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## Bank supervision Russian style: rules versus enforcement and tacit objectives

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Sophie Claeys, Gleb Lanine, Koen Schoors

# Bank supervision Russian style: Rules versus enforcement and tacit objectives



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Sophie Claeys, Gleb Lanine and Koen Schoors

## Bank supervision Russian style: Rules versus enforcement and tacit objectives

### Tiivistelmä

Tässä tutkimuksessa tarkastellaan keskuspankin kahden keskeisen tavoitteen – yksittäisen pankin vakauden ja koko rahoitusjärjestelmän vakauden – potentiaalista konfliktia. Tutkittavana on, miten Venäjän keskuspankki on peruuttanut pankkien lisenssejä vuosina 1999–2002. Näyttää siltä, että lisenssin peruuttaminen on epätodennäköisempää, kun on kyse niistä pankeista, jotka toimivat aktiivisesti interbank-markkinoilla. Lisäksi jotkut pankit ovat ilmeisesti liian suuria, jotta niiden pankkilisenssi voitaisiin helposti peruuttaa. Myös pankit, jotka toimivat seuduilla, joilla on vähän pankkeja, näyttävät olevan paremmin turvassa lisenssin peruuttamiselta. Venäjän keskuspankki on myös haluton peruuttamaan pankkiluvan sellaisilta pankeilta, joilla on enemmän talletuksia suhteessa omaan pääomiin kuin on luvallista. Näyttää siis siltä, että keskuspankki välittää koko rahoitusjärjestelmän vakaudesta ja tallettajien luottamuksen säilyttämisestä.

Asiasanat: pankkivalvonta, pankkikriisit, Venäjä



# Bank Supervision Russian Style: Rules versus Enforcement and Tacit Objectives\*

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## Abstract

We focus on the conflict between two central bank objectives – individual bank stability and systemic stability. We study the licensing policy of the Central Bank of Russia (CBR) during 1999–2002. Banks in poorly banked regions, banks that are too big to be disciplined adequately, and banks that are active on the interbank market enjoy protection from license withdrawal, which suggests a tacit concern for systemic stability. The CBR is also found reluctant to withdraw licenses from banks that violate the individual's deposits-to-capital ratio as this conflicts with the tacit CBR objective to secure depositor confidence and systemic stability.

*Keywords:* Bank supervision, bank crisis, Russia.

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# 1 Introduction

Considerable attention has been paid to the various roles of central banks – setter of monetary policy, lender of last resort, banking supervisor, and maintainer of the payments system and financial stability – as have some of the complementarities and conflicts arising out of these multiple functions. Kaminsky and Reinhart’s (1999) finding that crises are often preceded by relaxed monetary policy, asset price bubbles and lending booms suggests that there exists a trade-off between monetary policy and systemic stability. For example, central banks that pursue a too narrow price stability objective may, through an accommodative monetary stance, induce a lending boom and asset price inflation. This increases the risk of systemic instability, as was the case in the Nordic bank crises of the early nineties. They also found that most crises were preceded by financial liberalization, probably because the financial liberalization was incomplete or not followed by appropriate regulation and supervision in the newly liberated financial sectors. This suggests another trade-off, namely one between systemic stability and individual bank supervision. In their seminal paper, Peek, Rosengren, and Tootell (1999) conclude that the implementation of monetary policy may benefit from information obtained by prudential supervision and control of the banking system. This finding has heated the debate as to whether bank supervision should be assigned to the central bank or not (Di Noia and Di Giorgio, 1999). The possible conflicts arising from the coexistence of lender-of-last-resort and deposit insurance functions have also been studied (e.g. Sleet and Smith, 2000; Repullo, 2000).

In this paper, we devote our attention to the conflict between systemic stability and individual bank stability, which are explicit objectives for many central banks. To assure systemic stability, central banks typically take on the role of lender of last resort. This comes at the cost of moral hazard by individual banks. This problem can be mitigated through adequate prudential regulation and control (see Dewatripont and Tirole, 1994), which in several countries is in the hands of the central bank too. Bank supervision is meant to give individual banks an incentive to take less risk and thereby alleviate the moral hazard of individual banks that are confronted with a lender of last resort. The strict enforcement of bank regulation may however endanger systemic stability and draw the regulator to a policy of regulatory forbearance, which again creates moral hazard.

In short, individual and systemic bank stability are sometimes conflicting objectives, so rule-based supervision of individual banks may be inconsistent with the objective of systemic stability. This could for example occur when the regulatory failure of a money-center bank or a large deposit

bank threatens to affect trust in the interbank market or the deposit market respectively, giving rise to contagion and inflating the risk of systemic instability. This inherent conflict is even present in central banks that have neither systemic nor individual bank stability as explicit objectives – all central banks need a stable banking system to be able to conduct effective monetary policy.

The economic literature often refers to this tension created by bank supervision and lender-of-last-resort functions, yet there is no conclusive theory that explains how these roles should be balanced. The quaint Bagehot rule of 1873 (“lend freely to illiquid but solvent banks at a penalty rate”) is still defended by many authors. Goodhart (1988, 1995) puts forward that liquidity should not be denied to any bank a priori, since the difference between illiquidity and insolvency is sometimes hard to discern. Goodhart and Huang (1999) propose that central banks should reduce the moral hazard of individual banks by employing a policy of constructive ambiguity in the bailout decision. Other authors dispute this harsh policy and claim that softer policies will induce truthful reporting of asset quality and ultimately lead to cheaper bank rescues and higher systemic stability (see Povel, 1996; Aghion et al, 1999). Cordella and Yeyati (2003) claim that an ex ante central bank commitment to a bailout contingent on adverse macro-shocks is welfare-superior to a policy of constructive ambiguity. Freixas, Parigi, and Rochet (2000) show that, when all banks are solvent, it is optimal for the central bank to prevent a speculative gridlock in the payments system by guaranteeing the credit lines of all banks. Individual bank insolvency, however, should be solved by orderly bank closure, whereby the central bank bypasses the insolvent bank in the interbank network to avoid contagion. They also show that it may be optimal for the central bank to show forbearance towards money-center banks, which is their interpretation of the too-big-to-fail hypothesis (see Wall and Peterson, 1990).

Central banks also have several more obscure incentives for regulatory forbearance. Boot and Thakor (1993) show that regulatory discretion urges reputation-seeking regulators to show more-than-optimal forbearance, since they want to avoid failures on their books and leave their jobs with a clean slate. This tendency to resumé polishing suggests that a rule-based prudential control might be better. Mailath and Mester (1994), on the other hand, show that if regulators cannot commit themselves, temporary forbearance may be the equilibrium outcome. In this vein, Acharya (1996) also finds that regulatory forbearance may be optimal if the dead-weight losses of closure are important. Kane (2000) suggests that some banks may simply be too big to discipline adequately (TBTDA), which can lead to undesired de facto forbearance. Heinemann and Schüller (2004) analyze

how there may be a problem of regulatory capture (see Laffont and Tirole, 1991) by specific interest groups. When this is the case, one cannot be certain that the enforcement of prudential rules is optimal for welfare even in a situation of unthreatened systemic stability.

In short, there is no consensus in the literature as to how to strike a balance between individual and systemic bank stability when the central bank performs both prudential control and lender-of-last-resort functions.<sup>1</sup> We look at this question from an empirical angle by analyzing one of the most intriguing cases of central banking in recent history – Russia.

The Central Bank of Russia (CBR) is a young central bank. From its establishment in 1990, it was entrusted with the role of monetary policy, bank regulation, and bank supervision. The CBR also plays a central role in the money circulation and the payments system and has frequently acted as lender of last resort to secure systemic stability. In our data window, the CBR was active as a commercial bank through its giant subsidiaries, Sberbank and Vneshtorgbank. Hence, its objectives and the potential conflicts arising among them are manifold.

We specifically examine the CBR's supervision of Russian commercial banks. The CBR both designs the rules within the framework of the banking law and has sole authority to enforce them. This arrangement, in principle, should prevent turf wars between competing regulatory agents. In April 1996, the CBR announced a set of new and revised prudential regulations to which banks must comply to maintain their bank license. By setting bank standards, the CBR seeks to create incentives for banks to eschew risk.<sup>2</sup> However, such bank standards can only induce the desired effect on bank risk-taking if banks expect enforcement. Proper enforcement dictates license withdrawal as the ultimate penalty for banks that repeatedly violate the rules. We refer to this as the regulatory failure of a bank. Regulatory forbearance by the CBR would impair the credibility of its own bank standards, resulting in soft legal constraints (see Perotti 2002).

The empirical question here is whether CBR de-licensing is driven by enforcement of its own supervisory bank standards or by other more tacit objectives related to the systemic stability of the banking system that may induce regulatory forbearance. We employ a quarterly panel of Russian banks in the period 1999–2002 and relate license withdrawal or lack thereof to standard economic

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<sup>1</sup>In developed economies, bank supervision has tended in recent years to increasingly fall under the auspices of a single authority without central bank involvement. Of course, it is not inconceivable that this trend might reverse in the long run.

<sup>2</sup>Although Blum (1999) demonstrates theoretically that the effect of e.g. capital rules on bank risk-taking is ambiguous.

variables (i.e. we control for economic failure), to tacit objectives by the CBR in the large domain of systemic stability, and to compliance with bank standards. Controlling for economic failure, we cannot reject the thesis that tacit CBR objectives skew the license withdrawal decision. We also find regulatory forbearance for certain bank standards.

More specifically, our results indicate regulatory forbearance by the CBR for large deposit banks (safeguarding depositor trust), banks that are active on the interbank market (safeguarding interbank market stability), and banks in already highly concentrated regional bank markets (safeguarding minimal bank competition). Hence, we can infer that the CBR cares about systemic stability, implying conflicts with rule-based bank supervision. We also find indications that the CBR leaves alone banks that are too big to be disciplined adequately. There is even weak evidence that banks that hold a large share of total government debt tend to be less likely to be subject to license withdrawal. In short, the biases in the CBR’s de-licensing behavior are best understood as the result of conflicting objectives at the heart of the CBR rather than as a case of pure regulatory discretion.<sup>3</sup>

The next section gives an overview of the Russian banking sector and the process of bank creation and destruction in Russia during the last 15 years. Section 3 explains our empirical approach, focusing consecutively on the data and the empirical hypotheses. In section 4, we estimate a panel logit model and interpret the results. In section 5, we perform a robustness check by estimating a survival model and reviewing the results. Section 6 concludes.

## **2 The Russian banking sector in a nutshell**

### **2.1 Problems of the Russian banking sector**

The Russian commercial banking sector suffered serious problems in its first decade of existence. And even today, Russian commercial banks have yet to adequately take up the role of intermediary between savings and investments.

Early in transition, banks clearly preferred speculation to lending (Schoors, 2001). Lending to the economy as a percentage of total banking assets sank year after year until 1999 and has not spectacularly improved since. In 2003, bank assets reached only 42.1% of GDP and loans

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<sup>3</sup>Malyutina and Parilova (2001) argue that the CBR bases its closure policy on discretion rather than on its prudential regulations. We argue other “tacit” objectives are at stake.

to the non-financial sector were still just 17.0%. Bank credits financed as little as 4.8% of fixed investment in 2003.<sup>4</sup> Yet this behavior appears quite rational in hindsight. The presence of soft legal constraints made it quite difficult for banks to enforce overdue claims. Bank lending was also depressed by huge information asymmetries between banks and their prospective customers, and by the lack of screening and monitoring skills in the banks themselves and the economy at large. Banks were unable to identify good potential borrowers (Brana, Maurel and Sgard, 1999), so they preferred not to lend at all. Moreover, the vast amount of tiny banks and the lack of a transparent information system about credit histories may have also depressed lending (Pyle, 2002).

The little lending that did take place was mainly to connected parties or to the government (under various forms), as witnessed in the August 1998 crisis when several large banks became illiquid and insolvent overnight after the government defaulted on its treasury bills. The widespread connected lending is partly explained by historical factors. The successors of the former specialized state banks were reluctant to restructure and continued to lend passively to their owners (Schoors, 2003). Moreover, many of the newly founded private banks had been captured by their dominant shareholders. Such “pocket banks” operated as treasuries for a firm or a group of firms rather than independent banks; they preferred “putting their money where their mouth is” to normal relationship lending. This made the problem of connected lending or insider lending omnipresent in Russia. Most banks now predominantly lend to connected agents, regardless of the viability of the lending project, and with only very weak monitoring incentives (Laeven, 2001). Note that the government, too, is to some extent a connected party, because several banks are captured by local, regional, or national governments. At the start of 2003, Russia had 23 banks in which the state (federal or regional authorities) held majority stakes, the regional authorities hold minority stakes in many more banks and a large number of state unitary enterprises were part-owners of banks (Tompson, 2004).

The problem of connected lending combined with the presence of soft legal constraints, information asymmetries and the lack of screening and monitoring skills implied that the Russian banking sector was riddled by bad loans well before the 1998 crisis. A leaked analysis of Russian banks after the crisis of August 1998 shows that the major cost for banks was not the devaluation loss or the government default on treasury bills (GKOs), but bad loans abandoned years earlier.<sup>5</sup> The banks merely hid these bad loans. Schoors and Sonin (2005) explain that the Russian banking system was

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<sup>4</sup>Data from the CBR Bulletin of Bank Statistics.

<sup>5</sup>See “The newly-wed and the nearly dead,” *Euromoney*, June 1999.

stuck in a passivity trap, whereby it was rational for banks to hide bad loans rather than attempt to collect them. The real growth that has taken place since 1999 has allowed Russian banks to “grow” their way out of bad loans, but we should keep in mind that in the end loan quality is a flow, rather than a stock, variable. It does not go away unless the nature of the flow changes.

The Russian banking sector has also suffered from poor capitalization when compared to liquid assets (deposits and interbank loans), especially considering the poor quality of assets and the large exposure to exchange rate risk.<sup>6</sup> This overexposure was revealed when the devaluation in August 1998 sent capital of many Russian banks from positive to negative overnight (Perotti, 2002). The CBR has steadily raised capital standards since 1999, but bank capitalization is still substantially lower in Russia than in developed banking markets. Our data also reveal that average capitalization is substantially higher than the weighted average capitalization, indicating that the largest banks have the weakest capitalization – not exactly a comforting finding. The difference is most pronounced when total bank deposits are used as weights, implying that the buffer of capital is lowest in the banks that need it most.

Over the years, many Russian banks have been liquidated or simply vanished. Sometimes this was due to a combination of the above-mentioned factors (poor capitalization, excessive speculative risk, endemic bad loans, connected lending, etc.), but there were also a large number of financial scandals and scams in which depositors were simply cheated by crooks who fled with their money. The extremely soft legal constraints faced by banks encouraged asset stripping by management and owners, leaving the creditors to bear the brunt of the cost of failure (Perotti, 2002). As a result, popular distrust of the banking system grew and depositors gradually shifted their money to Sberbank and Vneshtorgbank – two banks that are still largely in state hands (see OECD, 2004).<sup>7</sup> Sberbank has a huge branch network and carries a government guarantee. The government lent credibility to this guarantee by supporting Sberbank when needed and using it as a device to absorb deposits from large defunct deposit banks in the aftermath of the 1998 crisis. The same holds for Vneshtorgbank as demonstrated in the mini-crisis in May–July 2004, when Vneshtorgbank acquired Gutabank, one of the larger deposit banks under attack. As a result, Sberbank and Vneshtorgbank continue to dominate a highly concentrated deposit market. Figure 1 shows Herfindahl indices for deposits in several federal districts and reveals that deposit markets were highly concentrated in the period 1999–2002, although regional differences were substantial.

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<sup>6</sup>See, for example, Buch and Heinrich (1999).

<sup>7</sup>In 2004, ownership of Vneshtorgbank moved from the CBR to the state directly.



In the period under study, some regions enjoyed an acceptable amount of competition, while other regions exhibited high concentration. This can be seen in Figure 2 from the regional data on bank branches per capita. Regions have on average only two bank branches per 100,000 inhabitants, which is quite low by European standards. The large regional differences in concentration are demonstrated in Figure 3, that exhibits regional Herfindahl indexes for bank assets. The absence of a national market can also be seen directly from the substantial differences in regional interest rates (and even exchange rates),<sup>8</sup> a situation only possible in fragmented markets. Note that the deposit market (Figure 1) is even more concentrated than the banking sector as a whole (Figure 3).

**Insert figures 1 to 3 here**

Restructuring of the banking sector was clearly long overdue already in 1998. Several observers and notably the IMF repeatedly expressed hope that the 1998 crisis would finally urge the CBR to undertake serious bank restructuring. In the immediate aftermath of the crisis, the CBR indicated it expected 400 to 600 banks to disappear. These expectations were quickly dashed, mainly because the banks themselves faced soft legal constraints. Many of the Russian banking system's most salient characteristics persist to this day.

## **2.2 An overview of bank creation and bank destruction in Russia**

Before analyzing the bank licensing behavior of the CBR in more detail, an introductory description of the main trends in CBR bank licensing may be appropriate.

**Insert figure 4 here**

Figure 4 shows the detailed dynamics of monthly bank creation and destruction in Russia. It is based on data posted on the CBR website. The solid line shows new bank registrations, while the dotted line shows bank licenses withdrawn in a given month. We first turn to bank creation. There is a striking peak of bank creation at the end of 1990: 228 banks were created in October 1990, 347 in November 1990, and 269 in December 1990. This peak is to a large extent explained by the secessionist privatization of the former state banks (*spetsbanki*) that started in 1988 (i.e. well before the collapse of the Soviet Union in December 1991) and initially continued unattended. This secessionist privatization yielded over 600 often unrecognizable state-bank successors as explained

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<sup>8</sup>These numbers can be found in the CBR publication Bulletin of Bank Statistics, available in English on the CBR website.

in detail by Schoors (2003). At the same time, individuals, governments, corporations, and other organizations created a number of new banks. Bank creation by economic agents other than former state banks took off spectacularly in 1992–1994. Many of these new banks were more like casinos than banks. In the worst cases, they were simply fronts for smartly clad crooks (e.g. Sergei Mavrodi’s MMM pyramid scheme). This situation partly reflected the relaxed bank supervision under Viktor Gerashenko, a former president of Gosbank who became president of the CBR in the summer of 1992 after the hard-nosed, but inexperienced, CBR president Matyukhin had been outmaneuvered by the industrial lobby. The bank creation numbers suggest that bank supervision was tightened after 1995 under the reign of Tatiana Paramonova. The process of bank creation dropped sharply and remained very low from 1996 onward. The change came in response to the introduction and enforcement of stricter minimum capital requirements in April 1996 with Sergei Dubinin at the helm of the CBR. Bank creation did not revive until 2001.

Bank destruction follows a different pattern altogether. There is a peak of license withdrawals in the first half of 1992 when the CBR was headed by the hard-nosed reformer Matyukhin. Under political pressure, he was replaced in mid-1992 with Gerashenko, the last president of the defunct Gosbank, the former state monobank that ceased to exist, along with the Soviet Union, at the end of December 1991. Immediately, the number of license withdrawals dropped substantially. Indeed, from mid-1992 to end-1994, the CBR had a very relaxed policy towards bank licensing and bank refinancing, and banks were awash with liquidity (Schoors, 2001). This left Russia with well above 2,000 banks at the end of 1994. The exchange rate crisis in October 1994 cost Gerashenko his position as president; he was replaced with the more reform-minded Paramonova. Her first sweep of the banking sector in early 1995 targeted cleaning up the exchange rate crisis mess. The second wave of license withdrawals peaked in November 1995 in the aftermath of the meltdown on the Russian interbank money market in August 1995. Apparently, the CBR reacted to crises by enforcing some of its regulations *ex post*, a pattern of behavior it has since repeated. Once the new chairman of the CBR, Dubinin, came into power he swept through licenses in May 1996 on the heels of new minimal capital requirements, then repeated this exercise in March 1997. The majority of banks that lost their license under Paramonova and Dubinin were mostly tiny banks without political clout. In several cases, the de-licensed bank was already bankrupt or looted by its directors. In this sense the CBR was, even in the apparent good times of 1995–1997, following events, rather than anticipating them.

With the crisis of August 1998, Dubinin had to go. Gerashenko was reinstalled at the helm of the CBR to sort things out. He achieved the stabilization of the banking system and unclogged the jammed payments system by bailing out banks without enforcing a change in their behavior. Officially, the clean-up was led by the “Agency for the Restructuring of Credit Organizations” (ARCO).<sup>9</sup> In fact, ARCO was underfunded and achieved little in the way of bank restructuring. Figure 4 shows that the pace of license withdrawals did not pick up, but rather fell precipitously. This not only reflected Gerashenko’s weak policy but also resulted from a striking, but well-hidden, deficiency in Russian law – the exemption of banks from the bankruptcy code, a dreary detail of which many foreign creditors were not fully aware. This ensured that creditors could not easily enforce their claims on banks. The banking sector had insisted on this exemption and thereafter was successful in blocking all draft laws on bankruptcy of banks until the law on the restructuring of credit organizations entered into force in March 1999. This legal loophole gave less benevolent banks the opportunity to loot creditors by stripping banks from their valuable assets and transferring them to “bridge” banks. This procedure was practiced on a grand scale in the aftermath of the 1998 crisis. Insolvent institutions transferred their valuable assets to bridge banks, while leaving their liabilities in the defaulting or troubled institutions. Foreign creditors were furious and when the March 1999 law came into power, the IMF strongly pressed the CBR to perform at least some restructuring. As a consequence, several high profile banks lost their licenses, including Promstroibank and Mosbusinessbank, two direct successors of the former specialized state banks. These bankruptcies were more symbolic than real. The quiet deaths of these banks were convenient to everyone but creditors, which again had much to do with the stipulations of the new law and the choices of the CBR. The March 1999 law provided that creditors could only force a bank to bankruptcy after the CBR has withdrawn its license. Since the CBR often delayed withdrawal of licenses, it both postponed bankruptcy proceedings and provided time for owners to loot bank assets. All too often licenses were only withdrawn after the bank was a stripped, illiquid shell. This pattern of convenient bankruptcy was typical of the “mired restructurings” that took place after 1998 (Schoors, 1999).

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<sup>9</sup>See Mizobata (2002) and Tompson (2002) for more on this topic.

### 3 Empirical approach

We analyze the licensing behavior of the CBR in the period 1999–2002. This period was chosen for four reasons. First, most of the casinos, exchange offices, tiny banks, and smartly clad crooks had already disappeared from the system by virtue of the successive purges of bank licenses in the period 1995–1997 (see previous section). Thus, it is reasonable to assume that most of the banks in the sample performed at least a few standard bank functions. Second, we consider a period with a consistent regulatory policy, since earlier CBR chairmen had shown widely different supervisory preferences. During 1999–2002, bank licensing behavior is again in the hands of Viktor Gerashenko, who emerged at the head of the CBR after the 1998 crisis. Third, the CBR introduced a new accounting system in 1998 that moved away from Russian accounting standards (RAS) and toward international accounting standards (IAS). This renders it much more difficult, though not impossible, to compare bank data before and after the crisis, unless a major conversion effort is undertaken. Last, the new law on bank restructuring that came into effect in March 1999 gave the CBR a central role in bank restructuring, which was expected to strongly affect the CBR’s licensing behavior.

We use data from three sources: Interfaks, Mobile, and the CBR. We describe the data in detail in appendix A. In section 4, we estimate a panel logit model, where the dependent variable will be a dummy variable equal to 1 for every bank quarter that sees a license withdrawal, and 0 otherwise. In section 5, we turn to bank license survival as a dependent variable and perform a survival analysis. We will relate license withdrawals and bank license survival to three groups of variables: 1) compliance to regulatory standards, 2) variables that capture the tacit objectives of the central bank, and 3) economic (bank- and market-specific) variables, predicted by economic theory. In the remainder of this section, we list all variables and explain why we use and how we calculate them. Table 1 summarizes the definitions and sources of all variables.

**insert Table 1 around here**

#### 3.1 Compliance with regulatory standards

The dataset reveals how each bank scores for each prudential bank standard in every quarter. From the legislation and from CBR documents, we know how banks are supposed to score on each bank standard in each quarter (see appendices A and B for a detailed description). When a score does

not satisfy the standard, we say the standard has been breached. We use this information on breaches to construct measures of individual bank compliance to the CBR’s regulatory standards. We start observing bank-specific scores on bank standards at time  $t_0^{PR}$ .<sup>10</sup>

We construct several vectors of variables assumed to measure compliance with CBR standards. For each bank standard, we have bank-specific scores on a quarterly basis. Based on the definition for each bank standard  $n$  and its regulatory minimum or maximum imposed by the CBR, we define standard-specific breaches and count breaches per bank and per bank standard. For each quarter, we then correct the number of past breaches for two reasons. First, we want the number of breaches to be time-varying, which implies that the total number of breaches will be higher for later quarters. Second, some banks are created after  $t_0^{PR}$ , the first quarter in which we observe standards, which means that they will have fewer bank quarters in the sample and ceteris paribus will register fewer breaches. Therefore, we correct the simple sum of breaches for bank  $i$  until  $t$  by dividing it by the maximal number of possible breaches at time  $t$  and multiplying it by the number of breaches that is maximally possible for banks created before  $t_0^{PR}$  and still operational at time  $t$ . More specifically, we define for each regulation  $n$  and for each bank  $i$ , the number of past breaches at time  $t$ :

$$nbreach_{n,i,t} = \frac{\sum_{z=k}^t breach_z}{t - k} (t - t_0^{PR}),$$

with *breach* equal to one when a bank violates the rule and zero otherwise,  $k$  the start of observations for bank  $i$  and  $t$  the observed bank quarter for bank  $i$ . Figure 5 illustrates what this implies for banks with different dates of entry.

**Insert figure 5 here**

A second measure assumes that the CBR is likely to attach greater importance to current breaches than past breaches. Put simply, a bank that has had two violations in the previous two quarters has the same score on *nbreach* at time  $t$  as a bank with only two breaches in the past year, although one might expect the CBR at time  $t$  to attach more value to the former than the latter. We thus construct a second vector of compliance variables that discounts past breaches.

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<sup>10</sup>For most bank standards, this is in 1997:Q2. For N10.1 this is in 1997:Q3 and for N9.1 this is in 1998:Q1 as these standards were introduced later. The data between 1997:Q2 and 1999:Q1 on scores of banks on prudential bank standards were collected from Mobile. For 1999:Q2 -2002:Q4, the scores on bank standards were collected from Interfaks. See appendix A for a detailed description of the different datasources available for Russian banking and their compatibility.

Define the weights:

$$\varpi_t = \alpha(1 - \alpha)^t, \text{ with } \sum_{t=0}^{\infty} \varpi_t = 1.$$

Then the discounted number of breaches for each regulation  $n$  and a given bank  $i$  at time  $t$  is:

$$dnbreach_{n,i,t} = \frac{\sum_{z=k}^t \varpi_t(breach_z)}{t - k} (t - t_0^{PR}).$$

To compare the coefficients of the two variables in the regressions, these should have the same measure. However, the sum of the weights used to calculate  $dnbreach$  equals unity, while implicitly the sum of the weights used to calculate  $nbreach$  equals  $t - k$ . Therefore, we adjust the measure for  $dnbreach$  by multiplying by  $t - k$ , which gives:

$$dnbreach_{n,i,t} = \sum_{z=k}^t \varpi_t(breach_z)(t - t_0^{PR}).$$

The CBR may be more concerned about the average severity of breaches than the number of breaches. We therefore construct a third variable for each norm  $n$  to capture this notion:

$$sbreach_{n,i,t} = \frac{\sum_{z=k}^t \left( \frac{|\text{score}_z - \text{standard}_z|}{\text{standard}_z} \right)}{t - k}.$$

Obviously, we calculate this as a one-sided variable. The deviation of the score from the standard is only counted in the case of a breach; it equals zero otherwise. We take absolute values to ensure that a breach is always defined as a positive number. Again, the CBR is likely more concerned about the severity of current breaches than the severity of past breaches. The discounted severity of breach is then defined as:

$$dsbreach_{n,i,t} = \frac{\sum_{z=k}^t \varpi_t \left( \frac{|\text{score}_z - \text{standard}_z|}{\text{standard}_z} \right)}{t - k}.$$

To ensure comparability of the coefficients, we need again multiply with  $t - k$ , which gives:

$$dsbreach_{n,i,t} = \sum_{z=k}^t \varpi_t \left( \frac{|\text{score}_z - \text{standard}_z|}{\text{standard}_z} \right).$$

The CBR may also be more concerned about the total volume of breaches than the number of breaches or their average severity. We therefore construct a variable that captures the total volume of breaches. This should be interpreted as the one-sided total distance over time for a given bank between any bank standard  $n$  and the bank’s actual score on the standard:

$$vbreach_{n,i,t} = nbreach_{n,i,t} * sbreach_{n,i,t}.$$

There is a final twist in the measurement of compliance variables. For some banks in some quarters, the scores on bank standards are missing. Apparently, banks sometimes fail to report their score to the CBR. Since non-reported bank scores may be treated as compliance, non-compliance, or something in between by the CBR, we avoid making any assumption by introducing a dummy variable for non-reported bank scores in a given bank quarter as a separate variable in the regressions and allow the data to decide how the CBR interprets missing values. We find, in fact, that banks that often fail to report are much more likely to lose their licences and are less likely to survive. This suggests that either the CBR interprets non-reported scores as a sign of poor underlying bank health or that banks expecting to lose their licenses do not bother to submit their scores on bank standards.

### 3.2 Tacit objectives of the CBR

**Regional banking coverage** In the period surveyed, the CBR was worried that banking had become too concentrated in some regions. ARCO indicated it supported some banks with regional networks to avoid certain regions becoming underbanked (Mizobata, 2002; Tompson, 2002). We therefore expect that banks in already highly concentrated regional banking markets are less likely to lose their licenses compared to identical banks in less concentrated regions. As a concentration measure, we use the regional Herfindahl index, calculated as the sum of squared regional market shares for each region  $j$  and quarter  $t$ :

$$\sum_{i=1}^{n_j} [(MS_{ijt})^2].$$

Regional banking coverage is very stable in our data window, with some very poorly banked and some very well banked regions. The low variability of this variable in our sample implies it is not suitable for explaining quarter-specific variance in the bank licence withdrawal behavior of the

CBR. Therefore, in the estimations we employ the average of this variable over time such that we have one observation per region.

**Systemic stability** The CBR’s concern for systemic stability is likely to lead to biases in its de-licensing behavior. We look at the following variables:

- The CBR may wish to protect banks that are active on the interbank market to minimize the risk of contagion. As a proxy for banks that are active on the interbank market, we use the ratio of interbank liabilities  $IL$  to total liabilities  $TL$ .
- The CBR may wish to specifically protect money-center banks to enhance the stability of the interbank market. If large banks at the heart of the interbank system fail, the entire banking system could collapse.<sup>11</sup> The CBR will want to avoid this in order to preserve systemic stability.<sup>12</sup> This cannot be captured by the relative importance of interbank liabilities  $IL$  in total, bank-specific, liabilities. Since all important banks are active on the Moscow interbank market, we include the interbank market share  $MSIL$  in total interbank liabilities:

$$MSI_{it} = \frac{IL_{it}}{\sum_{i=1}^n IL_{it}}$$

- The CBR may wish to protect large deposit banks to avoid deposit runs<sup>13</sup> and maintain confidence in the banking sector. Interestingly, this can be measured by the regulatory bank standard N11 (household deposits over capital). We expect therefore to see forbearance of breaches of N11, since enforcement of this standard is not consistent with other CBR objectives (see appendix B for a more detailed description of this bank standard).

## Political influence

- We include the ratio of government claims  $G$  to total assets  $TA$  to measure government capture. Banks that lend relatively more to the government may have greater political clout and

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<sup>11</sup>See, for example, Wall and Peterson (1990) on the FDIC bailout of Continental Illinois and Kapstein (1994) and Davis (1992) on the failure of Herstatt Bank.

<sup>12</sup>Freixas et al. (2000) show that it may be too costly to close down money-center banks, because it might trigger the liquidation of all other banks. See also Rochet and Tirole (1996) on this point.

<sup>13</sup>Models of bank runs include Diamond and Dybvig (1983), Postlewaite and Vives (1987), Wallace (1990), Chari (1989), Champ, Smith, and Williamson (1996), and Alonso (1996).



receive protection against de-licensing. When a bank has a substantial amount of government bonds in its portfolio, the CBR might prefer not to close the bank if it has an interest in distributing these bonds. This was precisely the case for GKO prior to 1998 (Malyutina and Parilova, 2001).

- We possibly need to look at the portfolio of the Ministry of Finance rather than the individual bank portfolio. Specifically, the CBR may mainly be captured by banks that hold a large absolute amount of government claims  $G$  (mainly bonds). Indeed, the government may be less willing to liquidate its largest financiers than less influential small banks. Therefore, we include the government portfolio market share  $MSG$  in total government claims:

$$MSG_{it} = \frac{G_{it}}{\sum_{i=1}^n G_{it}}$$

- The CBR may be less willing to sort out pocket banks, which are often dominated by powerful, but closed, groups with considerable political clout. Pocket banks tend to be isolated from the rest of the banking sector and rarely accept household deposits. From the standpoint of systemic stability, the CBR has few incentives to enforce bank standards N9.1 and N10.1, but strong political incentives to show forbearance for breaches of bank standards N9.1 and N10.1 (see appendix B for a more detailed description of these bank standards).

**Too big to be disciplined adequately** Some banks may be simply too big to fail. This can be justified on the grounds that the collapse of a large bank poses a threat to the banking system as a whole (see Wall and Peterson, 1990). This is already measured in our analysis by the interbank market share that identifies money-center banks. There is also evidence that the CBR extended considerable credit to the largest banks (Malyutina and Parilova, 2001). It is reasonable to assume that as the costs of closure increased the idea of closing down these banks became more distasteful to the CBR. Kane (2000) suggests that some banks may simply be too big to discipline adequately (TBTDA), rather than too big to fail. Such situations create problems of undesired de facto forbearance even in developed market economies such as the US. This was doubtless a problem in Russia, where the understaffed and relatively young department of bank supervision was not up to the task of inspecting the intricate balance sheets of huge banks engaging in complex activities. We measure the TBTDA-bias in licensing behavior by including bank size (the log of total assets), which should be positively (negatively) related to survival (license withdrawal) probability.

### 3.3 Economic variables

We include a set of bank- and market-specific variables that are expected to influence license withdrawal, along with (non-)compliance with prudential regulation and variables related to tacit CBR objectives:

- A high return-to-assets ratio  $ROA$  should reduce (increase) license withdrawal probability (survival).
- The cost-to-assets ratio is expected to correlate positively (negatively) with license withdrawal (survival).
- The ratio of interbank liabilities to total liabilities  $IL/TL$  is an indicator of the liquidity of liabilities and should correlate positively (negatively) with license withdrawal (survival) (Calomiris and Mason, 2000).
- The regional market share in assets is a proxy for market power. In the structure-conduct-performance framework the effect of market power on license withdrawal (survival) is expected to be negative (positive).

$$MSA_{ijt} = \frac{TA_{ijt}}{\sum_{i=1}^n TA_{ijt}}$$

- Poor loan quality, measured as the ratio of non-performing loans  $NPL$  to total loans  $TL$ , should increase (reduce) the license withdrawal probability (survival).
- The ratio of total reserves (including excess reserves)  $TR$  to total assets  $TA$ , as an indicator of absolutely safe liquidity, should reduce (increase) license withdrawal probability (survival).

### 3.4 Contradictory hypotheses

There are several clear contradictions in the above hypotheses:

1. Either the CBR enforces N11 or it protects large and weakly capitalized deposit banks, which implies forbearance.

2. Either the CBR enforces N9.1 and N10.1, or it prefers to leave pocket banks alone, which implies forbearance.
3. Large holdings of government bonds either protect banks against de-licensing because of government capture or accelerate a bank's demise when the government defaults on treasury bills in August 1998 and the bank faces subsequent liquidity problems.
4. Either the CBR protects banks that are active on the interbank market (high  $IL/TL$ ) or these highly liquid liabilities make banks more vulnerable and therefore more likely to fail as suggested by Calomiris and Mason (2000).

### 3.5 Summary statistics and correlations

Summary statistics for all variables are given in Table 2. Note that we exclude Sberbank, Vneshtorgbank, and Vnesheconombank from the sample. As they are totally dominated by the CBR, their survival is ensured in any case. This leaves us with over 20,000 bank quarters of data available for estimations. Table 2a shows summary statistics for the economic variables and the variables that measure tacit CBR objectives. The Moscow control variable reveals that 48% of bank quarters are from banks registered in the Moscow region. All other variables show reasonable average values. The ratios are never below zero and never above 100%, although in some bank quarters they reach the maximum of 100%. The regional Herfindahl index indicates considerable variation in bank concentration across regions.

The summary statistics of regulatory compliance variables in Table 2b reveal that the maximum number of breaches is disconcertingly close to 23 for some bank standards, i.e. the number of bank quarters used for the calculation of the compliance variables. Apparently, some banks breached some standards in nearly all bank quarters and still managed to keep their banking licenses. Bank standard N11 (individuals' deposits to capital) is on average breached most often (on average in 1.54 quarters in a total of 23 quarters) and the breaches are on average relatively severe (13% away from the standard). The capital adequacy standard is also breached quite often (on average in 0.53 quarters out of 23) and relatively severely (on average 19% away from the standard). Next, the liquidity standards are regularly breached by commercial banks. From the summary statistics on the volume of breaches (Table 2b, lower panel) the most severely breached bank standard is the deposits-to-capital ratio N11, closely followed by a number of liquidity standards and the capital

adequacy standard. Still, banks on average breach the standards rather infrequently and not terribly severely. In addition, the minimal values for the compliance variables in Tables 2b are always 0. For every bank standard, one can always find at least one bank that complies all the time.

Correlations between the variables are shown in Table 3. There is one noteworthy source of correlation; the compliance variables of liquidity standard N5 seem to be highly correlated to compliance with other liquidity standards. This is not surprising given the very general definition of this liquidity standard. Moreover, one could question the usefulness of such a liquidity standard in the Russian setting. Indeed, standard N5 only looks at very broadly defined liquid assets and neglects all aspects of assets/liabilities management. Having high liquid assets only adds to bank health in the presence of corresponding highly liquid liabilities. Banks that score high on this standard typically hold few real bank assets (loans).

**Insert Table 2 and Table 3 here.**

We are not only interested in the number of bank quarters, but also in the number of banks used in the estimations. Table 4 reveals that the more than 20,000 bank quarters cover 1,509 banks (of which, 226 lost their licenses in the sample period). Most de-licensings were, according to the CBR, due to violations of bank regulations (over 25%) or compulsory bankruptcy (over 53%). Of course, these two reasons for license withdrawal may overlap. Economically bankrupt banks tend to violate a number of bank standards. Hence, compliance and economic variables should do well in picking up these license withdrawals in the empirical analysis. Table 4 also shows that more than 17% of the licenses disappeared through bank mergers. Of course, mergers could hide bank failures (mergers to avoid license withdrawal or economic failure), but they may also be genuine mergers for strategic reasons as most banks are too small to be economically efficient. To test how the treatment of mergers affects our results, we alternatively include and exclude mergers in the sample of banks that lose their licenses as a robustness check.

## 4 A logit model

We first use a logit model to investigate the competing hypotheses affecting a bank's probability of license withdrawal. Specifically, we estimate the specification:

$$\begin{aligned}
\text{Prob}(\text{license withdrawal})_{i,t} &= c + \alpha'_{i,t-1} (\text{economic variables}) + \\
&\quad \beta'_{i,t-1} (\text{tacit CBR objectives}) + \\
&\quad \gamma'_{i,t-1} (\text{compliance measures}) + v_i + \varepsilon_{i,t}.
\end{aligned}$$

The dependent variable is a dummy variable which equals one in the quarter when a bank loses its license, and zero otherwise. The independent variables are described in detail above. We control for inflation by including the deflator. We also include MOSCOW, a dummy variable that equals one when the bank is registered in the Moscow region, and zero otherwise. This accounts for any possible licensing bias for Moscow-based banks. In all specifications, we allow for bank-specific unobserved heterogeneity, since banks may differ in ways not observed in our dataset. The logit model is therefore estimated under a random effects (RE) assumption.<sup>14</sup> The results are reported in Table 5.

**insert Table 5 here.**

Panel A of Table 5 shows the estimation results using the standard compliance measures. In columns 1–3, we show the results with mergers excluded. Columns 4–6 show results with mergers included as license withdrawals. Our first observation is that the economic variables do reasonably well at explaining license withdrawal. Less profitable banks, banks with higher costs, banks with poorer loan quality, and banks with less liquidity are all more likely to lose their banking licenses. However, high interbank liabilities in themselves do not increase economic vulnerability as predicted by Calomiris and Mason (2000). Instead, higher interbank liabilities contribute significantly to a lower likelihood of license withdrawal in all specifications with the number of breaches as compliance variable, while being insignificant in the other specifications. If anything, this suggests that the CBR is more reluctant to withdraw licenses from banks that are active on the interbank market and provides the first indication that tacit objectives may also guide the CBR in its licensing policy.

The results also suggest that the CBR’s licensing policy is guided by other concerns than economic variables or compliance with bank standards alone. Some of the tacit CBR objectives identified in our study do surprisingly well in explaining bank de-licensing. Controlling for return to assets, cost to assets, bank liquidity, local market power, and compliance to bank standards, banks

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<sup>14</sup>We assume that there exists some time-invariant bank-specific factor (for example, political strings or managerial skills) that explain part of the license withdrawal probability.

in poorly banked regions are less likely to lose their licenses as shown by the strongly significant coefficient on the regional Herfindahl index. Large banks are still less likely to face withdrawal, suggesting that some banks are simply too large to be disciplined adequately. Holding an important share of total government liabilities also helps to avoid license withdrawal. Indeed, the sign on the government portfolio share is consistently negative, although often not significant. It is worth noting, however, that holding a large amount of government securities relative to assets unambiguously increases the likelihood of license withdrawal. This is probably still the effect of the government default in August 1998. Thus, in the survey period at least, we find that holding government securities was bad for retaining a bank license, but less so for banks that held a large amount of these securities. Money-center banks do not enjoy additional protection from license withdrawal beyond the protection enjoyed by all banks that are active on the interbank market (as revealed by the negative sign for the interbank liabilities variable).

As regards compliance measures, most show no significance. This suggests regulatory forbearance in the CBR's de-licensing policy. The variable on non-reported scores on bank standards is significantly positively related to license withdrawal. Apparently, a bank's failure to report its scores on the regulatory standards does not go down well with the CBR. Some of the liquidity standards show up, but often with inconsistent signs. This may be due to multicollinearity. Only the quick liquidity ratio seems to be enforced consistently, which is not necessarily good news because it implies the CBR may still be running behind the facts by de-licensing for the most part illiquid banks at a point where failure has become convenient to its owners. There is little evidence of enforcement for important standards such as capital adequacy, large risks to capital, or the individual's deposits-to-capital ratio. Some of these variable even tend to have the wrong sign, although they are not significant. Note also that the banks standards related to insider banks (N9.1 and N10.1) show some signs of enforcement only if mergers are included (see column 4). Apparently, banks in violation with the insider-related standards prefer to merge rather than lose their licenses.

The results of panel A may be biased since the CBR is implicitly assumed to attach equal weights to present and past bank behavior. In panel B of Table 5, we report specification (1) and (2) of panel A (mergers excluded) with the *discounted* compliance measures that attach more weight to current violations of bank standards than to past violations. The discount parameter  $\alpha$  is set alternatively to 0.3, 0.5 and 0.7, increasingly putting more weight on current violations. In the the first three columns of panel B, we run specification (1) of panel A with three versions

of the discounted number of breaches as compliance measures. In the last three columns of panel B, we repeat specification (2) of panel A with three versions of the discounted severity of breach as compliance measures. Results for the economic variables and the tacit CBR objectives are equivalent with the panel A results.

There are substantial changes for the compliance variables. Not reporting scores still goes down very badly with the CBR as shown again by the strongly positive sign for the non-reported scores dummy. However, we now find consistent indications for the enforcement of the capital adequacy standard, the quick liquidity ratio, the current liquidity ratio and the general liquidity ratio. Indeed, if these variables show up significantly in panel B, it is always with a positive sign, indicating that a greater number of breaches and more severe breaches of the bank standard relate to a higher probability of license withdrawal. The broad enforcement of liquidity standards is not necessarily good news. It again suggests that the CBR may be running behind the facts, mainly de-licensing already illiquid banks (and possibly illiquid because of asset stripping in the face of expected de-licensing), instead of anticipating future trouble. Moreover, the insider-related standards (N9.1 and N10.1) now show enforcement when mergers are excluded, which was not the case in panel A. Apparently, current violations of the pocket bank-related standards yield a disciplinary reaction from the CBR, while in the past these problems were solved through mergers.

However, a large risks-to-capital ratio does not show strong enforcement and the individual's deposits-to-capital ratio (N11) shows no enforcement at all. On the contrary, the sign for N11 is consistently negative. This corroborates our hypothesis that the enforcement of this standard would affect precisely those banks that are most active on the deposit market, and runs counter to the CBR objective of securing and restoring depositor trust and systemic stability. A conflict between two inconsistent CBR objectives is sharply revealed here.

## 5 A survival model

As a robustness check, we employ a survival model framework to estimate the expected survival time of a bank's license as a function of our three groups of determinants. The dependent variable is the survival time of a bank,  $t$ . We define survival time as the time that elapses between the quarter in which the CBR issued the bank's license and the quarter in which the license was revoked. The exit rate or hazard function is defined as:

$$h(t) = \frac{f(t)}{1 - F(t)} = \frac{f(t)}{S(t)},$$

where  $F(t)$  represents a distribution function over duration  $t$  and  $S(t)$  is the survivor function. For each bank, the hazard rate at time  $t$  is defined as the probability of license withdrawal at time  $t$ , conditional on having the license until time  $t$ . Once the functional form for the probability distribution  $F(t)$  is specified, the hazard rate and the distribution of duration  $t$  are completely known and can be made dependent on bank-specific covariates. We estimate:

$$\begin{aligned} F(t) = & c + \alpha'_{i,t-1} (\text{economic variables}) + \\ & \beta'_{i,t-1} (\text{tacit CBR objectives}) + \\ & \gamma'_{i,t-1} (\text{compliance measures}) + v_i + \varepsilon_{i,t}. \end{aligned}$$

We use the Akaike Information criterion (AIC) to select the appropriate specification for  $F(t)$ . We estimate survival models for the exponential, Weibull, Gompertz and log logistic hazard specification. Based on the reported log likelihoods for the different specifications, we construct the AIC as  $-2(\log\text{likelihood}) + 2(c + p + 1)$ , where  $c$  is the number of model covariates and  $p$  the number of model-specific ancillary parameters. The scores of the various models on the AIC criterion are reported in Table 6.

We select the model which minimizes the AIC and report the estimation results for the selected survival model in Table 7. For the hazard estimations, the issue of unobserved heterogeneity (frailty) is somewhat more elaborate. Since we lack left-censoring,<sup>15</sup> we could handle unobserved heterogeneity on the bank-level by using the Heckman and Singer (1984) estimator.<sup>16</sup> This estimator is non-parametric with respect to the density of unobserved heterogeneity and can consistently estimate the parameters of the distribution of unobserved heterogeneity and hazard function. We instead estimate a model where heterogeneity is allowed and incorporated as a random effects specification. More specifically, we assume a specific parametric representation of the distribution of

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<sup>15</sup>Although our sample is restricted to banks that were still holding licenses in the first quarter of 1999, we observe the complete survival history for all banks and therefore do not have the problem of left-censoring in the hazard specifications. We do have right-censoring (we do not observe bank balances after 2002), which is taken into account in the construction of the likelihood function.

<sup>16</sup>They assume that the unobserved heterogeneity is a bank-specific component that is assumed constant over time and distributed over the population with a mixing distribution.



the unobserved effect. We report an extra parameter, theta (an estimate of the frailty variance component) in the regression results. The likelihood ratio tests indicate that there is only negligible bank-specific heterogeneity.<sup>17</sup>

**Insert Tables 6 and 7 around here**

The results in Table 7 have the same structure as the results in panel B of Table 5. We have restricted ourselves to results with mergers excluded and discounted compliance variables. The other specifications of Table 5 (mergers included, volume of breach compliance measures, non-discounted compliance measures) are available on request. In the first three columns of Table 7, we use the discounted number of breaches as compliance measure, in the last three columns of Table 7 we use the discounted severity of breach as a compliance measure. The only difference between Table 5B and Table 7 is the econometric technique employed and the exact definition of the dependent variable, which is now survival time instead of the probability of license withdrawal. Due to the different econometric techniques, we expect opposite signs in Table 5 and Table 7.

For the economic variables, the results are quite comparable to the logit model. The main difference is that loan quality seems to have no impact on bank survival, although it was a good predictor in the logit model. The finding that banks with large interbank liabilities show longer survival in all specifications of Table 7 reinforces our previous conclusion that banks that are active on the interbank market enjoy some protection, again hinting at the presence of tacit CBR objectives. As regards other tacit CBR objectives, we find again that banks in poorly banked regions and banks that are too big to be disciplined adequately survive longer. It is less clear, however, whether holding a large share of assets in government securities is all that bad for bank survival. This variable is only significant once in Table 7, and the sign is not consistent across specifications.

For the compliance variables, the results are qualitatively the same. Banks that fail to report their scores on bank standards have a lower survival probability. Banks that flaunt the capital adequacy standard also tend to have shorter lives, although this variable is not always significant. The quick liquidity ratio and the current liquidity ratio seem to be enforced, but again, this is not necessarily good news. We find evidence here of consistent enforcement of the bank standard on

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<sup>17</sup>Because we have already controlled for bank-specific characteristics, we could alternatively assume that there is still some observational frailty present in the data in stead of bank-specific unobserved heterogeneity. After selecting the appropriate parameterizations for this alternative specification, we still find only limited presence of heterogeneity. These results are available upon request.

insider lending (N10.1) as we did in Table 5B. Unfortunately, we also confirm the earlier finding that the individual's deposits-to-capital ratio (N11) is not properly enforced. Indeed, more violations and more severe violations tend to increase a bank's chances of survival, even significantly so for severe violations (see specifications 2a, 2b and 2c). In sum, we can again not reject the thesis that the CBR is very reluctant to withdraw licenses from banks that are most active on the deposit market, while there is some level of enforcement for most other bank standards. We interpret this as support for our thesis that the CBR suffers from a conflict between the objectives of individual bank safety and systemic stability.

## 6 Summary and conclusions

In this paper, we focused on the potential conflict between two central bank objectives: individual bank stability (usually assured through the enforcement of prudential bank standards) and systemic stability. We empirically studied the licensing policy of the Central Bank of Russia (CBR) during the period 1999–2002.

Russia provides an intriguing opportunity for analyzing potential conflicts in the objective function of a central bank. The CBR is a very young central bank that combines a broad swath of authorities and functions. Equally important, the period of study involved many banks and many bank failures, allowing us to study empirically how well the CBR enforced its own bank standards. Moreover, we believe that the possibility of conflict between individual bank stability and systemic bank stability in a central bank's objective function is a fundamental issue.

Our analysis revealed strong indications of this conflict. Controlling for economic reasons of bank failure (loan quality, profitability, liquidity, efficiency, market power), we found that there are a number of biases in the CBR's licensing policy. Specifically, banks in poorly banked regions, banks that are too big to be disciplined adequately, and banks active on the interbank market seemed to enjoy a certain degree of protection against license withdrawal by the CBR. This suggests that during the period investigated the CBR's concern for the banking system exceeded its concern for individual banks. We also examined the extent to which the CBR enforced its own prudential bank standards. While we observed an improvement in the level of enforcement of the bank standards over the period, an important exception emerged. The CBR apparently was quite reticent about withdrawing bank licenses from banks that repeatedly and severely violated the individuals'

deposits-to-capital ratio. We interpret this as a clear indication of a conflict with the tacit CBR objective of securing depositor trust and systemic stability.

These results are a mixed bag for the Russian banking sector. The fact that bank survival depends strongly on economic fundamentals is positive news. The finding that most bank standards show some level of enforcement is quite encouraging. On the other hand, the fact that liquidity regulations have for the most part been enforced is not particularly comforting, since it suggests that the CBR is still running behind the facts, mainly de-licensing already illiquid banks (possibly illiquid because of asset stripping in the face of expected de-licensing) instead of anticipating future trouble. Furthermore, we found that tacit objectives in the CBR objective function conflict with certain bank standards, creating an unwelcome inconsistency and prohibiting proper enforcement.

Robust economic growth has ensured that the Russian banking sector is currently awash with liquidity. The CBR should use this window of opportunity and embark on a serious restructuring and monitoring of the banking sector. This will require a clear statement from the CBR of its objectives, as well as transparent formulation of prudential bank standards consistent with those stated objectives and enforcement of standards by means of strong actions, including timely closures. If not, the CBR policy will suffer diminished credibility that will further postpone the emergence of a stable, sound banking sector in Russia.

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## A Data sources

The bank data were supplied by two well established Russian information agencies, Interfaks and Mobile, and by the CBR. Interfaks supplied a database with quarterly bank data on balances, profit and loss accounts and quarter-specific, bank-specific scores on a battery of regulatory standards for all Russian banks from 1999 to 2002. Mobile provided monthly bank balances and profit and loss accounts and a more limited list of quarter-specific, bank-specific scores on regulatory standards but for a longer period, from mid-1995 (although initially not for all banks) up to 2002. The two databases complement each other as they offer different classifications and different levels of detail of the same data. The financial data employed in the analysis includes 1,509 banks, i.e. almost all operational banks in the period under study, covering 16 quarters from 1999:Q1 to 2002:Q4. These financial data were linked to bank licensing data. From the freely available information on the CBR’s website, we reconstructed the complete register of bank licenses. The dataset contains bank license data of all banks from 1988 up to now. For every bank that ever existed in Russia, we know when it received a licence, the specific type of license it received, when it lost its license (if ever), and the official reason for losing it. We also know from the CBR instructions and regulations how the supervisory standards evolved in the period under study. Thus, for every bank in every period we know how the bank should score on a specific standard and how it actually does, which allows the identification of breaches of regulatory standards. For a highly detailed overview on all data issues, please consult Karas and Schoors on [www.ceriseonline.be](http://www.ceriseonline.be).

## B Prudential regulations of the CBR

The regulation that governs our period of study came into force on April 1, 1996 and draws on CBR Instruction No. 1 of January 30, 1996, “On the Procedure for Regulating the Activities of Credit Organisations.”<sup>18</sup> This regulation is issued in accordance with the Federal Law on the Central Bank of the Russian Federation (Bank of Russia) and established a set of new prudential bank standards, taking into account international banking practices. For Russian standards, the new bank standards were rather harsh and the CBR gave banks time to adjust to the new conditions. Yet the enormous peak of license withdrawals in May 1996 (see Figure 6) demonstrates that the adjustment process was rather abrupt. We concentrate on the bank standards (*normas* as the CBR

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<sup>18</sup>For more regulatory information, see the references for banking legislation described at the end of the appendix.



refers to them) imposed by the CBR. In addition to minimal capital requirements, the CBR has instituted regulations on capital adequacy requirements (N1), liquidity requirements (N2, N3, N4, N5), credit risk requirements (N7, N9, N10, N11, N12, N13), and a host of other less important regulations and voluntary guidelines.

### **B.1 Capital adequacy ratio (N1)**

From April 1, 1996, the bank equity capital adequacy ratio (N1) was established as the ratio of the bank's equity capital to the overall risk-weighted assets minus the sum of the reserves created for depreciation of securities and possible losses. Since February 1998, the minimum level of N1 is set depending on the amount of the bank's equity capital:

<i>5 million euro</i>	<i>1 to 5 million euro</i>	<i>Less than 1 million euro</i>
July, 1996 – 5%		
February, 1997 – 6 %		
February, 1998 – 7 %	February, 1998 – 7 %	February, 1998 – 7 %
February, 1999 – 8 %	February, 1999 – 9 %	
January, 2000 – 10 %	January, 2000 – 11 %	

### **B.2 Instant liquidity ratio (N2)**

N2 is defined as the ratio of the sum of the bank's highly liquid assets to the sum of the bank's liabilities on demand accounts. The minimum value of the N2 ratio was set at 10% since July 1, 1996 and 20% since February 1, 1997.

### **B.3 Current liquidity ratio (N3)**

The current liquidity ratio (N3) is established as the ratio of the sum of the bank's liquid assets to the sum of the bank's liabilities on demand accounts and accounts up to 30 days. The minimum value of the current liquidity ratio was set at no less than:

20% of total assets as of July 1, 1996;

30% of total assets as of February 1, 1997;

50% of total assets as of February 1, 1998;

70% of the balance as of February 1, 1999.

#### **B.4 Long-term liquidity ratio (N4)**

The long-term liquidity ratio (N4) is established as the ratio of the entire long-term debt to the bank, including guarantees and sureties with a maturity of more than one year, to the bank's equity capital and liabilities on deposit accounts, credits received and other debt liabilities with maturities exceeding one year. The long-term liquidity ratio should not exceed 120%.

#### **B.5 General liquidity ratio (N5)**

The general liquidity ratio is defined as the percentage of liquid assets in the bank's aggregate assets. The minimum value of the N5 ratio has been set at:

10% of total assets as of July 1, 1996;

20% of total assets as of February 1, 1997.

#### **B.6 Maximum large credit risk (N7)**

The maximum large credit risk (N7) is established as a percentage of the total amount of large credit risks in the bank's equity capital. A large credit is the total sum of the bank's risk-weighted claims to one borrower (or a group of related borrowers) on credits, taking into account 50% of the sum of off-balance claims – guarantees and sureties held by the bank with regard to one borrower (or a group of related borrowers), exceeding 5% of the bank's equity capital. Note that the decision to extend a large credit or loan must be made by the board of the bank or its credit committee, taking into account the opinion of the bank's credit department. Maximum large credit risk should not exceed the bank's capital by more than 12 times in 1996, 10 times in 1997 and 8 times in 1998.

#### **B.7 Maximum risk per borrower-shareholder (N9.1)**

The maximum risk per borrower-shareholder (partner) (N9.1) is established as the amount of credits, guarantees and sureties issued by the bank to one corporate or individual shareholder

(partner) or to a group of related corporate or individual shareholders of the bank divided by equity capital. Related shareholders are corporate and individual shareholders connected with one another economically and legally (i.e. having common property and/or mutual guarantees and/or obligations, and/or controlling each other's property, as well as an individual concurrently holding several senior executive positions) in such a way that the financial problems of one of the shareholders cause or may cause financial problems for another shareholder(s). N9.1 should not exceed 50% of the bank's equity capital from January 1, 1998.

### **B.8 Maximum credit to insiders (N10.1)**

The aggregate amount of credits and loans extended to insiders (N10.1) may not exceed 3% of the bank's equity capital. Insiders comprise the following individuals: shareholders who own more than 5% of shares, directors (presidents, chairmen, and their deputies), Board members, members of the credit committee, senior executives of subsidiary and parent structures, and other persons who may influence the decision to issue credit, as well as relatives of insiders, former insiders and other persons participating in outside structures in which insiders also participate.

### **B.9 Minimal coverage of household deposits by capital (N11)**

N11 is established as the ratio of the sum of household deposits to equity capital. Since July 1996, household deposits should be 100% covered by equity capital.

### **B.10 Minimal coverage of the bank's investments in shares by capital (N12)**

The bank's own investments in shares of other legal entities has been limited to:

45% of equity capital as of July 1, 1996;

35% of equity capital as of October 1, 1996;

25% of equity capital as of January 1, 1997.

### **B.11 Bank's own promissory note liability risk ratio (N13)**

N13 is established as the percentage of the bills of exchange and bills of acceptance issued by the bank plus 50% of the bank's off-balance liabilities arising from the endorsement of bills, sureties

and bill brokerage in the bank's equity capital. The maximum levels have been set at:

200% of the balance as of October 1, 1996;

100% of the balance as of March 1, 1997.

## **B.12 References for banking legislation**

Bank of Russia Instruction No.1 of May 5, 1991, "On the Procedure of Regulating the Activities of Credit Organisations."

Bank of Russia Instruction No.1 of January 30, 1996, "On the Procedure of Regulating the Activities of Credit Organisations."

Bank of Russia Instruction No.59 of March 31, 1997, "On Imposing Sanctions to Credit Organizations for Infringement of Prudential Norms."

Bank of Russia Instruction No.1 of October 1, 1997, "On the Procedure of Regulating the Activities of Credit Organisations."

Bank of Russia Letter No.121-T of August 20, 2003 "About actions which should be taken when facts of breaching norms N8, N9, N11, N11.1 and N14 are revealed."

Bank of Russia Letter No.124-T of August 21, 2003 "On the bank's own promissory note liability risk ratio N13."

Civil Code of the Russian Federation, part I.

Federal Law of December 2, 1990, No. 395-1, "On Banks and Banking Activity."

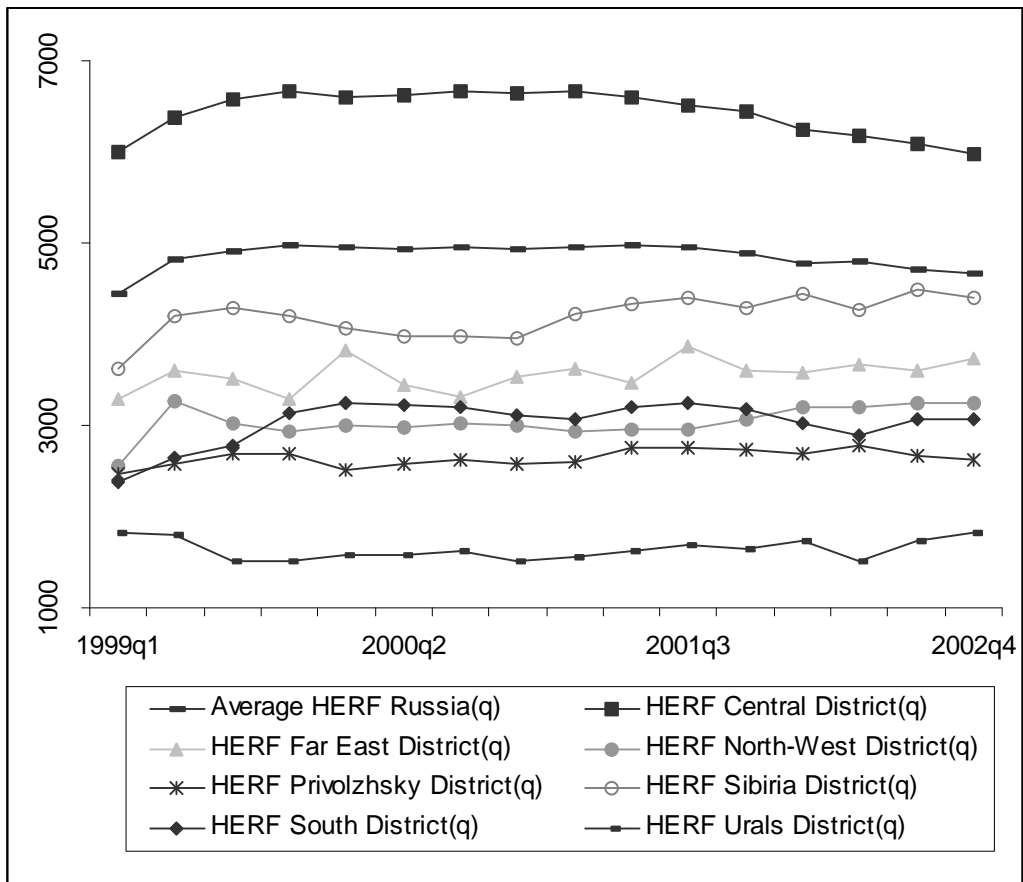


Figure 1: Herfindahl indices (deposits) for several federal districts within Russia (quarterly, 1999-2002). Source: Own calculations based on Interfaks data.

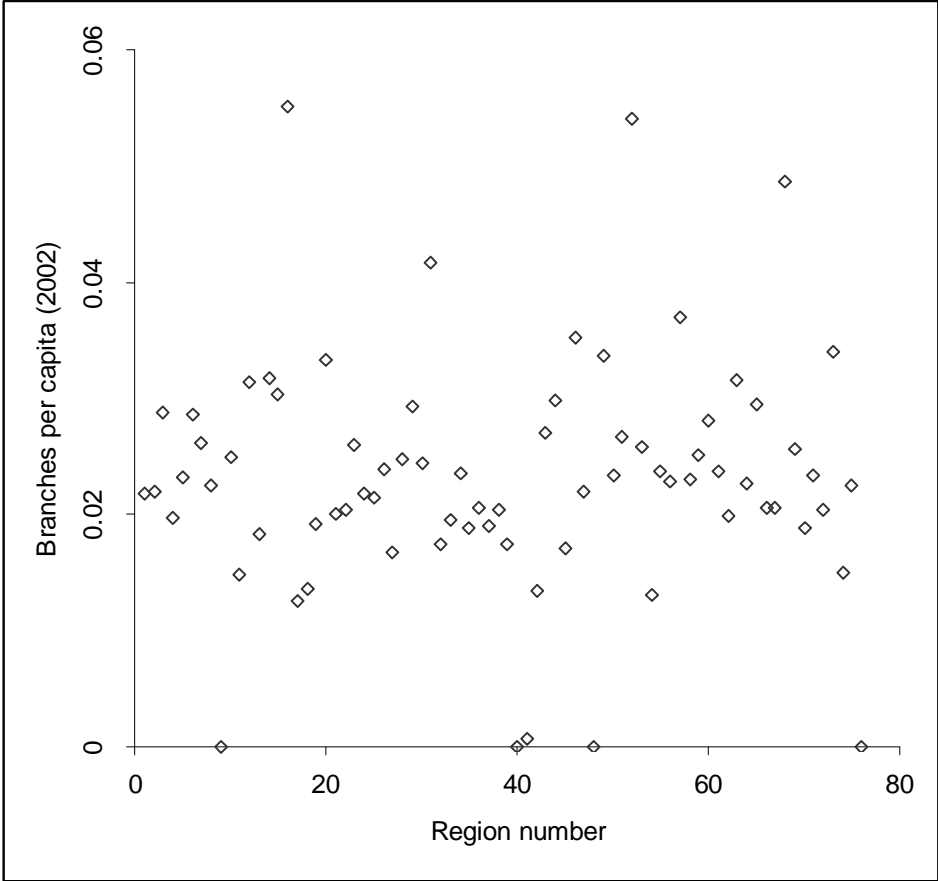


Figure 2: Bank branches per capita (2002). Source: own calculations based on data from the CBR (bank branches per region) and Goskomstat (population expressed in thousands).

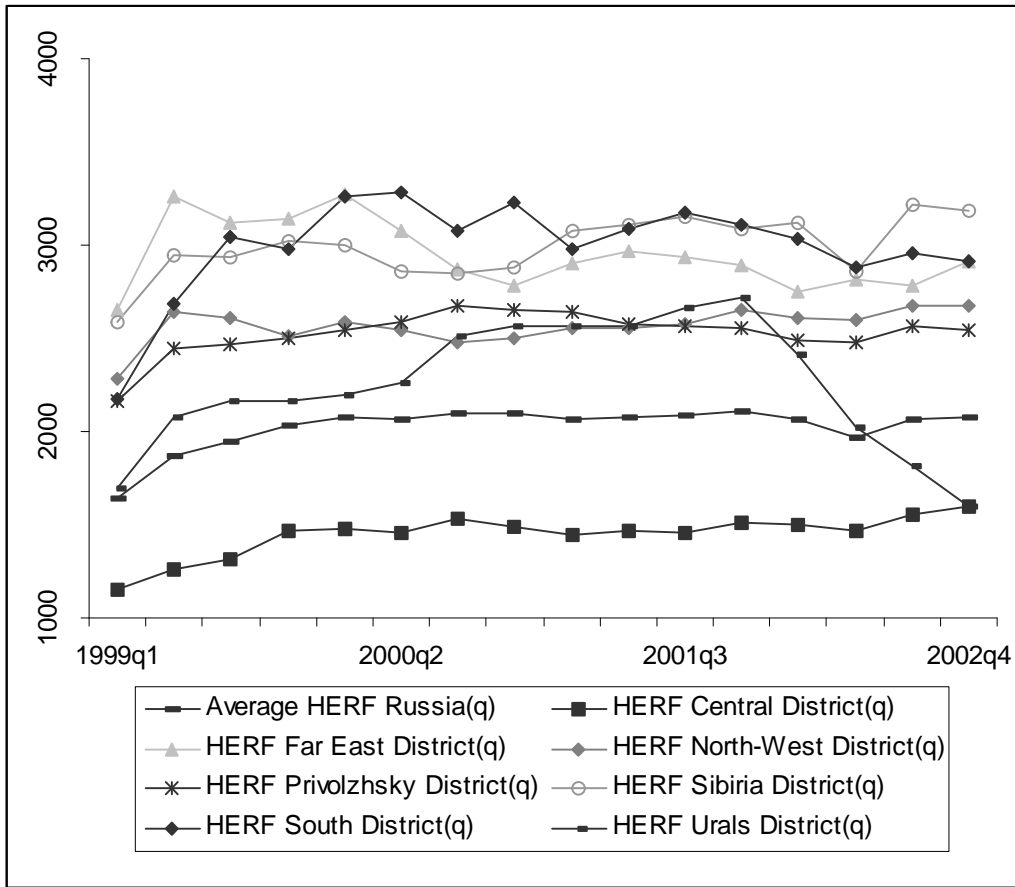


Figure 3: Herfindahl indices (assets) for several federal districts within Russia (quarterly, 1999-2002). Source: Own calculations based on Interfaks data.

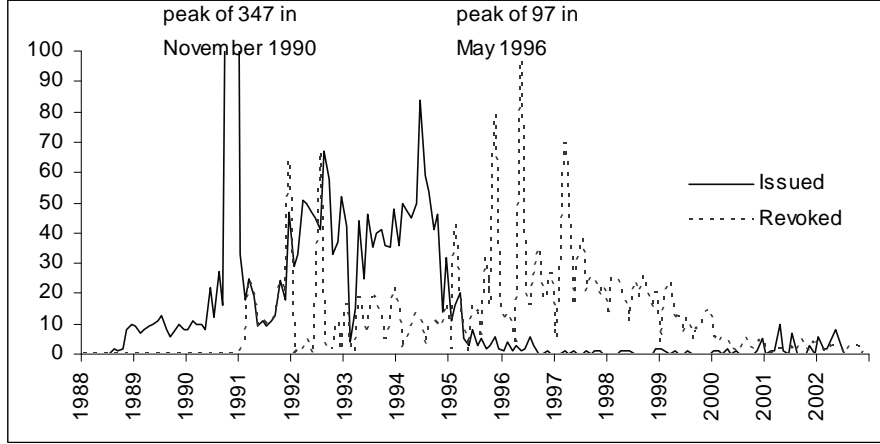


Figure 4: Bank creation and bank destruction in Russia (monthly data). Bank creation is defined as the number of licenses issued; bank destruction is defined as the number of license withdrawals.

Source: CBR.

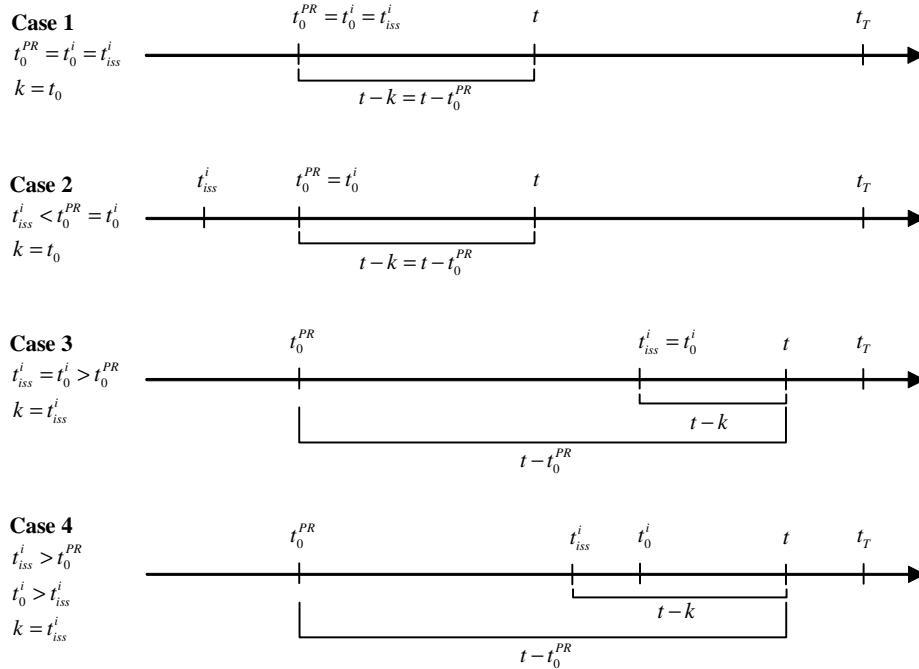


Figure 5:  $t_0^{PR}$  marks the first quarter in which we observe bank-specific scores on different regulations;  $t_T$  marks the end of our sample (2002:Q4);  $t_{iss}^i$  marks the quarter in which bank  $i$ 's license was issued;  $t_0^i$  marks the first observation of bank  $i$ ;  $t_T - t_0^{PR}$  marks the sample period for observing bank standards;  $t - k$  is the number of potential breaches;  $t - t_0^{PR}$  is the number of quarters used to correct for “late entry” or “late license issuance”.



TABLE 1

## Description of Variables and Data Sources

Deflator <sup>1</sup>	Average monthly inflation (%).
Moscow Dummy	A dummy variable which equals one if the bank is located in Moscow, zero otherwise.
<b>Economic Variables</b>	
Return on assets <sup>2</sup>	The returns-to-assets ratio of bank $i$ in quarter $t$ (%).
Cost/assets <sup>2</sup>	The ratio of personnel costs to two month average of total assets of bank $i$ in quarter $t$ (%).
Interbank liabilities/liabilities <sup>2</sup>	Interbank liabilities to total liabilities of bank $i$ in quarter $t$ (%).
Regional market share (assets) <sup>2</sup>	The regional <sup>4</sup> market share in assets, calculated as the ratio of bank $i$ 's individual assets to the sum of bank assets for region $j$ in quarter $t$ (between 0 and 100).
Non performing loans/loans <sup>2</sup>	The ratio of non-performing loans to total loans of bank $i$ in quarter $t$ (%).
Reserves/assets <sup>2</sup>	The ratio of total reserves (including excess reserves) to total assets of bank $i$ in quarter $t$ (%).
<b>Tacit CBR Objectives</b>	
Regional Herfindahl (assets) <sup>2</sup>	The regional <sup>4</sup> Herfindahl index, calculated as the sum of squared regional market shares for each region $j$ in quarter $t$ (between 0 and 1000).
Size (log assets) <sup>2</sup>	The log of assets of bank $i$ in quarter $t$ .
Interbank market share - (money centre banks) <sup>2</sup>	The share of interbank liabilities of bank $i$ 's individual interbank liabilities to the country total in quarter $t$ (%).
Government claims/assets <sup>2</sup>	The ratio of government claims to assets of bank $i$ in quarter $t$ (%).
Government portfolio share <sup>2</sup>	The share of bank $i$ 's individual government claims to the country total in quarter $t$ (%).
<b>Compliance with Regulatory Standards<sup>3</sup></b>	
Non-reported scores	A dummy variable which equals one when information on regulatory standards 7, 9.1, 10.1, 11, 12 and 13 is not reported and zero otherwise.
$breach_{n,i,t}$	A dummy variable which equals one whenever bank $i$ violates regulation $n$ in quarter $t$ , zero otherwise.
$nbreach_{n,i,t}$	The sum of actual breaches -relative to the maximum potential- registered by bank $i$ from $t_0^{PR}$ up till $t$ , corrected for 'late entry' (see Figure 5).
$dnbreach_{n,i,t}$	An exponentially smoothed version of $nbreach$ with varying weights for $\alpha$ .
$sbreach_{n,i,t}$	The average severity of breaches registered by bank $i$ from $t_0^{PR}$ up till $t$ . Severity is defined as the relative deviation from the prudential standard whenever $breach$ equals one.
$dsbreach_{n,i,t}$	An exponentially smoothed version of $sbreach$ with varying weights for $\alpha$ .
$vbreach_{n,i,t}$	The product of $nbreach$ and $sbreach$ of bank $i$ in quarter $t$ .

<sup>1</sup> Source: Russian Economic Trends. <sup>2</sup> Source: Own calculations based on Interfaks. <sup>3</sup> Source: Own calculations based on regulatory standards published by the CBR (see Appendix B) and bank-specific scores on regulatory standards acquired from Interfaks and Mobile. <sup>4</sup> Note: We use 80 regions for the calculation of regional market shares.

TABLE 2a

## Summary Statistics: Economic Variables

	Obs	Mean	Std. Dev.	Min	Max
Deflator	20840	1.97	1.75	0.46	8.02
Moscow Dummy	20840	0.48	0.50	0	1
<b>Economic Variables</b>					
Return on assets	20730	0.58	8.18	-149.61	479.61
Cost/assets	20807	1.30	2.16	0	76.60
Interbank liabilities/liabilities	20801	10.66	19.19	0	100
Regional market share (assets)	20840	5.75	13.97	0	100
Non performing loans/loans	20387	5.06	12.96	0	100
Reserves/assets	20840	17.63	15.49	0	100
<b>Tacit CBR Objectives</b>					
Regional Herfindahl (assets)	20840	1746	1302	399	8955
Size (log assets)	20840	4.92	1.95	-1.94	11.75
Interbank market share (money centre banks)	20840	0.08	0.54	0	16.78
Government claims/assets	20840	1.91	6.50	0	100
Government portfolio share	20840	0.08	0.85	0	35.65

Source: Own calculations based on Interfaks, Russian Economic Trends and CBR. Detailed information on variable definitions is provided in Table 1.

TABLE 2b

## Summary Statistics: Compliance with Regulatory Standards

	Obs	Mean	Std. Dev.	Min	Max
Non-reported scores	20840	0.07	0.25	0	1
<i>Number of Breaches</i>					
Capital adequacy ratio (N1)	20503	0.53	1.66	0	21
Quick liquidity ratio (N2)	20493	0.74	1.89	0	16
Current liquidity ratio (N3)	20494	1.06	2.14	0	17
Long-term liquidity ratio (N4)	20492	0.13	0.66	0	11
General liquidity ratio (N5)	20500	1.10	2.48	0	20
Large-risks-to-capital ratio (N7)	20493	0.07	0.41	0	6
Owner-related-credit-risks-to-capital ratio (N9.1)	20491	0.19	0.64	0	6
Insider-related-credit-risks-to-capital ratio (N10.1)	20492	0.16	0.63	0	9
Individuals' deposits-to-capital ratio (N11)	20491	1.54	3.37	0	22
Investment-to-shares-to-capital ratio (N12)	20491	0.16	0.60	0	8
Issued-promissory-notes-to-capital ratio (N13)	20492	0.35	1.18	0	16
<i>Severity of Breach</i>					
Capital adequacy ratio (N1)	20488	0.19	2.03	0	59.12
Quick liquidity ratio (N2)	20473	0.15	0.79	0	13.98
Current liquidity ratio (N3)	20491	0.14	0.95	0	26.38
Long-term liquidity ratio (N4)	20433	0.01	0.09	0	1.82
General liquidity ratio (N5)	20481	0.05	0.16	0	2.70
Large-risks-to-capital ratio (N7)	20401	0.00	0.02	0	0.50
Owner-related-credit-risks-to-capital ratio (N9.1)	20440	0.03	0.18	0	4.18
Insider-related-credit-risks-to-capital ratio (N10.1)	20407	0.05	0.41	0	16.44
Individuals' deposits-to-capital ratio (N11)	20462	0.13	0.55	0	8.67
Investment-to-shares-to-capital ratio (N12)	20473	0.03	0.20	0	4.35
Issued-promissory-notes-to-capital ratio (N13)	20452	0.05	0.29	0	5.66
<i>Volume of Breach</i>					
Capital adequacy ratio (N1)	20387	0.35	3.20	0	99.40
Quick liquidity ratio (N2)	20441	0.75	4.76	0	81.52
Current liquidity ratio (N3)	20477	0.83	5.79	0	99.99
Long-term liquidity ratio (N4)	20424	0.03	0.26	0	5.11
General liquidity ratio (N5)	20442	0.34	1.36	0	15.33
Large-risks-to-capital ratio (N7)	20401	0.00	0.04	0	0.65
Owner-related-credit-risks-to-capital ratio (N9.1)	20435	0.06	0.43	0	9.13
Insider-related-credit-risks-to-capital ratio (N10.1)	20407	0.13	1.29	0	40.95
Individuals' deposits-to-capital ratio (N11)	20420	0.85	3.49	0	50.58
Investment-to-shares-to-capital ratio (N12)	20462	0.07	0.56	0	11.85
Issued-promissory-notes-to-capital ratio (N13)	20426	0.16	1.18	0	26.97

Source: Own calculations based on Interfaks, Mobile and CBR. Note: The calculations of the compliance variables are based on the period 1997:Q2 - 2002:Q4. The estimation sample is restricted to the period 1999:Q1 - 2002:Q4. More detailed information on variable construction is provided in Table 1. Detailed information on regulatory standards is provided in appendix.

TABLE 3a

## Correlation Matrix of Economic Variables - Other CBR Objectives

	Deflator	Moscow Dummy	Non-reported scores	Return on assets	Cost/assets	Interbank liabilities/liabilities	Regional market share (assets)	Non performing loans/loans
Deflator	1							
Moscow Dummy	-0.0007	1						
Non-reported scores	0.1025*	0.0082	1					
Return on assets	-0.0013	-0.013	-0.0121	1				
Cost/assets	0.3098*	-0.2743*	-0.0475*	-0.0188*	1			
Interbank liabilities/liabilities	-0.0275*	0.2557*	-0.0193*	-0.0221*	-0.1449*	1		
Regional market share (assets)	-0.0216*	-0.3879*	-0.0085	0.0103	0.0427*	-0.0851*	1	
Non performing loans/loans	0.1172*	-0.1525*	0.0900*	-0.0298*	0.2099*	0.0071	0.0136	1
Reserves/assets	-0.0587*	-0.1188*	-0.0540*	0.0580*	0.0730*	-0.3025*	0.0149*	-0.0500*
Regional Herfindahl (assets)	-0.0094	-0.6836*	-0.011	0.0123	0.2427*	-0.1925*	0.5737*	0.1230*
Size (log assets)	-0.1621*	0.2349*	-0.1098*	-0.0054	-0.3487*	0.3174*	0.1511*	-0.2214*
Interbank market share (money centre banks)	-0.0042	0.1148*	-0.0068	-0.0121	-0.0579*	0.2702*	-0.0209*	0.0309*
Government claims/assets	-0.0072	-0.1878*	0.0111	0.0111	0.0281*	-0.0793*	0.1340*	0.0129
Government portfolio share	-0.0027	0.0107	-0.0053	0.0009	-0.0288*	0.0117	0.0588*	-0.0084

	Reserves/assets	Regional Herfindahl (assets)	Size (log assets)	Interbank market share	Government claims/assets	Government portfolio share
Reserves/assets	1					
Regional Herfindahl (assets)	0.1024*	1				
Size (log assets)	-0.2178*	-0.2046*	1			
Interbank market share (money centre banks)	-0.1124*	-0.0829*	0.3206*	1		
Government claims/assets	0.0890*	0.1459*	0.0854*	0.0136*	1	
Government portfolio share	-0.0339*	-0.0004	0.1933*	0.1735*	0.3206*	1

Source: Own calculations based on Interfaks, RET and CBR. Detailed information on variable definitions is provided in Table 1.

TABLE 3b

Correlation Matrix of Compliance variables: *nbreach*

	N1	N2	N3	N4	N5	N7	N9.1	N10.1	N11	N12	N13
N1	1										
N2	0.5884*	1									
N3	0.5684*	0.8130*	1								
N4	0.3351*	0.2693*	0.3152*	1							
N5	0.4603*	0.7195*	0.7488*	0.2654*	1						
N7	0.4109*	0.1813*	0.2392*	0.3236*	0.1247*	1					
N9.1	0.1292*	0.1554*	0.2041*	0.1817*	0.2280*	0.0999*	1				
N10.1	0.1892*	0.1304*	0.1613*	0.2620*	0.1013*	0.1865*	0.1980*	1			
N11	0.1082*	0.0679*	0.1267*	0.0875*	0.0419*	0.1057*	0.1727*	0.1309*	1		
N12	0.1626*	0.1450*	0.1555*	0.1745*	0.1601*	0.0451*	0.0657*	0.0627*	0.0770*	1	
N13	0.1809*	0.1191*	0.1590*	0.1830*	0.0920*	0.3126*	0.0945*	0.1426*	0.2143*	0.1941*	1

TABLE 3b

Correlation Matrix of Compliance variables: *sbreach*

<i>sbreach</i>	N1	N2	N3	N4	N5	N7	N9.1	N10.1	N11	N12	N13
N1	1										
N2	0.1739*	1									
N3	0.1875*	0.6581*	1								
N4	0.0278*	0.1022*	0.1059*	1							
N5	0.3788*	0.6136*	0.5249*	0.1677*	1						
N7	0.0943*	0.0993*	0.0889*	0.2981*	0.1752*	1					
N9.1	0.0178*	0.1495*	0.1269*	0.1123*	0.1949*	0.0716*	1				
N10.1	-0.0002	0.0522*	0.0319*	0.1631*	0.0603*	0.1367*	0.1692*	1			
N11	0.0547*	0.1608*	0.1252*	0.1588*	0.1725*	0.2226*	0.2532*	0.2020*	1		
N12	0.1012*	0.0712*	0.0962*	0.2075*	0.1498*	0.1366*	0.0370*	0.0729*	0.2418*	1	
N13	0.0115	0.1015*	0.1198*	0.2626*	0.1041*	0.2474*	0.2234*	0.0847*	0.1964*	0.2578*	1

TABLE 3b

Correlation Matrix of Compliance variables: *volume*

<i>volume</i>	N1	N2	N3	N4	N5	N7	N9.1	N10.1	N11	N12	N13
N1	1										
N2	0.1711*	1									
N3	0.1655*	0.7979*	1								
N4	0.0345*	0.1054*	0.1650*	1							
N5	0.2215*	0.5460*	0.6195*	0.1906*	1						
N7	0.0568*	0.1139*	0.1396*	0.3213*	0.1515*	1					
N9.1	0.0744*	0.1856*	0.1640*	0.0555*	0.0913*	0.0583*	1				
N10.1	0.0340*	0.0302*	0.0563*	0.2384*	0.0184*	0.0888*	0.0915*	1			
N11	0.0331*	0.0973*	0.0765*	0.1160*	0.0804*	0.1378*	0.1646*	0.0347*	1		
N12	0.0256*	0.0515*	0.0863*	0.1433*	0.1342*	0.0996*	-0.0004	0.0021	0.0970*	1	
N13	0.0125	0.0714*	0.1554*	0.2088*	0.0753*	0.2075*	0.0681*	0.0706*	0.1268*	0.1529*	1

Source: Own calculations based on Interfaks, Mobile and CBR. Note: The calculations of the *breach* variables are based on the period 1997:Q2 - 2002:Q4. The estimation sample is restricted to the period 1999:Q1 - 2002:Q4. More detailed information on variable construction is provided in Table 1. Detailed information on regulatory standards is provided in appendix. \* indicates significance at the 5 percent level.

TABLE 4

## Descriptive statistics

Analysis time	In Sample of Estimation 1999:Q1 - 2002:Q4	
No. of banks	1509	
No. of failures	226	

Reason of Failure	Percent	Cum.
Violation of bank legislation	25.23	25.23
Compulsory Bankruptcy	53.47	78.7
Voluntary bankruptcy		
Voluntary liquidation	3.66	82.36
Merger	17.64	100

Source: Own calculations based on CBR. Note: The calculations of the compliance variables are based on the period 1997:Q2 - 2002:Q4. The estimation sample is restricted to the period 1999:Q1 - 2002:Q4. More detailed information on variable construction is provided in Table 1. Detailed information on regulatory standards is provided in appendix.

TABLE 5A

## Regression Results for the Logit Model

	(1) <i>nbreach</i>	(2) <i>sbreach</i>	(3) <i>vbreach</i>	(4) <i>nbreach</i>	(5) <i>sbreach</i>	(6) <i>vbreach</i>
	Merger Excluded			Merger Included		
Constant	-4.0066*** [0.7937]	-3.1001*** [0.5546]	-3.3791*** [0.5762]	-7.4230*** [1.0699]	-3.2379*** [0.4875]	-3.4072*** [0.5171]
Deflator	-0.0588 [0.0700]	-0.0273 [0.0508]	-0.0237 [0.0522]	-0.3853*** [0.1187]	0.01 [0.0453]	0.0068 [0.0474]
Moscow Dummy	0.2892 [0.4317]	0.1633 [0.3208]	0.3086 [0.3331]	-0.3431 [0.5495]	-0.086 [0.2714]	-0.0008 [0.2850]
<b>Economic Variables</b>						
Return on assets	-0.0159** [0.0065]	-0.0171*** [0.0060]	-0.0181*** [0.0061]	-0.0051 [0.0040]	-0.0099* [0.0059]	-0.0103* [0.0060]
Cost/assets	0.1439*** [0.0338]	0.1206*** [0.0240]	0.1300*** [0.0254]	0.2230*** [0.0529]	0.1026*** [0.0227]	0.1099*** [0.0242]
Interbank liabilities/liabilities	-0.0131** [0.0060]	-0.0053 [0.0049]	-0.0052 [0.0050]	-0.0129* [0.0076]	0.0006 [0.0043]	0.0016 [0.0044]
Regional market share(assets)	-0.0083 [0.0194]	-0.0039 [0.0174]	0.0114 [0.0175]	0.0142 [0.0372]	0.0071 [0.0124]	0.0166 [0.0125]
Non performing loans/loans	0.0308*** [0.0059]	0.0233*** [0.0046]	0.0279*** [0.0050]	0.0533*** [0.0083]	0.0216*** [0.0044]	0.0265*** [0.0049]
Reserves/assets	-0.1253*** [0.0190]	-0.1263*** [0.0178]	-0.1306*** [0.0184]	-0.0669*** [0.0146]	-0.0778*** [0.0120]	-0.0800*** [0.0124]
<b>Tacit CBR Objectives</b>						
Regional Herfindahl (assets)	-0.0009*** [0.0002]	-0.0008*** [0.0002]	-0.0008*** [0.0002]	-0.0015*** [0.0003]	-0.0006*** [0.0002]	-0.0007*** [0.0002]
Size (log assets)	-0.2068*** [0.0783]	-0.1329** [0.0614]	-0.1318** [0.0641]	-0.1523 [0.0992]	-0.1493*** [0.0569]	-0.1613*** [0.0598]
Interbank market share (money centre banks)	0.2703 [0.2099]	0.117 [0.1679]	0.0489 [0.2108]	-0.0443 [0.3890]	0.0831 [0.1786]	0.0278 [0.2126]
Government claims/assets	0.0231 [0.0159]	0.0344*** [0.0132]	0.0270* [0.0140]	0.0318 [0.0205]	0.0317*** [0.0119]	0.0264** [0.0127]
Government portfolio share	-0.3357 [0.4349]	-0.1351 [0.2721]	-0.1307 [0.2584]	-1.5549* [0.9145]	-0.2063 [0.3294]	-0.2078 [0.3333]

(Continued)



TABLE 5A

CONTINUED

	(1) <i>nbreach</i>	(2) <i>sbreach</i>	(3) <i>vbreach</i>	(4) <i>nbreach</i>	(5) <i>sbreach</i>	(6) <i>vbreach</i>
	Merger Excluded			Merger Included		
<b>Compliance with Regulatory Standards</b>						
Non-reported scores	1.7734*** [0.2219]	1.5782*** [0.2077]	1.6133*** [0.2104]	1.5015*** [0.2506]	1.3474*** [0.1976]	1.3596*** [0.2004]
Capital adequacy ratio (N1)	-0.0253 [0.0688]	-0.0824 [0.0506]	0.0219 [0.0164]	0.0394 [0.0964]	-0.0878* [0.0485]	0.018 [0.0165]
Quick liquidity ratio (N2)	0.4368*** [0.1137]	0.3406*** [0.0755]	0.1173*** [0.0207]	0.9817*** [0.1910]	0.3270*** [0.0741]	0.1098*** [0.0212]
Current liquidity ratio (N3)	0.2160** [0.1030]	-0.5292** [0.2121]	-0.1137*** [0.0362]	0.4314*** [0.1384]	-0.5307** [0.2069]	-0.1101*** [0.0348]
Long-term liquidity ratio (N4)	-0.4393* [0.2297]	0.7402 [0.5946]	0.1457 [0.2991]	-0.8064** [0.3297]	0.8383 [0.5734]	0.0741 [0.2910]
General liquidity ratio (N5)	-0.2391*** [0.0886]	2.0223*** [0.5491]	0.1420* [0.0744]	-0.5500*** [0.1506]	1.8343*** [0.5287]	0.1232* [0.0704]
Large-risks- to-capital ratio (N7)	0.0605 [0.3349]	2.2841 [2.3742]	2.5463 [1.9380]	0.1014 [0.3757]	2.1966 [2.3479]	2.4205 [1.8426]
Owner-related-credit-risks- to-capital ratio (N9.1)	0.2722 [0.1794]	0.0796 [0.4097]	0.1778 [0.1963]	0.6665*** [0.2194]	-0.0498 [0.3717]	0.1088 [0.1833]
Insider-related-credit-risks- to-capital ratio (N10.1)	0.193 [0.1894]	-0.0577 [0.2778]	0.0023 [0.0736]	0.4861** [0.2362]	-0.1303 [0.2873]	-0.0122 [0.0782]
Individuals' deposits- to-capital ratio (N11)	-0.0106 [0.0561]	-0.2558 [0.2028]	-0.0231 [0.0358]	-0.0227 [0.0601]	-0.1877 [0.1806]	-0.0046 [0.0276]
Investment-to-shares- to-capital ratio (N12)	0.3902** [0.1580]	0.3268 [0.3409]	0.1757 [0.1278]	0.7198*** [0.2403]	0.1757 [0.3536]	0.113 [0.1281]
Issued-promissory-notes- to-capital ratio (N13)	0.0052 [0.1235]	0.2787 [0.2424]	-0.0109 [0.0883]	-0.0031 [0.1045]	0.2943 [0.2229]	0.0719 [0.0518]
Observations	19728	19381	19168	20048	19694	19475
Number of banks	1393	1376	1364	1432	1413	1401
Log Likelihood	-635.91	-602.89	-601.29	-819.86	-779.52	-776.8
Wald chi2	220.48	296.42	268.87	175.09	299.17	269.72

Note: The breach variables in the regression equations are: (1) and (4) the number of breaches (*nbreach*), (2) and (5) the severity of breaches (*sbreach*) and (3) and (6) the volume of breaches (*vbreach*). The dependent variable is a dummy variable, license withdrawal, which equals one in the quarter when a bank's license was revoked and zero otherwise. Moscow is a dummy variable which equals one if the bank is located in Moscow and zero otherwise. The Herfindahl index is an average over time. All other variables are time-varying. Table 1 provides a more detailed description of all variables. The logit estimations are performed under the RE assumption. Robust standard errors are given in brackets. \*, \*\* and \*\*\* indicate significance levels of 10, 5 and 1 percent respectively.

TABLE 5B

Regression Results for the Logit Model - Discounted Breach Variables (Merger Excluded)

	<i>dnbreach</i>			<i>dsbreach</i>		
	(1a)	(1b)	(1c)	(2a)	(2b)	(2c)
	$\alpha = .3$	$\alpha = .5$	$\alpha = .7$	$\alpha = .3$	$\alpha = .5$	$\alpha = .7$
Constant	-4.6578*** [0.9064]	-4.3521*** [0.7788]	-4.0474*** [0.7159]	-3.4314*** [0.5268]	-3.3687*** [0.6102]	-3.1164*** [0.5360]
Deflator	-0.0636 [0.0750]	-0.0353 [0.0654]	-0.0115 [0.0606]	-0.0536 [0.0501]	-0.1107* [0.0618]	-0.0679 [0.0507]
Moscow Dummy	0.3821 [0.4946]	0.3412 [0.4422]	0.285 [0.4065]	0.5047 [0.3204]	0.452 [0.3509]	0.425 [0.3279]
<b>Economic Variables</b>						
Return on assets	-0.0103* [0.0055]	-0.0093* [0.0049]	-0.0083* [0.0047]	-0.0161*** [0.0058]	-0.0115* [0.0061]	-0.0107* [0.0056]
Cost/assets	0.1602*** [0.0391]	0.1390*** [0.0342]	0.1247*** [0.0319]	0.1175*** [0.0230]	0.1207*** [0.0267]	0.1084*** [0.0243]
Interbank liabilities/liabilities	-0.0171** [0.0068]	-0.0155** [0.0064]	-0.0141** [0.0060]	-0.0032 [0.0047]	-0.0043 [0.0050]	-0.0058 [0.0046]
Regional market share(assets)	-0.0035 [0.0223]	-0.0002 [0.0197]	0.0032 [0.0183]	0.0049 [0.0150]	0.0027 [0.0153]	0.0066 [0.0139]
Non performing loans/loans	0.0223*** [0.0060]	0.0178*** [0.0055]	0.0157*** [0.0052]	0.0147*** [0.0040]	0.0165*** [0.0050]	0.0126*** [0.0042]
Reserves/assets	-0.1093*** [0.0198]	-0.0972*** [0.0187]	-0.0906*** [0.0177]	-0.1063*** [0.0172]	-0.1076*** [0.0178]	-0.1103*** [0.0177]
<b>Tacit CBR Objectives</b>						
Regional Herfindahl (assets)	-0.0011*** [0.0003]	-0.0010*** [0.0002]	-0.0009*** [0.0002]	-0.0006*** [0.0002]	-0.0006*** [0.0002]	-0.0006*** [0.0002]
Size (log assets)	-0.2573*** [0.0886]	-0.2796*** [0.0833]	-0.2912*** [0.0787]	-0.1659*** [0.0591]	-0.2116*** [0.0667]	-0.2136*** [0.0598]
Interbank market share (money centre banks)	0.2456 [0.3069]	0.1417 [0.3520]	0.1018 [0.3404]	0.1429 [0.1518]	0.1774 [0.1708]	0.1104 [0.1892]
Government claims/assets	0.0178 [0.0173]	0.0146 [0.0163]	0.0121 [0.0151]	0.0359*** [0.0125]	0.0352*** [0.0137]	0.0336*** [0.0122]
Government portfolio share	-0.6673 [0.7189]	-0.5481 [0.6301]	-0.445 [0.5674]	-0.1332 [0.2929]	-0.1438 [0.3111]	-0.0926 [0.2415]

(Continued)

TABLE 5B

CONTINUED

	<i>dnbreach</i>			<i>dsbreach</i>		
	(1a)	(1b)	(1c)	(2a)	(2b)	(2c)
	$\alpha = .3$	$\alpha = .5$	$\alpha = .7$	$\alpha = .3$	$\alpha = .5$	$\alpha = .7$
<b>Compliance with Regulatory Standards</b>						
Non-reported scores	1.8602***	1.7681***	1.7048***	1.5326***	1.5002***	1.4089***
	[0.2440]	[0.2372]	[0.2308]	[0.2130]	[0.2247]	[0.2188]
Capital adequacy ratio (N1)	0.0405	0.0926**	0.1151***	-0.0477	-0.0143	0.1852*
	[0.0570]	[0.0434]	[0.0365]	[0.0689]	[0.0688]	[0.0978]
Quick liquidity ratio (N2)	0.3829***	0.2850***	0.2272***	0.2064***	0.1426**	0.0056
	[0.0730]	[0.0477]	[0.0370]	[0.0658]	[0.0673]	[0.0708]
Current liquidity ratio (N3)	0.1863**	0.1208**	0.0889**	-0.5346	0.5276	1.5077***
	[0.0734]	[0.0516]	[0.0413]	[0.3405]	[0.4386]	[0.5664]
Long-term liquidity ratio (N4)	-0.1946	-0.0832	-0.0444	0.5298	0.8268	2.5782***
	[0.1534]	[0.0979]	[0.0753]	[0.8485]	[0.9808]	[0.9392]
General liquidity ratio (N5)	-0.0251	0.0263	0.0416	2.6931***	1.7517***	0.67
	[0.0744]	[0.0517]	[0.0404]	[0.4980]	[0.5036]	[0.5093]
Large-risks-	0.2082	0.1406	0.0909	-0.292	4.6287	5.4788*
to-capital ratio (N7)	[0.1325]	[0.0869]	[0.0652]	[2.5027]	[3.1311]	[3.0403]
Owner-related-credit-risks-	0.3313*	0.1867	0.1311	1.1493***	0.7023	0.9933*
to-capital ratio (N9.1)	[0.1790]	[0.1302]	[0.1032]	[0.4413]	[0.5689]	[0.5271]
Insider-related-credit-risks-	0.3147***	0.1928**	0.1167	0.0009	0.0787	0.4321**
to-capital ratio (N10.1)	[0.1179]	[0.0945]	[0.0826]	[0.0880]	[0.1644]	[0.2167]
Individuals' deposits-	-0.0542	-0.0578	-0.0551	-0.2562	-0.2294	-0.3398
to-capital ratio (N11)	[0.0627]	[0.0546]	[0.0479]	[0.2312]	[0.2669]	[0.2641]
Investment-to-shares-	0.2175	0.1043	0.0514	0.0387	-0.6422	0.015
to-capital ratio (N12)	[0.1432]	[0.1138]	[0.0893]	[0.7810]	[1.4594]	[1.1001]
Issued-promissory-notes-	0.0203	0.0353	0.0357	-0.0199	-0.3255	-0.405
to-capital ratio (N13)	[0.0999]	[0.0711]	[0.0571]	[0.3569]	[0.5980]	[0.4963]
Observations	19481	19728	19728	19445	19484	19507
Number of banks	1393	1393	1393	1382	1382	1385
Log Likelihood	-572.84	-553.12	-545.77	-560.38	-546.38	-547.22
Wald chi2	166.27	193.34	212.38	413.15	243.15	435.23

Note: The breach variables in the regression equation are: (1) discounted number of breaches assuming exponential smoothing: (1a) *dnbreach* ( $\alpha=0.3$ ), (1b) *dnbreach* ( $\alpha=0.5$ ), (1c) *dnbreach* ( $\alpha=0.7$ ), (2) discounted severity of breaches assuming exponential smoothing: (2a) *dsbreach* ( $\alpha=0.3$ ), (2b) *dsbreach* ( $\alpha=0.5$ ), (2c) *dsbreach* ( $\alpha=0.7$ ). The dependent variable is a dummy variable, license withdrawal, which equals one in the quarter when a bank's license was revoked and zero otherwise. Moscow is a dummy variable which equals one if the bank is located in Moscow and zero otherwise. The Herfindahl index is an average over time. All other variables are time-varying. Table 1 provides a more detailed description of all variables. The logit estimations are performed under the RE assumption. Robust standard errors are given in brackets. \*, \*\* and \*\*\* indicate significance levels of 10, 5 and 1 percent respectively.

TABLE 6

Model Selection for the Survival Model: Akaike Information Criterion

			Exponential	Weibull	Gompertz	Loglogistic
<i>dnbreach</i>	(1a)	$\alpha = .3$	182.39	181.09	182.38	<b>146.43</b>
	(1b)	$\alpha = .5$	144.48	144.91	145.86	<b>119.01</b>
	(1c)	$\alpha = .7$	127.66	128.69	129.42	<b>108.80</b>
<i>dsbreach</i>	(2a)	$\alpha = .3$	302.75	299.15	300.01	<b>197.85</b>
	(2b)	$\alpha = .5$	291.26	288.56	289.30	<b>163.61</b>
	(2c)	$\alpha = .7$	270.24	268.13	268.87	<b>127.38</b>

Note: The breach variables in the regression equation are: (1) discounted number of breaches assuming exponential smoothing: (1a) *dnbreach* ( $\alpha=0.3$ ), (1b) *dnbreach* ( $\alpha=0.5$ ), (1c) *dnbreach* ( $\alpha=0.7$ ), (2) discounted severity of breaches assuming exponential smoothing: (2a) *dsbreach* ( $\alpha=0.3$ ), (2b) *dsbreach* ( $\alpha=0.5$ ), (2c) *dsbreach* ( $\alpha=0.7$ ). We choose the parameterization which minimizes the AIC (bold).

TABLE 7

Regression Results for the Survival Model - Discounted Breach Variables (Merger Excluded)

	<i>dnbreach</i>			<i>dsbreach</i>		
	(1a) $\alpha = .3$	(1b) $\alpha = .5$	(1c) $\alpha = .7$	(2a) $\alpha = .3$	(2b) $\alpha = .5$	(2c) $\alpha = .7$
Constant	3.8072*** [0.2094]	3.7392*** [0.1938]	3.7302*** [0.1893]	4.1602*** [0.2922]	3.9582*** [0.2725]	3.9480*** [0.2827]
Deflator	-0.0283 [0.0185]	-0.0277 [0.0170]	-0.0303* [0.0161]	0.0211 [0.0307]	0.0251 [0.0302]	0.0389 [0.0299]
Moscow Dummy	-0.1996 [0.1311]	-0.1653 [0.1233]	-0.1773 [0.1188]	-0.4914** [0.1951]	-0.4179** [0.1773]	-0.4744** [0.1863]
<b>Economic Variables</b>						
Return on assets	0.0035** [0.0017]	0.002 [0.0017]	0.0015 [0.0016]	0.0014 [0.0025]	0.0018 [0.0070]	0.0007 [0.0025]
Cost/assets	-0.0260** [0.0112]	-0.0238** [0.0100]	-0.0216** [0.0096]	-0.0510** [0.0198]	-0.0452** [0.0184]	-0.0412*** [0.0144]
Interbank liabilities/liabilities	0.0058** [0.0025]	0.0052** [0.0023]	0.0046** [0.0022]	0.0053 [0.0032]	0.0053* [0.0030]	0.0054* [0.0029]
Regional market share (assets)	-0.0041 [0.0064]	-0.0021 [0.0068]	-0.0015 [0.0062]	0.0109 [0.0133]	0.0027 [0.0110]	0.002 [0.0100]
Non performing loans/loans	-0.0029 [0.0024]	-0.0026 [0.0021]	-0.0023 [0.0020]	-0.0043 [0.0033]	-0.002 [0.0030]	-0.0027 [0.0029]
Reserves/assets	0.0338*** [0.0067]	0.0298*** [0.0063]	0.0266*** [0.0059]	0.0318*** [0.0078]	0.0313*** [0.0082]	0.0313*** [0.0074]
<b>Tacit CBR Objectives</b>						
Regional Herfindahl (assets)	0.0002*** [0.0001]	0.0002*** [0.0001]	0.0002*** [0.0001]	0.0001 [0.0001]	0.0001 [0.0001]	0.0001 [0.0001]
Size (log assets)	0.0653*** [0.0232]	0.0700*** [0.0222]	0.0780*** [0.0219]	0.0825** [0.0323]	0.0871*** [0.0314]	0.0883*** [0.0284]
Interbank market share (money centre banks)	-0.0225 [0.1094]	-0.016 [0.1276]	-0.013 [0.1290]	-0.0506 [0.1099]	-0.037 [0.1270]	-0.0025 [0.1770]
Government claims/assets	-0.006 [0.0093]	-0.0013 [0.0079]	0.0009 [0.0059]	-0.0133 [0.0107]	-0.0158* [0.0093]	-0.0131 [0.0108]
Government portfolio share	0.1537 [0.1929]	0.2388 [0.3193]	0.2166 [0.2915]	0.8542 [0.6338]	0.6535 [1.5134]	0.7296 [0.6081]

*(Continued)*

TABLE 7

CONTINUED

	<i>dnbreach</i>			<i>dsbreach</i>		
	(1a)	(1b)	(1c)	(2a)	(2b)	(2c)
	$\alpha = .3$	$\alpha = .5$	$\alpha = .7$	$\alpha = .3$	$\alpha = .5$	$\alpha = .7$
<b>Compliance with Regulatory Standards</b>						
Non-reported scores	-0.6639***	-0.6443***	-0.6254***	-0.7727***	-0.7678***	-0.7460***
	[0.1023]	[0.0919]	[0.0889]	[0.1342]	[0.1158]	[0.1122]
Capital adequacy ratio (N1)	-0.0297	-0.0267	-0.0284*	0.2259	-0.0784	-0.3751
	[0.0272]	[0.0202]	[0.0170]	[0.1740]	[0.1330]	[0.3024]
Quick liquidity ratio (N2)	-0.1463***	-0.1005***	-0.0790***	-1.5551**	-1.3822***	-1.2931***
	[0.0285]	[0.0200]	[0.0155]	[0.6215]	[0.3681]	[0.3240]
Current liquidity ratio (N3)	-0.0629**	-0.0502***	-0.0421***	-4.0266***	-1.9672***	-1.2172***
	[0.0248]	[0.0179]	[0.0145]	[1.1415]	[0.6934]	[0.4609]
Long-term liquidity ratio (N4)	0.1499**	0.1044**	0.0737**	2.7154	2.7784**	1.8269*
	[0.0615]	[0.0422]	[0.0376]	[2.1230]	[1.2303]	[0.9578]
General liquidity ratio (N5)	0.0133	0.0011	-0.0062	0.7897	0.2532	-0.0164
	[0.0227]	[0.0165]	[0.0138]	[0.6787]	[0.4786]	[0.3608]
Large-risks-	-0.0157	-0.0104	-0.0034	-0.9381	-2.8056	-4.2494**
to-capital ratio (N7)	[0.0424]	[0.0313]	[0.0270]	[2.3161]	[1.8444]	[1.8832]
Owner-related-credit-risks-	-0.0523	-0.0398	-0.04	0.4501	0.2899	0.0642
to-capital ratio (N9.1)	[0.0556]	[0.0415]	[0.0375]	[0.3709]	[0.4224]	[0.3412]
Insider-related-credit-risks-	-0.0921***	-0.0655***	-0.0548***	-0.0012	-0.3293***	-0.3046***
to-capital ratio (N10.1)	[0.0296]	[0.0233]	[0.0203]	[0.0230]	[0.1035]	[0.0916]
Individuals' deposits-	0.0305	0.0231	0.019	0.3554*	0.2845*	0.3701**
to-capital ratio (N11)	[0.0186]	[0.0151]	[0.0137]	[0.2013]	[0.1557]	[0.1739]
Investment-to-shares-	-0.0941*	-0.0538	-0.0392	-0.5241	-0.0729	-6.7723***
to-capital ratio (N12)	[0.0565]	[0.0562]	[0.0629]	[0.4581]	[0.6801]	[1.8875]
Issued-promissory-notes-	0.0074	-0.0089	-0.0124	0.3182	0.3193	0.0271
to-capital ratio (N13)	[0.0272]	[0.0190]	[0.0158]	[0.2411]	[0.3699]	[0.2705]
Observations	19481	19728	19728	19445	19484	19507
Number of banks	1393	1393	1393	1382	1382	1385
Log Likelihood	-45.22	-31.5	-26.4	-70.92	-53.8	-35.69
Wald chi2	642.84	673.97	684.18	531.66	557.49	602.4
No. of failures	160	160	160	135	133	137
theta	0.09	1.16E-09	7.77E-10	0.40	1.32E-10	1.46E-10
LR test heterogeneity	0.22	0.00	0.00	1.63	0.00	0.00
Prob	0.32	1	1	0.10	1	1

Note: The breach variables in the regression equation are: (1) discounted number of breaches assuming exponential smoothing: (1a) *dnbreach* ( $\alpha=0.3$ ), (1b) *dnbreach* ( $\alpha=0.5$ ), (1c) *dnbreach* ( $\alpha=0.7$ ), (2) discounted severity of breaches assuming exponential smoothing: (2a) *dsbreach* ( $\alpha=0.3$ ), (2b) *dsbreach* ( $\alpha=0.5$ ), (2c) *dsbreach* ( $\alpha=0.7$ ). The dependent variable is the number of quarters between the issuance and revokal of a bank's license. Table 1 provides a detailed description of all explanatory variables. The functional form for the hazard ratio was chosen based on the Akaike information criterion of model selection. Detailed results for model selection are included in Table 6. All survival model estimations allow for bank-specific unobserved heterogeneity which is assumed to be inverse Gaussian distributed. Theta is an estimate of the variance of heterogeneity. The LR test for heterogeneity is a likelihood ratio test of the null hypothesis that this variance is zero. \*, \*\* and \*\*\* indicate significance levels of 10, 5 and 1 percent respectively.

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