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Current Problems in the Development of the Banking System of the Russian Federation

ABSTRACT

In 2013 the situation in the banking sector of the RF underwent major changes. On the one hand, the volume indicators of the banking sector continued to grow, although more slowly than before. However, this growth was mainly due to aggressive behaviour of the banks in the consumer lending market, despite actions by the Bank of Russia aimed at reducing the attractiveness to the banks of such loans. On the other hand, there was an increased imbalance in the banking sector related to the non-uniform distribution of liquid funds, the outflow of customers from small and medium-sized banks to larger ones (principally to banks with government participation in their capital). This last factor was strengthened by the Bank of Russia’s efforts to rehabilitate the banking sector by withdrawing the licences of a significant number of banks, including those working in the market of private deposits. Within the framework of this policy of the Bank of Russia, aimed at reducing the number of banks and terminating the activities of any banks violating prudential standards, one should note the necessity for a more integrated approach to the reform of the sector, including measures aimed at increasing capitalisation, and the formation of an institute of systemically important banks with a reduction in the proportion of banks with government participation.

Current Problems in the Development of the Banking System of the Russian Federation

1. General features of the situation in the banking sector at the end of 2013

Based on the results of 2013 the growth rates of the main indicators of the level of development of the banking sector slowed down compared with 2011-2012. Total assets in 2013 had increased by 16.0% (in 2012, by 18.9%) and loans to companies and individuals, by 17.6% (in 2012, by 21.0%)[1]. The dependency of the banking sector on refinancing by the monetary authorities increased (Goryunov, Trunin, 2013)[2]. The total indebtedness of banks to the Bank of Russia and to the Ministry of Finance of the RF stood at 8% of the total assets, having reached Rb 4.5 trillion. Loans from the Bank of Russia and deposits from the Ministry of Finance of the RF accounted for 17% of the annual growth in assets of the banking sector. The profitability of banking activities is decreasing. In 2013, return on equity decreased by 3 p.p. compared with 2012 (16.7% versus 19.7%) whilst, for the first time since the crisis, nominal profits turned out to be lower than in the previous year (Rb 994bn in 2013 versus Rb 1,012bn in 2012).

At the same time, in late 2013, the existing trends in the development of individual segments of the banking system, changed. For example, the increase in private savings in banks in November-December 2013 was only 5.2% (Rb 820bn) whilst in November-December of the previous year the increase in deposits had been 8.3% (Rb 1,088bn). However, the growth of deposits in the 30 largest banks remained almost unchanged (8.6% in November-December 2013 versus 8.9% in November-December 2012) and the growth of deposits in state-owned banks, including Sberbank, increased by 8.7% at the end of 2012 compared with 10.9% at the end of 2013, whilst, in the small and medium-sized banks, private funds decreased by Rb 208bn (5.3%) in November-December 2013 compared with a growth of Rb 214bn (6.5%) in the corresponding period of 2012.

In November-December 2013 the large banks increased their fundraising from corporate customers by 14.2% (Rb 1,304bn), with the increase for state-owned banks being 15.0% (Rb 926bn), which is considerably higher than in the previous year (8.4 and 6.5%, respectively). However, the funds of corporate customers in small and medium-sized banks, in November-

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[1] Unless otherwise specified, hereinafter, data from the Central Bank of the RF.

[2] Evgeny Gorunov & Pavel Trunin, 2013. The Bank of Russia at the Crossroads: does the monetary policy need easing, Working Papers 0067, Gaidar Institute for Economic Policy, revised 2013. http://ideas.repec.org/p/gai/wpaper/0067.html; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2268289

December 2013, increased by only 5.8% (Rb 176bn) versus 12.0% in the corresponding period of 2012.

The retail lending market in November-December also showed a tendency towards the outflow of customers from small banks to larger ones. The growth of loans to individuals from the 30 largest banks for these first two months was 6.0% (Rb 453bn) with the growth for the state-owned banks being 7.9% (Rb 414bn). Meanwhile, in the two last months of 2013, small and medium-sized banks lost 3.8% of their retail loan portfolio (Rb 101bn).

These tendencies were mainly due to a process, initiated by the new management of the Bank of Russia, to increase control over the activities of commercial banks. This process of putting the banking system in order began during the period of instability in the Russian banking system related to the liquidity deficit faced by many banks (see Fig. 1). Comparative analysis shows that the liquidity deficit at the end of 2011 was larger than at the end of 2008[3]. The main reason for this situation was, in our opinion, an extremely active policy by the banks, aimed at extending consumer lending. The creation of reserves for providing high-risk consumer loans resulted in the "freezing" of a major part of the liquid resources of many banks (especially since the Bank of Russia toughened its requirements for the classification of such loans in 2013).

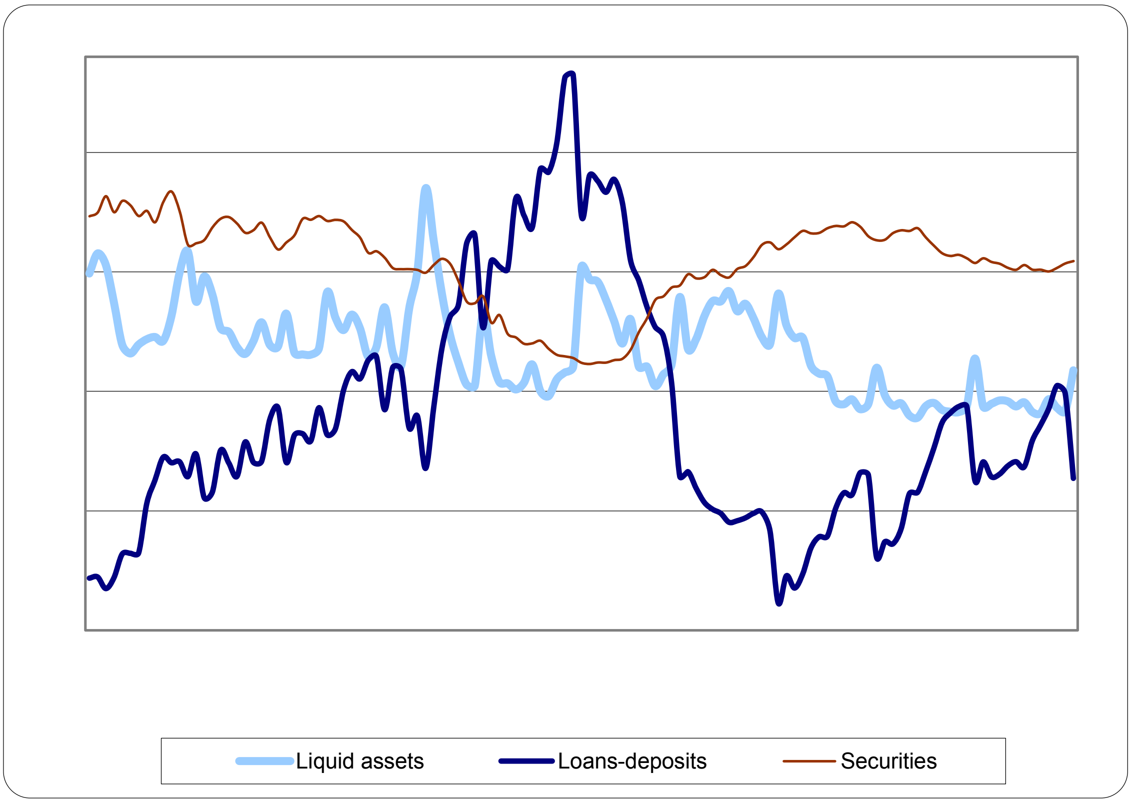
The liquidity deficit occurred at the same time as an increase in banking system segmentation. In the crisis period the position of state-owned banks strengthened considerably, with the main competition in the market for banking services being between these banks[4]. In contrast, the position of small and medium-sized banks substantially worsened. Meanwhile, the large banks actively made use of the Bank of Russia's refinancing of the banking system. Taking into account the higher economic risks[5] and the increasing gap between the maturity of banking assets and liabilities one could say that the stability of the banking sector is steadily declining.

[3] Comparison of the liquidity crises of 2008 and 2011 for different groups of banks see A.L. Vedev "Basic characteristics of the dynamics and structure of the financial and banking sector of Russia at different stages of modern development (1999-2012)". M. Publishing house "Delo", Russian Presidential Academy of National Economy and Public Administration, 2014. — 84 p. — (Scientific reports: economy)

[4] We should note that a greater level of competition within the group of state-owned banks than that between the state-owned and private banks is traditional for the RF (S.M. Drobyshevsky, S.A. Paschenko. Analysis of competition in the Russian banking sector. Institute for the Economy of Transitional Period scientific papers, No.96P. — M.: Institute for the Economy of Transitional Period, 2006).

[5] For more information about the situation in the Russian economy in the current conditions and the possible risks to development , see Georgy Idrisov & Sergey Sinelnikov-Murylev, 2013 . "Budget Policy and Economic Growth," Working Papers 0076 , Gaidar Institute for Economic Policy, revised in 2013 . Http:// ideas.repec.org/p/gai/wpaper/0076.html; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2367933. G.I. Idrisov, S.G. Sinelnikov Murylev. Formation of Prerequisites of Economic Growth: How to Understand Them? / / Voprosi Ekonomiki, 2014, No.3; Vladimir Mau, 2013, "Between Modernisation and Stagnation. Russian Economic Policy and Global Crisis", Working Papers 0057, Gaidar Institute for Economic Policy, revised in 2013 . Http://ideas.repec.org/p/gai/wpaper/0057.html; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2230355

Fig. 1. Liquid assets, investments in securities and excess of loans over deposits for the non-financial sector, as % of assets



Source: Bank of Russia, calculations by IEP

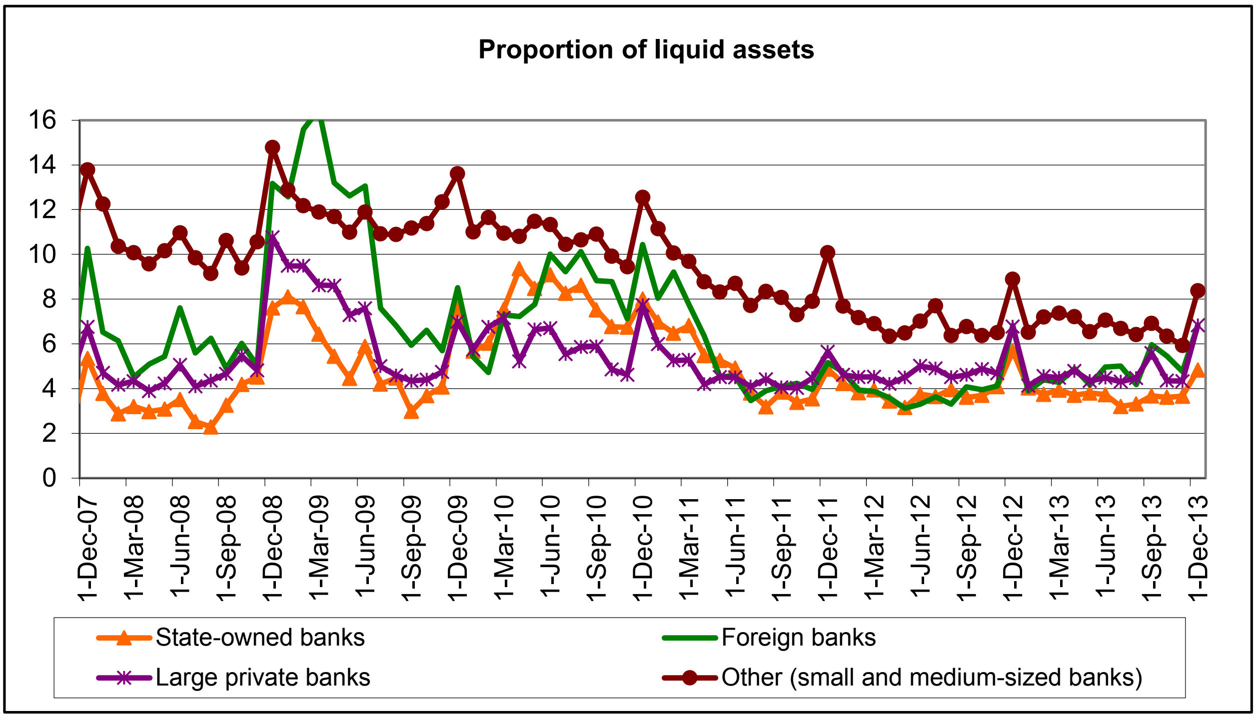
In this situation of liquidity deficit and an excess of loans over deposits for the non-financial sector, the stability of small and medium-sized banks (those not included in the top 30 or top 100) is decreasing sharply[6]. Normally, smaller banks require more liquid assets to sustain their

[6] Martin D. (1977). Early warning of bank failure: A logit regression approach // Journal of Banking & Finance. Vol. (1). P. 249–276.

current operations. This is related to a lack of diversification in the client base of small banks. A relatively large volume of liquid assets is required to support uninterrupted payment transfers where there is considerable volatility in clients' account balances[7].

Whilst in the large banks (included in the 30 largest banks by asset volume) the liquidity level[8] is being maintained at 4% of assets, for small banks the liquidity level had been at 10% of assets before the 2008-2009 crisis (see Fig. 2). In 2011 the liquidity of small banks decreased to 8% and since 2012 it has been between 6-7%. This evidences the decreasing stability of small banks in recent years.

Fig. 2. Ratio of liquid assets to total assets by type of bank group, %

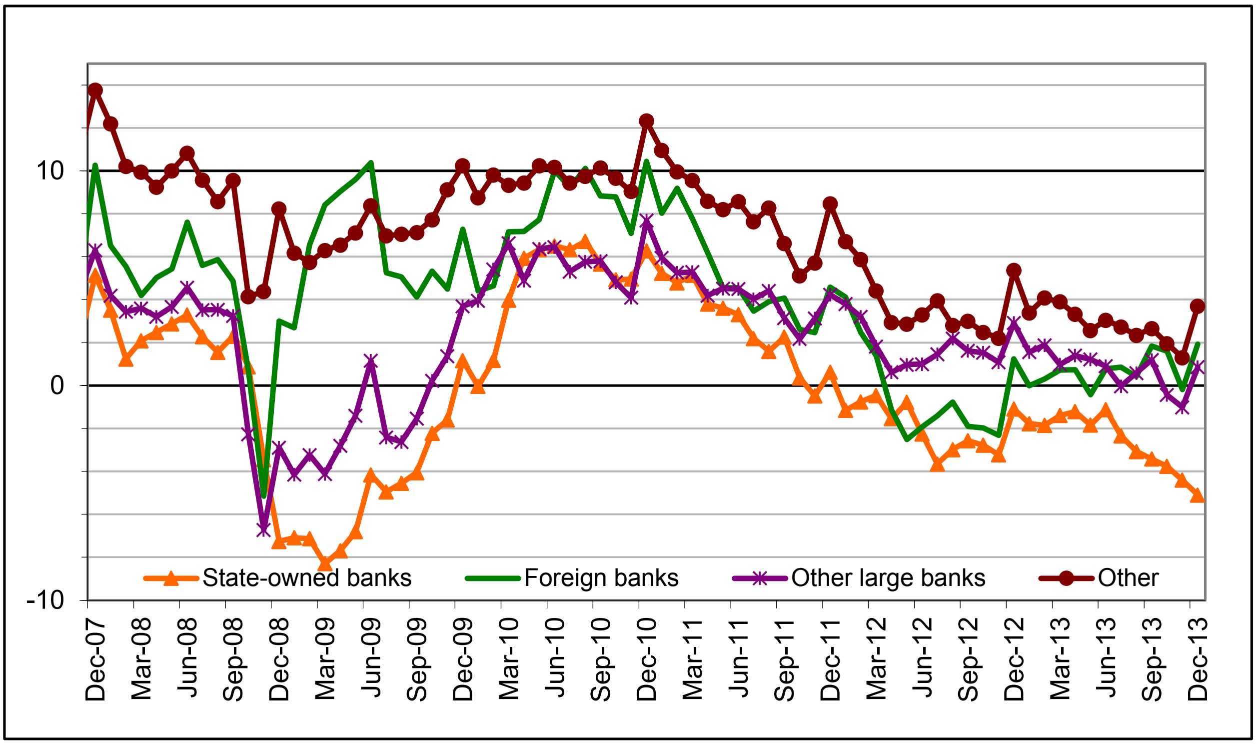


Source: Bank of Russia, calculations by IEP

One of the factors determining the decrease in liquidity of small banks was their limited access to refinancing by the Bank of Russia. In 2013 about two thirds of the total volume of refinancing of the banking sector was accounted for by the large state-owned banks: Sberbank, the VTB group, Gazprombank and the Russian Agricultural Bank. The result of this has been that, for more than two years (since October 2011), the own liquidity[9] of the state-owned banks has been negative (see Fig. 3). In recent months the own liquidity of all the large banks also reached zero, with stable levels of liquid assets.

[7] Hwang Dar-Yeh, Lee C.F., Liaw K.T. (1997). Forecasting bank failures and deposit insurance premium // International Review of Economics & Finance. Vol. 6(3). P. 317–334.
[8] Ratio of liquid assets (cash on hand in banks, correspondent and deposit accounts in the Bank of Russia) to total assets.
[9] Liquid assets, excluding Bank of Russia loans. The analogue indicator of "non-borrowed reserves" in the FRS balance sheet.

Fig. 3. Ratio of liquid assets, excluding Bank of Russia loans, to the total assets by type of bank, %



Source: Bank of Russia, calculations by IEP

2. Consumer lending

As was stated above, one of the reasons for the deterioration of the situation with liquidity in the banking sector has been the fast growth of credit activity in the area of consumer lending. However, in addition to its threats to the stability of the banking sector this process can have more serious consequences from the point of view of total demand and wealth in the economy.

The growth of household debt on bank loans is gradually slowing down. In 2013 the retail loan portfolio of the banking sector increased by 27.9%, which is higher than in the two previous years (2012 — 38.8%, 2011 — 36.1%). The volume of loan indebtedness had reached Rb 10.7 trillion as of 1 January 2014, which is 25% of the disposable income of households, or 16% of GDP. By world standards, these values are not very high. For example, in the U.S. in 2007 indebtedness of the population on mortgage and consumer loans exceeded 90% of GDP, although this decreased to 78%[10] based on the results for 2012.

However, despite the modest figures of total loan indebtedness, the situation with the solvency of the population has become threatening. Based on the results of 2013, the planned debt burden on population income reached 12% of the value of the disposable income of households[11]. This value includes debt principal repayments in accordance with loan repayment schedules and the payment of interest. Actual payments differ from the schedule, normally exceeding it, due to the considerable value of early repayments. For example, based on the results for 2013, the total volume of payments of the population to banks under loans exceeded 20% of available income.

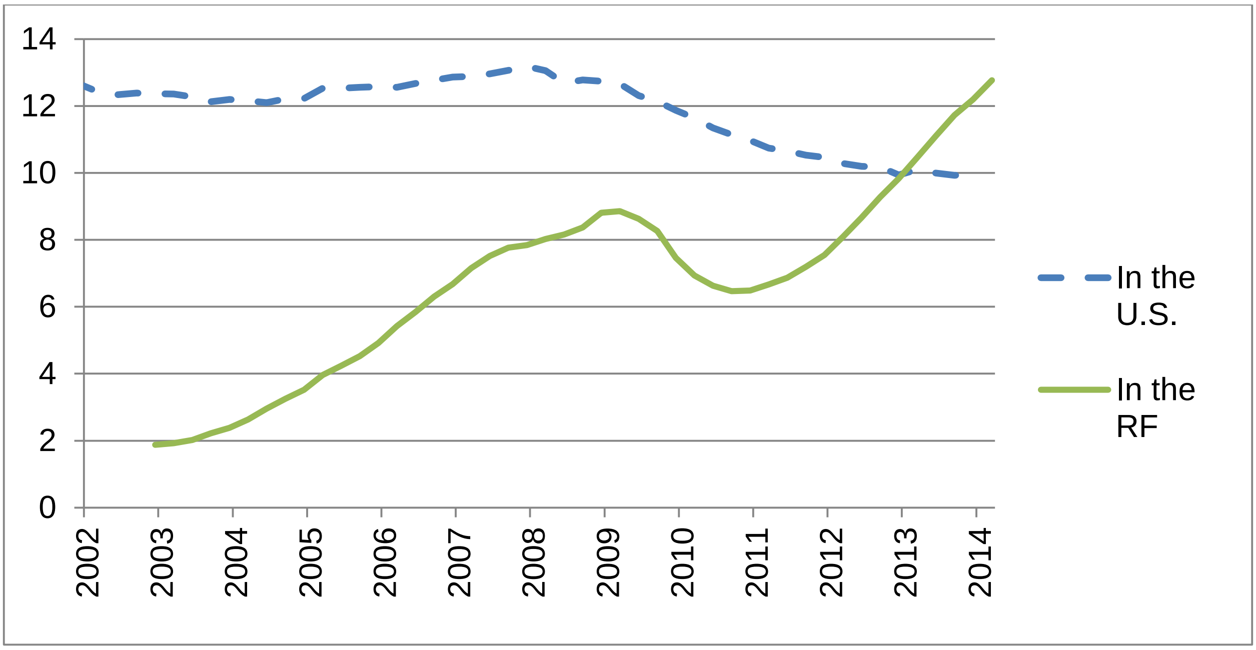
However, the statistics do not allow us to identify only those who borrow from banks and so payments under loans made by bank customers can only be related to the overall income of the population. In reality the credit load on income for borrowers should therefore be higher. According to our estimates, it can reach 40-50% of the borrower's income.

In the U.S., where the relative level of indebtedness of the population is 4-5 times higher, the load of servicing and repayment of loans with available income is even lower than in Russia, and did not exceed 10% in 2013 (see Fig. 4).

Fig. 4. Servicing of household debt as % of their available income

[10] According to the U.S. Federal Reserve System.

[11] Estimate by the IEP on the basis of data from Rosstat and the Bank of Russia.



Source: FRS, Bank of Russia, Rosstat, IEP estimates.

The main reason for this paradox is that the debts of Russian citizens are short and expensive. The average life of a loan from a Russian bank to individual borrowers, in accordance with the payment schedule, is a little more than 2.5 years, including medium term mortgage loans of just under 8 years.

Moreover, the data from bank reports for 2013 evidence that the average profitability of a retail loan portfolio exceeds 18% per annum, excluding commissions, additional insurance and other encumbrances. However, one must take into account that one quarter of the total volume of loans were provided for the purchase of residential property at the lower rate of 12% per annum. Hence, the other loans cost even more. The available bank reports do not allow for estimation of the interest rates under various types of loans but only disclose the currency and temporal structure of interest rates. In 2013 ruble loans for a period of less than 1 year were provided at an average rate of 24-25% per annum. The average rates for loans provided for a period of over one year decreased from 20-21% in the first half-year to 18-19% per annum in the second. However, the average weighted interest rate under retail loans, calculated as a ratio of interest payments to the average debt volume, continued to grow until the 4th quarter of 2013.

The main reason for the high demand for banking loans on the part of the population is the desire to maintain a certain level of consumption. The increase in income in 2011-2013 was less than the growth in consumption and the difference was covered, inter alia, by bank loans. Recently, the necessity to service loans that had been received previously has become an additional factor in the demand for loans. This is confirmed by data from the largest credit agencies, according to which the share of borrowers who have more than one loan increased sharply. However, it also appears important that the decline in growth of the loan portfolio to the level of interest rates (18-20%) will nullify the macroeconomic effect of the growth in lending to the population. In this case, at the level of the household sector in general, the entire growth in the volume of loans will be used to pay interest under existing indebtedness, and bank loans will no longer provide for additional consumer demand.

From the point of view of the stability of the banking system this will be a very negative factor, since any possible decrease in the income of the population will result in an inability to service and repay the existing loan portfolio, that will eventually result in an increase in the share of non-performing consumer loans and the further aggravation of liquidity problems.

3. Reduction in the number of banks

In 2011 the process of strengthening control over the functioning of the banking system began, however, until the new management of the Bank of Russia had been appointed, it proceeded very slowly. In 2013 the Bank of Russia revoked the licences of 32 banks and another two were subject to reorganisation procedures. 26 of these banks had been licensed to work with individuals and the deposits in these banks were subject to compensation by the Deposit Insurance Agency.

Licences were revoked mainly from small banks. The average volume[12] of the assets of these banks amounted to Rb 10bn. Without taking into account the largest two banks included in the top 100 by asset volume, Master-Bank and Investbank, the average volume of assets of the banks whose licences were revoked amounted to Rb 5bn. 17 banks out of the 32 were registered in the Moscow region, another 7 in the North Caucasus Federal District (Dagestan and North Ossetia), two in each of Samara and Smolensk, and one in each of Tula, Lipetsk, Tver and Chelyabinsk. For some of these regions their banks had occupied a significant place in the regional market for banking services before their licences were revoked. For example, the Tula bank First Express owned 62% of the bank assets registered in the Tula region and the banks Smolensky and Askold owned 84% of the bank assets registered in the Smolensk region.

Among the reasons for the licence revocations were the following: loss of own funds, absence of necessary reserves, non-compliance with instructions of the supervisory authorities, doubtful transactions, actual cessation of activities of the credit institution, payment for sham imports, disbursement of large amounts of a doubtful nature, incomplete identification of the bank's customers, etc.

[12] Information on the banks whose licences were revoked is laid out as of the last reporting date preceding the date of licence revocation.

Private depositors had placed funds with a total value of over Rb 170bn in the banks which lost their licences in 2013. The DIA liability under these insured events was Rb 125bn. In January-February 2014, eleven more licences were revoked from banks whose total assets amounted to about Rb 60bn and the funds invested by individuals exceeded Rb 25bn. These cases have increased the DIA liability to depositors by Rb 20bn, according to preliminary estimates.

The policy of the Bank of Russia that activated the process of licence revocation has received somewhat conflicting responses from the banking community and the banks' customers. On the one hand, it is perceived as a positive signal evidencing a change in policy of the Bank of Russia and its intention to carry out consistently the process of a systemic rehabilitation of the banking system. It is necessary to cleanse the banking system of those banks which have potential problems with repayment ability (negative capital), of banks carrying out illegal transactions, and of captive banks which mainly service one or a few related customers.

On the other hand, the fact that, amongst the banks whose licences were revoked, there is a range of significantly large ones (that are included in the top 100 by asset volume or have important positions in individual local markets) has aroused a quite predictable panic in many bank depositors and customers. Obviously, just the idea that most banks carry out illegal transactions (regardless of whether this is true or not) is sufficient for the banks' customers to assume that there is the possibility of licence revocation from almost any bank (with the exception, perhaps, only of those banks with government participation in capital, or of systemically important banks).

Regardless of the way in which the process of rehabilitation of the banking system which has been initiated is carried out, we should expect, and be prepared for, the following negative consequences.

1. Decreasing confidence amongst the depositors and creditors of many banks (especially the small, medium-sized and regional ones) will drive a flow of customers and deposits towards the largest banks, especially those with government participation in their capital. The first evidence of such an outflow of customers from small banks to the large ones could be observed in the results for November 2013 and in December the process had obviously intensified. At the end of 2013 the three major segments of the banking market (servicing of individuals and legal entities and the retail lending market) recorded a decrease in the absolute volumes of deposited funds and of debts on retail loans in the small and medium-sized banks, whilst large banks, principally the state-owned ones, saw an upward acceleration of these.

2. Such increasing concentration in the banking sector may naturally lead to a decrease in competition, and an increase in the market prices for banking services[13].

[13] Barros F., Modesto L. 'Portuguese banking sector: a mixed oligopoly?', International Journal of Industrial Organisation, 17, 1999.

3. Resolving the financial problems of those banks whose licences have been revoked by using the DIA funds creates disincentives for the owners and managers of potentially problematic banks, so, rather than taking measures to improve, they may withdraw assets, on the assumption that it will soon be their turn for licence revocation[14].

4. If any large banks (including the 50 largest ones) face problems, it will only be possible to use the mechanism of licence revocation with appropriate additional capitalisation by the DIA[15]. This means that an increase in supervision over those banks categorised as systemically important, will become even more urgent.

5. One can expect the organisation of regular information attacks on individual banks, including the use of unfair competition tactics, which could result in self-fulfilling crises, including for those banks which do not, in fact, have any serious problems.

6. Initiating the rehabilitation of the banking system has created not only an atmosphere where clients distrust the banks, but also distrust within the banking system itself, which could result in a shrinking of the inter-bank loan market and a slowdown of liquidity transmission in the economy.

7. The implementation of measures for rehabilitation of the banks will result in an increased pressure on the management of the Bank of Russia, and of all governmental authorities, in order to stop this process because of the growth in the above negative consequences.

We believe that the campaign for rehabilitation of the banking system which has been started by the Bank of Russia is, certainly, necessary. The existence in the Russian banking system of a large number of non-transparent banks, many of which are of a semi-criminal nature, considerably decreases trust in the sector, its stability and the investment attractiveness of Russia as a whole. This is why, in order to move to balanced growth, it is necessary to continue decisive actions aimed at cleansing and consolidating the banking sector. Consistent single-point work for the identification of banks showing the most obvious signs of conducting illegal banking activities should be continued (violations of the regulations of the Bank of Russia, maintenance of obviously low equity levels, regular detection of signs of suspicious banking transactions, noticeable quantities of transactions for ghost companies, etc.).

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[14] Demirgüç-Kunt A., Detragiache E. (1998). The determinants of banking crises in developing and developed countries // IMF Staff Papers.
Vol. 45(1). P. 81–109

[15] The size of the Obligatory Insurance Fund at the beginning of 2014 was Rb 154bn, or Rb 128bn, taking into account the reserve for payments under insured events. Considering that the average amount of liability of the DIA is about 70% of all the deposits in banks with licences revoked in 2013, this amount of funds is no longer sufficient to cover a single insured occurrence for those banks included in the top 10, or for covering more than one occurrence for banks in the second ten, in terms of the amount of funds attracted from the population.

Cleansing of the banking sector should be performed with the minimum of consequences for private clients and small businesses. In particular, a decrease in the negative impact on the economy and the banking system can be achieved by starting the rehabilitation process with banks that have minimum participation in the market for deposits by the public or minimal regional importance, excluding, of course, any cases used to prevent obvious bankruptcy of a bank or the dishonest behaviour of its owners. Such an approach would decrease the risk of self-perpetuating panic amongst the banks.

Furthermore, in our opinion, the policy of the Bank of Russia should be supplemented by three other areas of activity, which are: the consolidation of the banking system, increased supervision over systemically important banks and the privatisation of banks which currently have government participation. The enlargement of banks by toughening the minimum value of authorised capital requirement, on the one hand, will allow the removal of small problematic banks, not by making painful single-point decisions, but through a previously announced policy requiring an increase in the amount of the authorised capital. On the other hand, the sharp reduction in the number of banks caused by this policy will enable the central bank to increase its real control over the remaining institutions within the banking system. An active continuation of licence revocation without the above measures may lead to banking panic (and an outflow of deposits from the banking system) and to disruption of the normal functioning of the system of settlements between companies, as a result of economic agents (both banks and their customers) not understanding the quantitative benchmarks and scale of reduction of the banking system[16].

4. Consolidation of the banking system

Consolidation of the banking system should be carried out by increasing the requirements for a minimum amount of authorised capital for banks, regardless of the date of their incorporation. Under Strategy-2020[17], we proposed to increase the minimum level of banks' authorised capital to Rb 1bn from 2013, and to Rb 3bn from 2015. Rehabilitation of the banking system using this approach also requires not only improved supervision, and action by the Bank of Russia, but also assumes a reduction in the scale of doubtful transactions, as a result of the increased risk of their detection (taking into account the reduction in the number of banks) and the greater value of the possible losses if they are detected (on account of the investment of additional equity in the

[16] An alternative approach could be the announcement of a policy for the preservation of commercial banks of any size (with a possible differentiation of licences depending on the amount of authorised capital), however, until recently, the major emphasis was on an increase in the banks' authorised capital as an ultimate goal of state policy (see "Strategy for Development of the Banking Sector of the Russian Federation for the period until 2015".

[17] See website http://2020strategy.ru/ and the publication "Strategy-2020: The New Model of Growth — New Social Policy. Final Report on the Results of Expert Work on Topical Issues of Social and Economic Strategy in Russia for the period until 2020", Book 1.2, under scientific editing by V.A. Mau, Ya.I. Kuzminova — M.: Publishing House "Delo" at the Russian Presidential Academy of National Economy and Public Administration, 2013.

authorised capital). This reduces the attractiveness of the functioning of banks that do not perform the full range of banking activities.

However, discussion of these ideas within the expert community has not persuaded decision-makers of the feasibility of this approach. As a result, minimum equity was increased only to Rb 300m. As practice has shown, this increase was obviously insufficient. Banks with only a small capital are not able to ensure a sufficient volume of assets for the performance of bank transactions based on market principles, they are either captive, or perform transactions which are not typical banking activities in the full sense of the word, or they specialise in carrying out illegal transactions.

The terms set out for increasing the required amount of authorised capital could be quite soft. For example, Rb 1bn — from 1 January 2015, Rb 3bn — from 1 January 2018, Rb 5bn — from 1 January 2020. On this basis, those banks whose owners are not able to find sufficient funds for their capitalisation or to find partners with which to merge to form larger structures will have either to close or to have their banking licence reissued to allow performance of the activities of a non-banking credit institution, or of a specialised bank with a limited licence. Specialised banks with limited licences may include banks with capital of not less than Rb 1bn, performing transaction in niche markets, requiring special knowledge, such as the provision of loans to highly technological small business, and the provision of loans for certain types of transactions (sea transport, low-rise construction, etc.).

As of 1 January 2013 there were 923 credit institutions in the RF, including 64 non-banking facilities and 859 banking facilities. Currently, the minimum equity for a newly created bank is Rb 300m, but for them to obtain a general licence the capital has to be Rb 900m[18]. As of 1 January 2014 there were 237 credit institutions with the equity below Rb 300m. The additional capitalisation required for these credit institutions to reach a capital of Rb 300m will require a total of Rb 26bn this year.

A decision on the implementation of a phased increase in the requirements for bank equity should take into account the following considerations.

- The Management of the Bank of Russia will face maximum pressure just before and after the announced dates for raising the minimum amount of equity. However, any softening or postponement of such deadlines will, in fact, mean rejection of the policy of putting the banking system in order, whilst a strict compliance would mean a sharp decline in trust in those banks whose authorised capital might be close to the established limit (regardless of its exact value) and

[18] Permitted by the Law 'On Banks and Banking Activities' for banks incorporated before 1 January 2012 with capital of not less than Rb 180m.

in those banks which could be in breach of the established requirement at the subsequent announced date.

- Similarly, adopting the solutions being discussed sets a clear time horizon for the withdrawal of assets by bank owners who do not intend to increase their capital. Increased control over all such banks is difficult for the same reason as is the continuous monitoring of all 900 Russian banks at the moment — there are too many of them. Therefore it is necessary to identify the risk criteria and focus control on the group of banks which are at the highest risk, from the point of view of possible dishonest behaviour by their owners.

- Frontal charter capital increase means the elimination of “niche” and local banks (the transformation of banking institutions into non-banking financial institutions) extending the range of services provided by the system and creating competition in the local markets[19]. In this case strict deadlines for the toughening of capital requirements will help build the rehabilitation process with greater clarity and without the necessity to make too many complex discretionary decisions related to the revocation of bank licences and with less danger of destabilisation of the financial system.

Authorised capital can be increased in two ways — either by owners making additional contributions, or through a merger (acquisition) transaction. The proposed increase of the minimum amount of capital to Rb 1bn will affect over 550 credit institutions, whose additional capitalisation in this case will require Rb 340bn, which is 1.5 times higher than the existing capital of these banks (Rb 210bn).

Formally, as a result of mergers and acquisitions, out of 550 banks with capital lower than Rb 1bn, 210 banks with capital of Rb 1bn can be created, which implies a reduction in the number of operating credit institutions by 343 units, as an extreme case in the absence of additional investment in the banking sector. However, the reduction in the number of banks could be more considerable, due to objective difficulties in conducting the mergers and acquisitions of small banks (conflicts of interests amongst owners, different strategies of development, etc.).

Corresponding indicators for the different values of restriction on the minimum amount of capital of credit institutions are laid out in Table 1.

Table 1. Assessment of the influence of changes in the requirements for the minimum capital on the number of operating credit institutions as of 1 January 2014

Minimum capital of credit institution	300m	1bn	3bn	5bn

[19] In order to mitigate the negative consequences arising, countervailing measures related, for example, to the introduction of the above mentioned limited banking licence could be introduced. At the same time, these measures should be determined in advance, simultaneously with announcement of the minimum levels of authorised capital so that small banks, acting in good faith, could choose and announce to their customers programmes of reorganisation in the future. The conduct of required law-making and administrative work requires sufficient time for clear development of all the decisions relating to increases in the minimum authorised capital.

Number of credit institutions with a capital less than the minimum	237	553	726	785
Aggregate capital of credit institutions without "additional capitalisation"	45	210	497	722
Additional capitalisation requirement, Rb bn	26	343	1681	3203
Number of credit institutions with a minimum capital and aggregate capital equal to the capital of credit institutions without "additional capitalisation"	150	210	166	144
Potential decrease in the number of credit organisations	87	343	560	641
Potential number of operating credit institutions capable of maintaining the total volume of capital	836	580	363	282

Source: the Bank of Russia, bank reports, calculations by IEP

Thus, according to our rough estimates, in the case of establishing requirements for equity in the amount of Rb 1bn, the number of banks (in the absence of specialised regional banking licences) in the Russian Federation would be reduced to 580 units; if the limit is established at Rb 3bn, the reduction is to 363 units, whilst at Rb 5bn, to 282 units. This reduced number of banks would enable the Bank of Russia to carry out prudent supervision much less formally than it is conducted at the moment.

Raising the authorised capital requirements affects the degree of concentration and competition in the banking sector. Hence, we can highlight both positive and negative effects of toughening this condition of the licences for banking activities. The positives are:

- reduction in the cost of borrowing for the economy due to the effect of economies of scale on the cost of funding;
- creation of banks of an international size;
- increase in the efficiency of distribution of financial resources amongst different sectors and individual economic activities — large banks have greater possibilities for diversification of their resource base and in the directions of investing their assets;
- simplification of banking regulation and supervision, and a reduction in the relevant costs.

At the same time, the following negative effects can be identified:

- reduction in competition in the key banking markets;

- possibility of destabilisation of regional economic systems in times of crisis since large banks may prefer the strategy of curtailing their business in the crisis regions, whilst regional banks would try to persist with their activities in order to survive the crisis;
- risks of systemic instability due to the growth of influence of banks which are “too-big-to-fail” and, hence, greater costs during the reorganisation of systemically important banks.

However, it is evident that larger, systemically important banks (including private banks), will have more opportunities from the point of view of access to transactions with the Bank of Russia. Perhaps the possibility of becoming one of these banks will be a key incentive for mergers and the emergence of larger private banks.

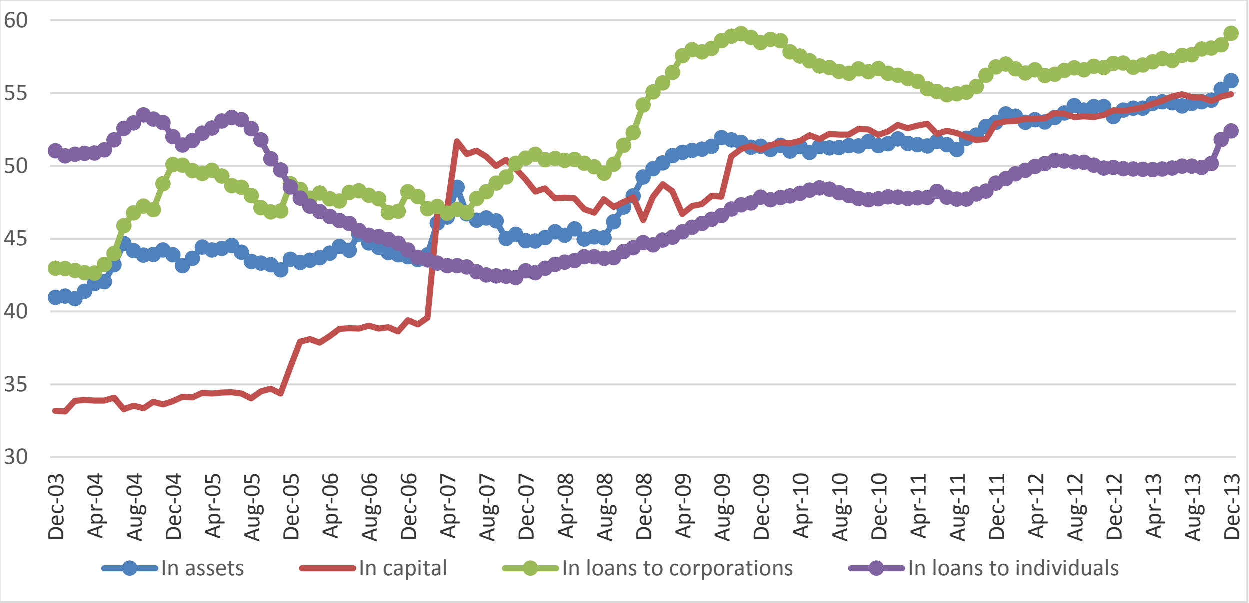
4. Increased of supervision of state-owned systemically important banks

At the moment federal banks, directly or indirectly connected with the state, constitute the core of the banking sector. In fact, the government acts as a dominant owner in the banking market. The predominance of government-related banks within the Russian market is explained by the lasting effect of a range of factors:

- inheritance of Soviet infrastructure in the banking sector;
- servicing of the financial needs of the state (including the placement of considerable volumes of budgetary resources at different levels) and of state corporations and companies with state participation in their capital;
- economy of scale, meaning that state-owned banks are leaders in terms of profitability, having proportionally lower costs and the opportunity to attract cheap international loans;
- administrative support from the government and reputation for stability;
- the concentration of liquidity provided by the Bank of Russia in the state-owned banks.

As a result of the continuous growth of state-owned banks, from 1 January 2007 to 1 January 2014 the share of the largest state-owned banks in the total volume of bank assets increased from 44% to 56% (see Fig. 1), and Russia started to be included in the small group of countries with strong state ownership in the banking sector. In the Eurasian region, state-owned banks dominate only in those countries which are at the beginning of the path of market reforms. Apart from Russia, state-owned banks account for over 50% of the market in only three other countries: Uzbekistan, Belarus and Turkmenistan. Thus, in these economies, as in Russia, such banks play a “systemically important” role. The consequences of the state-owned nature of the banking sector have both positive and negative sides.

Fig. 1. Proportion of state-owned banks in certain segments of the banking market



Source: Bank of Russia, calculations by IEP

Note: Sberbank of Russia, the VTB group banks, Gazprombank, the Bank of Moscow and the Russian Agricultural Bank are considered as state-owned banks.

On the one hand, the government can count on the high stability of the banking sector during financial shock; the state-owned banks are under government control, the Bank of Russia is exposed to minimal credit risks in the case of refinancing and the refinancing system works steadily.

On the other hand, the negative effects result from governmental use of state-owned banks as financial agents. While private banks are concerned with the maximisation of profits, and capitalisation, the state-owned banks do not have such a clearly stated functional target. However, they do have the opportunity to carry out the full range of activities of commercial organisations with preferential treatment from the state, including priority in attracting budgetary funds. Moreover, banks with government participation have additional non-market competitive advantages due to the possibility of using the financial and administrative resources of the state. Finally, as was discovered in the post-crisis period, by using implied guarantees of state support, large banks may be involved in risky transactions of doubtful nature (the Bank of Moscow and the Russian Agricultural Bank are examples of this).

Special attention should be paid to asset quality indicators and to market risks. The regulator should express a keen interest in financial stability indicators (non-performing loans, the distribution of portfolios by sector and industry, the foreign currency position, income from trade transactions within the total income, etc.). The increased requirements of key indicators are aimed at limiting the appetite of large banks for risk whilst relying on governmental support in the case of difficult situations.

A crisis tends to spread through systemically important banks onto other agents of the financial sector, and then further, into the real economy sector. In our opinion, the largest banks should be subject to special banking regulation. Currently, the Bank of Russia treats all credit institutions equally in terms of prudential standards. Moreover, de-facto the largest banks are subject to even more lenient requirements. There has been more than one occasion when the Bank of Russia has turned a blind eye on violations of the capital adequacy of Gazprombank and has not paid attention to the potential threat to other large banks, such as Mezhprombank and the Bank of Moscow. In certain cases the regional branches of the Bank of Russia have unreasonably raised the credit quality categories of large banks in order to reduce the pressure on their own capital due to rising loan-loss provisions. However, if we take into account that systemically important banks are sources of systemic risks for the entire sector, they should be subject to stricter requirements and to closer scrutiny than all other banks.

The following measures to optimise government participation in the banking sector seem realistic at present. Firstly, options should be considered for partial privatisation of the largest state-owned banks, to diversify their ownership structure. Secondly, it is necessary to limit the unreasonable growth of state-owned banks due to their use of budgetary and administrative resources as this leads to competitive distortion. Thirdly, state ownership in the banking sector should be optimised, completely eliminating the share of ownership of government in any banks outside the top 5 largest banking institutions.

At the same time, the privatisation of state-banks will allow an increase in the effectiveness of corporate management, the creation of a market for bank shares, an increase in the capitalisation of banks and an improvement in the macroeconomic performance of the banks. However, in planning the future of state-owned banks, the composition of their potential owners should be taken into account. In the domestic market there is a shortage of savings, and, as a result, the main volume of investments may be attracted only from abroad, although, with the continuing risks of investment in assets in developing markets in general, an inflow of foreign capital in sufficient volume also seems unlikely.

The combination of the processes for increasing the authorised capital requirements and the privatisation of those banks with government participation will stimulate the interest of the owners of private banks to join the capital of state-owned banks and, hence, to form large private banking institutions. These banks should occupy the niche for systemically important banking institutes and become the basis for a more stable and diversified banking sector, ready to meet the challenges of Russian economic development, to create a new growth model and to reinforce the national financial sector.