences between Russia and Central European countries are coincidental. They reflect different institutional dynamics inherent in two fundamentally different types of societies (Polanyi 1957, 1977; Rosefielde 2008). According to the theory of institutional matrices, China and Russia might both belong to the same type of predominantly non-market economies (X-type), based on centralized redistribution of resources, including finance (Kirdina 2012; Kirdina and Sandstrom 2010). Such economies presume a central role for the state in industry as well as in the financial system. In that case, the institutional design of the banking industry must be coherent with the rest of the economy. Within the paradigm of institutional matrices, the prevailing type of the matrix (either X or Y) is invariable and cannot be switched. Institutional consistency is key to the sustainable functioning of the system, which presupposes a sustainable proportion between the prevailing institutional forms (e.g., state-controlled banks and centralized credit reallocation) and complementary ones (e.g., private banking, both domestic and foreign). An attempt to renounce the prevailing 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 failed to deliver. The comeback of state-owned banks in Russia was thus predictable. This brings forth the question of whether the official plans to privatize core state-owned banks (e.g., *VTB*, *Sberbank*, and *Rosselkhozbank*) would do more harm than good. Divestment from those banks is not driven by efficiency considerations, nor by fiscal constraints, but by ideology. 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.

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 feature. We now refrain from discussing whether deposit insurance generates more damage than benefit 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: once, as owner of those banks, and then as guarantor of private deposits in those banks. Deposit insurance has generated all kinds of wrong incentives for smaller private banks (who raise expensive deposits to gamble on risky assets) and for people who no longer care about the quality of the bank. The competition it has enhanced is evidently counter-productive. 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 China's approach to other matters, which are more in line with Russia's political agenda.

In a summary, over the past twenty years, the Russian banking system has swung from a state monopoly, to a mainly private financial sector, and back to state control. Unlike authors who believe that the recent trend has disrupted 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. While development economics fails to explain this, the theory of institutional matrices can. Under the latter paradigm, the ratio of public to private banks must remain consistent with the underlying set of fundamental institutions that shape Russia's economy and society.

Core state-owned banks, along with development bank, have undertaken to finance government policies and projects. Rephrasing Joseph 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 development banks by representing the command force that drives socio-economic process.

If our hypothesis about 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 of commercial and policy banking and a better balance between public property and private initiative.

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