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## Russia' banking sector transition: Where to?

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Andrei V. Vernikov

## Russia's banking sector transition: Where to?



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All opinions expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.

Andrei V. Vernikov<sup>1</sup>

## Russia's banking sector transition: Where to?

### Abstract

This paper applies an analytical paradigm of institutional economics to the transition of the Russian banking sector, focusing on the interplay between ownership change and institutional change. We find that the state's withdrawal from commercial banking has been inconsistent and limited in scope. To this day, core banks have yet to be privatized and the state has made a comeback as owner of the dominant market participants. We also look at the new institutions imported into Russia to regulate banking and finance, including rule of law, competition, deposit insurance, bankruptcy, and corporate governance. The unfortunate combination of this new institutional overlay and traditional local norms of behavior have brought Russia to an impasse – the banking sector's ownership structure hinders further advancement of market institutions. Indeed, we may now be witnessing a retreat from the original market-based goals of transition.

Key words: banking sector reform, privatization, Russia, economic transition, institutional economics

JEL: G21, G28, P34, P37

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Andrei V. Vernikov

## Russia's banking sector transition: Where to?

### Tiivistelmä

Tässä tutkimuksessa käsitellään Venäjän pankkijärjestelmän muutosta institutionaalisen taloustieteen käsitteiden avulla. Pääpaino on pankkien omistuksen ja instituutioiden muutoksien vaikutuksessa toisiinsa. Julkisen vallan vetäytyminen pankkisektorilta on ollut epäjohdonmukaista ja varsin vähäistä. Tärkeimpiä pankeja ei ole vielä kukaan yksityistetty, ja valtio on itse asiassa lisännyt omistustaan pankkisektorilla. Työssä tarkastellaan myös, miten Venäjälle ulkomailta tuodut pankkisektoriin liittyvät instituutiot – lainsäädäntö, kilpailu, talletussuoja, konkurssit ja yritysten hallintajärjestelmä – ovat toimineet. Näiden muualta tuotujen instituutioiden ja Venäjän omien traditioiden yhdistelmä näyttää estävän pankkisektorin kehittymisen edelleen. Pankkisektorin omistusrakenne ei edistä markkina-instituutioiden kehittymistä. Saattaa olla, että pankkisektorin transition alkuperäisistä tavoitteista ollaan luopumassa.

Asiasanat: pankkisektorin uudistaminen, yksityistäminen, Venäjä, taloudelliset instituutiot, institutionaalinen taloustiede

# 1 Introduction

This discussion paper assesses the direction and nature of transition in the Russian banking sector, focusing on the somewhat overlapping spheres of ownership and institutional. Ownership can be seen as a set of fundamental institutions,<sup>2</sup> while private ownership may be treated as the solid core of a market economy that shapes economic institutions. Because the challenge for a transition economy is to build new institutions based on private ownership, there is an implied end to the dominance of collective ownership and the resulting tensions discussed here.

In less than a decade since the financial crisis of 1998, Russia's banking system has emerged from obscurity to become a popular area of study for scholars, experts, and investors. Researchers typically examine select aspects of the banking system or segments of the financial market, often relying heavily on econometric and mathematical models. This growing body of literature, however, rarely goes into depth about the interaction of ownership, institutions, and the management of Russian banks. Thus, I would like to pose three questions:

- What is the Russian state's current role in banking?
- Who will likely control Russian banks in the medium term?
- What is the outlook for market institutions ultimately dominating this sector of the Russian economy?

Answers to each of these questions should help us infer the direction of transition. Where possible, we compare Russia with other transition economies in Central and Eastern Europe (CEE),<sup>3</sup> Southeastern Europe, and the Commonwealth of Independent States (CIS).

The remainder of the paper is organized as follows. Section 2 discusses the state's role as controlling owner of Russian banks against the backdrop of bank privatizations in other European transition economies and China. Section 3 tackles the outcomes of the mass-scale import of financial institutions to Russia, examining the bad equilibrium created by the mixed-economy model in the banking sector and plausible scenarios of future development. Section 4 concludes.

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<sup>2</sup> Under new institutional theory, "institutions" are not "organizations" but rather the steady social norms and rules of conduct, traditions, and behavioral patterns. If institutions are the rules of the game in a society, then organizations are the players (North, 1990).

<sup>3</sup> CEE here refers to the eight post-socialist economies in the EU at the time of writing of this paper (i.e. ahead of the accessions of Romania and Bulgaria in January 2007).

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I draw extensively on my 14 or so years of experience in the financial sector (including stints at the Central Bank of Russia, two international financial institutions, a foreign bank subsidiary in Russia, and a major Russian private bank). Naturally, all views expressed are my own and should not be attributed to any other entity.

## 2 Reassertion of state ownership in the banking sector

### 2.1 The Russian state as bank owner

The Russian state essentially renounced its monopoly on banking in May 1988 with the adoption of the Law on Cooperatives. Two types of banking entities subsequently emerged to join the banking system's nascent second tier. The first group was made up of "greenfield" private banks established by private individuals and small business associations (cooperatives). The second group of "commercial banks" consisted of transmutations of local branches of state-owned "specialized banks." By 1992, second-tier banks represented 55% of the 1,414 banking entities in existence. Most of these new banks took the legal form of joint stock companies, essentially embodying the process of privatizing banks and state withdrawal. At the same time, however, the shareholders and owners (enterprises, associations, ministries, social organizations, etc.) of these banks were, at least nominally, public sector entities themselves.<sup>4</sup> Hence, this metamorphosis of state-owned banks took place almost entirely *within* the public sector.

Unlike CEE countries, Russia banks were not involved in voucher privatization or other privatization schemes. Moreover, state withdrawal was not motivated by poor asset quality of state-owned banks or banking crises. Instead, state withdrawal was attained *de facto* through dilution of state-owned stakes, asset-stripping, malicious bankruptcies, and other shady methods.<sup>5</sup> Indeed, Russian banking crises in recent years have generally been

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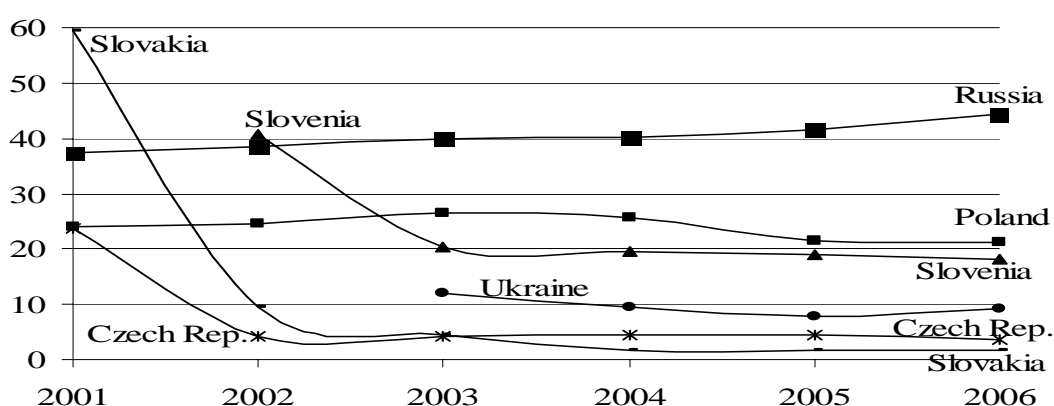
<sup>4</sup> State ownership loses its classical shape during transition from a communist economy. Industrial and other assets neither belong directly to the state nor become private in the legal sense. Stark (1997) proposes the term "recombinant property" to reflect special features of ill-defined transitional form of ownership. For our purposes here, however, the public-private dichotomy in ownership is preserved. Banks that once belonged to the state or any of its subunits are referred to as public property or public sector unless and until there has been a formal legal installation of new private owners.

<sup>5</sup> Genuinely private banks experienced brisk growth throughout most of 1990s.

precipitated by deteriorating liquidity situations (1995, 1998, and 2004) or default on the part of the state itself (1998).

There are no reliable statistical data or bank rankings that might help in calculating the relative shares of each sector in total banking assets prior to 2000. Empirical evidence, however, suggests that the decline of the combined market share of public sector banks from 100% to about 30% ended around 1998. The trend reversed thereafter with the Russian public banking sector steadily expanding its ownership to over 44% by 2006. The Russian state’s reassertion of its presence differs markedly from the general pattern in transition countries, whereby public-sector ownership in banking declines and then levels off (Fig. 1). Five of Russia’s top ten banks are public sector entities.

Figure 1 Combined market shares of public sector banks, percentage of total banking assets



Sources: Raiffeisen, 2006; author's calculations for Russia

Official Russian sources put the total share of public sector in banking at 33-34%.<sup>6</sup> This figure likely reflects a natural bias for understating state holdings. The actual figure is likely higher (say, 45%), as e.g. the “Big Four” (Sberbank; the Vneshtorgbank group, which includes VTB, its retail subsidiary Bank VTB 24, and Promstroybank; Gazprombank; and Bank Moskvyy) in themselves are reported to control 40.7% of Russia’s total banking assets (see Table 3 in Appendix).<sup>7</sup> Our approach in designating bank as public or private sector is transparent and simple: we search for state organizations, state-owned, and state-controlled companies (for which we use an umbrella term *broad state*) among listed

<sup>6</sup> Raiffeisen (2006, p. 49) gives a public sector share of 34.3%, a figure apparently borrowed from official Russian sources.

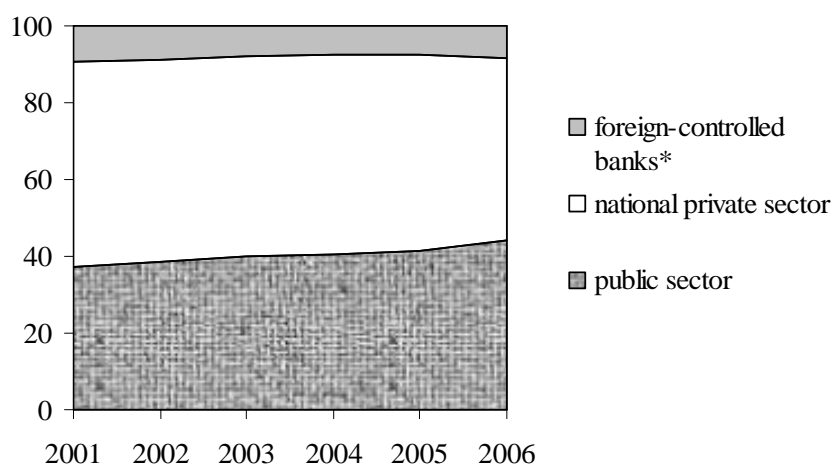
<sup>7</sup> For market shares of individual banks, we rely on rankings by assets regularly published by Interfax and RosBusinessConsulting.

shareholders at individual banks. Obviously, this is not fully effective, given Russia's lax public disclosure standards.

The *first* potential source of discrepancy lies in the attribution of sub-federal property. In the strict legal sense, municipal authorities do not belong to the state administration. Nor does the Central Bank of Russia (CBR), which is the main owner of the nation's largest bank (Sberbank). In light of the institutional essence of state structure in Russia, however, we consider authorities at *all* levels, including municipal, as part of the "state", and the banks they own or control (e.g. in Moscow, Tatarstan, and Khanty-Mansiysk Region) as parts of the public sector. Our *second* group of borderline cases includes banks controlled by nominally private and publicly-listed companies that are in fact state-controlled. If natural resource and infrastructure monopolies such as Gazprom, Rosneft, Transneft, RAO UES, Alrosa, and Russian Railways are regarded as public-sector companies, then it seems only fair to treat the banks that control them as public-sector entities as well. We assess the possible margin of error in allocation of individual banks at no more than 1% of total banking assets.

A breakdown of the Russian banking sector by form of ownership is displayed in Fig.2.

Figure 2 Breakdown of Russian banking sector by form of ownership, percentage of total banking assets on January 1



Sources: author's calculations and estimates based on CBR data

\* foreign ownership exceeds 50% of charter capital

While the majority of foreign subsidiaries in Russia belong to private foreign banks, public-sector banks of other nations<sup>8</sup> and international financial institutions<sup>9</sup> are also shareholders. In order to arrive at a more consistent breakdown by form of ownership, we must add the market shares of subsidiaries of foreign public-sector banks and international financial institutions to the share of the local public sector.

Public sector banks often form pyramid-like vertical holding structures, whereby the state entity controls the bank at the top, which in its turn controls several (nominally independent and private) banks below it. For example, the state-controlled natural gas monopoly Gazprom controls Gazprombank, which has several subsidiary banks with their own subsidiaries. The same goes for the Russia's second-largest bank, government-owned VTB. The mother bank owns nine banks in eight countries in Europe and CIS countries. Several of those banks, in turn, have subsidiaries in Russia (e.g. Evrofinance-Mosnarbank).

The ownership structures described above blur the boundaries between public and private sectors. The influence of private banks on the state goes beyond traditional "state capture," implying the involvement of private interests in shaping formal institutions. Business interests strive to control financial assets and flows that nominally remain under the ownership of the state. This may be an element of a piecemeal insider-dominated privatization – but not necessarily. In certain cases, maintaining the *status quo* can be the most efficient strategy for an insider. The Law on Privatization provides for contribution of state assets into equity of joint-stock banks as an accepted modality of privatization, delegated to the authority of the respective ministry, regional, or municipal body. Such decisions were often taken *ad hoc* under pressure from vested interests and insiders. They were not part of any consistent strategy or development plan. The result was a large number of tiny banks with minority state participation. The stakes of these banks were then diluted and ultimately appropriated with the tacit complicity of certain state agencies, companies, and individual officials. This situation partly explains the lack of public outcry or demands from private-sector decision-makers for clear formal institutions (laws) to govern bank privatization.

This situation has also put insiders, particularly top management, in position to "capture" state-owned banks. While management theory suggests such an agency problem

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<sup>8</sup> These include Credit Lyonnais (at least until its takeover by Credit Agricole Indosuez), Westdeutsche Landesbank, Bank of China, International Bank of Azerbaijan, National Bank of Uzbekistan, and Bank Melli Iran.

(self-dealing by top management) should not exist in the public sector as it should be fairly straightforward for the state to replace opportunistic top managers, the reality in Russia is that the state has trouble with bank oversight due to the thinness of managerial resources and a lack of competent supervisors. As a result, top bank managers enjoy a high degree of autonomy and can leverage their power against individual officials and selected wings of government. In addition, state-owned banks pay lower dividends on average than other state enterprises, suggesting the state takes its role as a shareholder differently in this case.

“Business capture” by the state refers to expansion of the state’s influence over private banks that behave like public sector entities. Dozens of banks not formally owned by the state remain under decisive influence from state bodies and individual officials, especially at regional and municipal levels. Influence can be exercised via a “golden share,” participation on the board of directors,<sup>10</sup> networking, and direct political intervention in decision-making. Private banks have even been taken over directly by public sector banks. For example, Vneshtorgbank took over the failed Guta-Bank in 2004 and the viable Promstroybank in 2005.<sup>11</sup>

The Russian state expects private banks to demonstrate enthusiasm and involvement in solving socio-economic problems at the macro level. Pursuit of profit maximization *per se* is deemed as socially unenlightened. Thus, bureaucrats push private banks to allocate funds along centrally-approved guidelines (including the much-touted national priority projects to improve healthcare, education, agriculture, and housing). When there is a discrepancy between non-economic motivation and normal market motivation, the institutional network can force banks to deviate from their implicit mandate to operate as efficient allocators of resources to retain the loyalty of the authorities. Although loyal banks find themselves providing loss-making services to certain client groups and engaging in high-risk lending, the state seems prepared to tolerate such inefficiency on their part and assist them in dealing with competitive pressures. Moreover, distrust on the part of state regarding the willingness of independent private-sector actors to act in accord with politi-

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<sup>9</sup> KMB-Bank was predominantly owned by the European Bank for Reconstruction and Development until it was sold to a strategic foreign investor.

<sup>10</sup> A recent example: The administration of the Novosibirsk region accepted the dilution of its controlling stake at Levoberezhniy bank by new private owners in exchange for being allowed to hold on to the majority of seats on the bank’s board of directors [Vedomosti – Novosibirsk, 21.09.2006, No.177 (1704)].

<sup>11</sup> These deals and the takeovers of several Russian subsidiary banks in Europe required considerable capital injections from VTB’s main owner, the government.

cal guidelines hinder privatization of core banks and are used to justify restrictions against foreign investment in the banking sector.

## 2.2 Alternative strategies of bank ownership transformation

Table 1 summarizes the main features of two strategies for bank privatization implemented in Russia, CEE countries, China, and Vietnam.

Table 1 Comparison of strategies for bank ownership transformation

	Strategy 1	Strategy 2
Goal	Complete ownership transformation	Improved performance of state-owned banks, maximization of revenue
Triggered by a banking crisis	Usually yes	No, but poor asset quality a major problem
Preceded by rehabilitation of state-owned banks	Yes	Yes
Envisaged role of the government	Withdrawal of government from commercial banks	Holder of controlling stake in core banks
Envisaged role of the national private capital	Not targeted	Not targeted
Envisaged role of foreign direct investors in privatized banks	Full control over privatized banks	Junior partner; source of technology, capital, and management skills
Envisaged role of foreign portfolio investors	Some room, but rather a contingency option	Junior partner of the state; a source of capital
Method of privatization	Auction of controlling stake	IPO for a minority stake, an outright sale of minority stake, or a combination thereof
Fiscal revenues	Not the main driver. Sometimes neutral impact if costs of rehabilitation are included	High, despite costs of rehabilitation
Pace of privatization	Fast	Slow
Accompanied by opening up of the banking sector	Yes	Yes, but in a measured and gradual way



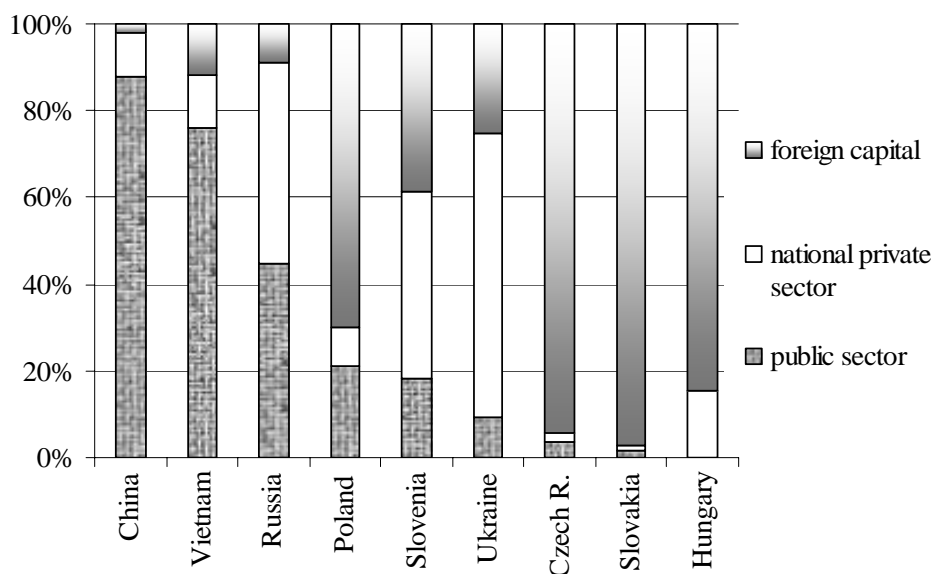
to foreign competition		
Regime for foreign direct investors in “greenfield banks”	Restrictive at first; liberal after privatization of core banks	Selective and restrictive; case-by-case approach
Part of a broader international integration effort	Yes, EU membership is a driver of paramount importance	No, except for compliance with WTO requirements
Possibility of reversal	No	Yes, if performance of banks politically unsatisfactory
Institutional impact	Strong	Weak
Countries following this strategy	Czech Rep., Hungary, Slovakia, Estonia, Lithuania, Croatia, Bulgaria, and Romania; Poland, Slovenia, and Latvia to some extent	China and Vietnam; Russia to some extent

The implementation of Strategy 1 in CEE countries was usually preceded by a period of evolutionary change without radical restructuring of ownership. The state did not withdraw from banks at the outset of reforms.<sup>12</sup> The main criterion distinguishing the two strategies, however, is not the pace of privatization or the share of either sector but rather the ultimate objective of change. Strategy 1 is an element of a broad context of transition toward a market system based on institutions of private ownership, competition, and economic freedom. Despite national specifics, the bank privatization strategy was similar for post-socialist countries that ultimately sought EU accession. Strategy 2 has been pursued in China, which is sticking with the socialist paradigm, and in Russia, where privatization has followed a different path than that of the CEE countries. Vietnam’s direction of the banking sector reforms is surprisingly similar to China’s.

The structure of banking sector ownership in Russia is closer to that of Vietnam than European transition economies (**Fig.3**). In Russia, the public sector and national private sector roughly hold equal market shares. Russia’s share of foreign-controlled banks (about 10%) is lower than for any European transition economy, including Ukraine, which is generally regarded as lagging behind Russia in market-oriented reforms.

<sup>12</sup> In Poland and Slovenia, this process is still not finalized.

Figure 3 Structure of national banking sectors, percentage of total banking assets, Jan. 1, 2006



Sources: Raiffeisen, 2006; VinaCapital, 2006; author's calculations for Russia

Comparing banking system structures in Russia and China is not a straightforward proposition as Chinese financial intermediation is highly diversified and embraces various organizational formats.<sup>13</sup> In the larger picture, however, it is obvious that China's four state-owned banks dominate the national banking industry with a combined market share of 53% (compared to 41% in Russia).<sup>14</sup> Moreover, minority stakes in state banks have both countries have been sold to investors (including foreign investors) through IPOs or private placements. The Bank of China, Industrial and Commercial Bank of China and China Construction Bank now have minority shareholders. In Russia, some 20% of Sberbank shares are held by foreign portfolio investors. Russia is planning public offerings of Sberbank and Vneshtorgbank (and perhaps Gazprombank) shares. In both countries, the strategy is apparently to maximize fiscal gains from partial privatizations, while preserving control of the state over core banks. Among institutional and political factors that predetermined this public choice, we note a willingness on the part of the state to preserve its own instruments for implementing industrial, social, regional, and other policies. In other words, the government is skeptical as to whether banks after privatization will continue to make resources

<sup>13</sup> We regard urban and rural credit cooperatives as perhaps the only private establishments in the Chinese financial system, while practically all national banks (the core state-owned banks, regional banks, development banks, city commercial banks, post-saving offices, etc.) are parts of the broad public sector.

<sup>14</sup> In Vietnam, the four main state-owned commercial banks account for around 70% of all lending activity (VinaCapital, 2006).

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available to companies and projects championed by bureaucrats. State officials are even more skeptical with regard to foreign banks as potential new owners.

Domestic private and foreign private banks are more prominent in Russia than in China. Russia has allowed 100%-owned foreign subsidiaries (currently 48), while China has limited the overall foreign stake in an individual bank to 25% and the individual stake of a foreign party to 20% of a bank's capital. Russia essentially grants national treatment to all market participants at post-investment stage, while China applies an elaborate set of restrictions and extra rules to foreign banks with respect to regional branches, local and foreign currency, banking products, etc.

Although Russia went farther than China in liberalizing its banking sector to private investors, it appears that on balance it refrained from bank privatization in favor of strategic foreign investors. The prospect of the state withdrawing from core banks and yielding control to the private sector, domestic or foreign, is equally remote. Indeed, Russia's strategy of bank ownership transformation seems more akin to the Chinese strategy of gradual improvement of core banks efficiency under firm state control than the radical market-oriented transformations of Eastern European banks.

### 2.3 The direction of ownership change

The withdrawal of the state from commercial banks that started in 1988 has been halting and limited in scope. After hitting a low in 1998, the share of public sector has risen to a combined market share of 44%. Much of the increase has come at the expense of the domestic private sector and has entailed a crowding-out of national private banks with their gradual replacement by either foreign private or national state-owned organizations. This trend of recent years took place under conditions of high rates of economic growth and political stability. It may well be that external or domestic shocks would probably accelerate this trend, as witnessed in 1998-1999 and in 2004 after the local bank liquidity crisis.

The partial privatizations of state-owned banks now under way in Russia and China are unlikely to produce major shifts in the macro structure of the banking system as long as control over core banks remains in the hands of the broad state. The incoming flows of investment, technology, and management skills that such partial privatizations trigger will strengthen existing banks and solidify their leadership, thus further marginalizing other

agents. The process of acquisition of Russian private banks by foreign banks will also not shift the gross balance because the transformation is occurring within a discrete sector.

Ultimately, this evolution is likely to produce a dual-component banking sector (public sector and foreign private sector), with the public-sector component being the driving force. National private banks continue as second-tier players, concentrating on serving certain niches. While the emerging structure of the Russian banking sector is unique among transition countries, it is analogous to the design of the financial system of Russia in the early twentieth century before the Bolshevik regime, when the number of players was restricted by high barriers to entry and the prevailing oligopolistic power in the hands of the main operators. Restricted competition will likely slow innovation in financial services offered by banks. Large enterprises and national priority projects will receive sufficient financing, while other sectors of the economy, especially small business, will have problems getting affordable bank loans.

A departure from the described trend line in terms of ownership structure implies state divestment of its core banks and a shift in control to private-sector agents. In the short-to-medium run, such a development seems highly unlikely. The state could, however, try to hinder the process of takeover of private national players by foreign strategic investors. This course of policy would artificially sustain the current large number of market participants, but hurt the economy as a whole through high transaction costs, broad interest margins, and a continued lack of competition.

The precise outcome of ownership changes resulting from a given policy is hard to predict. An intensification of control over foreign participation may not result in the strengthening of national private banks, but instead produce gaps that will be interpreted as market failures, justifying a preemptive action by the state through the banks it owns or controls. Likewise, greater public-sector participation in banking could foster state capture ("state privatization"), with nominally state-owned banks falling under the influence of groups of private interests or falling victim to opportunistic managers. Increased volumes of looting and embezzlement of public funds are also possible outcomes. As for foreign players, a *dirigiste* model with a prevailing public sector could diminish the attractiveness of the Russian market by increasing political risk and distorting price signals.

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### 3 Institutional change in the banking sector: The push to a bad equilibrium

As noted in Section 2, the Russian banking system is more or less evenly split between public and private sectors, so neither state property nor private property represent the dominant form. As a result, neither type of economic actor – state-owned or private banks – can take the lead in shaping the rules of the game (“institutions”). They all however face and/or use the entire set of existing institutions, i.e. the sum of old and new institutions. Russia did not go as far in its institutional change as CEE countries, which essentially adopted the body of European law (*acquis communautaire*). Russia has also borrowed from a broad set of formal institutions to regulate relations in the financial sphere. Apart from an independent central bank and a two-tier banking system, there are now also agencies for federal deposit insurance, credit history and credit tracking, collateral, credit ratings, bankruptcy, corporate governance, anti-money-laundering, supervision of derivatives trading, enhancement of competition, etc. These imported institutions do not necessarily conform to traditional accepted norms of Russian behavior, so promoting these new transplanted institutions has cost society in terms additional bureaucracy. Ever-growing staff numbers at the central bank and other agencies that regulate the banking industry (prudential supervision, financial monitoring and anti-money-laundering, currency control, arbitration, bankruptcy courts, deposit insurance, tax authorities) indicate that banks do not abide voluntarily by formal institutions and are prone to opportunistic behavior.<sup>15</sup> Rule of law and equality of all economic actors clash with social networks where informal institutions dominate. Moreover, banking law regulates only a certain relations and transactions. Gaps in the law have allowed banks to systematically assist their clients in avoiding taxes, as well as get around rules on currency, labor practices and corporate governance.

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<sup>15</sup> In the first nine months of 2006, the Central Bank of Russia pulled about 50 banking licenses. Most banks lost their licenses for engaging in money laundering or other criminal activities. Dozens of other banks are currently under investigation for similar behavior.

## 3.1 Rule of law

### 3.1.1 Non-deliverable forward contracts

The case of non-deliverable forward contracts on which the Russian banks defaulted *en masse* in 1998 has been used as evidence of the deficiencies of Russian law as it failed to protect a society from the impacts of certain types of transactions. The specific argument is that the import of alien foreign institutions led to a misalignment between formal and informal institutions (Kuzminov et al., 2005, p.164). The opportunistic behavior was not limited to micro-level agents, but enforcing forward contracts on Russian banks would have inflicted serious losses on them (and possibly bankruptcy followed by a takeover by their foreign counterparties). This was deemed unacceptable by Russian authorities (executive, judicial and others). Accordingly, the decision by the Supreme Arbitration Court No. 5347/98 in June 1999 ruled that forward contracts were essentially wagers (Art.1062 of the Civil Code), which left their holders without legal protection.

The ruling is quite extraordinary as Russian's Civil Code (Art.12) contains provisions governing forward contracts. The forward contracts had clear legal basis and were entered into voluntarily by parties that fully understood and accepted their respective rights and obligations. In the event of breach, both parties had an expectation that the terms of the delivery could be enforced on the other party or that they were otherwise entitled to damages. By choosing to bypass formal institutions (civil and contract law) in favor of informal institutions, the court apparently was choosing expediency over the complexities of sorting out a legal train wreck. Moreover, the ruling sent the signal that in Russia contracts are enforced only to the extent that their enforcement is not perceived as detrimental to the broadly defined economic and political interests of the Russian authorities. Eight years on, nothing has been done to solidify the institution of derivative contracts.

### 3.1.2 Treatment of branches of foreign banks

The informal ban on foreign banks establishing branches in Russia also illustrates the precedence informal institution can take over formal institutions. Russian leaders, including the president, consistently claim that foreign bank branches must not be allowed a foothold for reasons that include protecting the national market, ensuring "fair competition," and fighting money laundering. Russia has no foreign bank branches and the bank

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regulator (CBR) flatly refuses to issue licenses for them. Yet Russian law explicitly provides for foreign bank branches in the Law on Banks and Banking (Art.2) and none of the Russian authorities seeking to ban foreign bank branches have proposed amending the law. This situation again exemplifies the misalignment between law and the informal norms of paternalistic behavior of the state when executive authorities usurp the right to determine what is in the national interest. Interestingly, no foreign investor has dared to challenge the ban in court. It reflects the perception that either it is, by definition, impossible to overrule the sole bank regulator, or that in case of successful arbitration the subsequent extra-legal impact from the regulator will render the new banking operation unviable. Instead, foreign banks have had to find other ways to enter the Russian market.

### 3.2 Competition

Russia spent over 70 years eradicating competition from all spheres of economic activity. This legacy partly explains why freedom of enterprise and competition are misaligned with the paternalism of the state and the network organization based on interpersonal links. Competition is viewed as destructive, unfair, undesirable, and ultimately anti-social (Avtonomov, 1997), and xenophobic attitudes flourish where collusion is the norm of business behavior.

At the macro level, trends in the net interest margin may feature the degree of competitiveness of the banking system. Drakos (2003) analyzes eleven transition economies during the period 1993-1999, finding narrowing interest margins with the lowest levels registered by state-owned banks. A cross-country comparison suggests that the size of the net interest margin is negatively correlated with the share of foreign capital in the banking sector (Vernikov, 2005). In contrast, the average interest margin in Russia remains broad (see Table 2), while return on average capital in the banking sector has steadily grown to reach 24.2% in 2005.

Table 2 Bank interest rates in Russia, %

Year	1999	2000	2001	2002	2003	2004	2005	2006*
Deposit rate	13.68	6.51	4.85	4.96	4.48	3.79	3.99	3.87
Lending rate	39.72	24.43	17.91	15.71	12.98	11.40	10.68	10.72
Interest margin	26.04	17.92	13.06	10.75	8.50	7.61	6.69	6.85

\* January-June 2006

Source: IMF, pp.814-815.

Drobyshevsky and Paschenko (2006) apply a methodology from industrial economics (the Bresnahan and Barros-Modesto models) to the Russian banking sector to explain why average indicators of competitiveness are misleading. Despite a large number of participants (1,215 banks in Russia), the market is highly segmented and the degree of monopolization varies across segments. The markets for household deposits and corporate banking for a select range of viable clients (mainly raw material exporters and natural monopolies) are the most competitive and are dominated by state-owned banks. Other market segments typically have lower intensity of competition and a higher number of participants.

### 3.3 Deposit insurance

There appears to be only minor additional benefit from introducing the institution of deposit insurance into the banking sector dominated by state-owned banks enjoying *de facto* guarantees of performance from the state. When a comprehensive deposit insurance scheme was introduced in Russia in 2005, some 70% of household deposits were held by public sector banks, primarily Sberbank. The introduction of deposit insurance simply converted an implicit state guarantee into explicit protection, removed some agents from the household deposit market. It did practically nothing to discipline qualified market participants. Indeed, the major change since implementation of the scheme has been an inflow of deposits into new private accounts at national private banks offering high interest rates, suggesting a building moral hazard problem.



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## 3.4 Bankruptcy

The structure of the institution of bankruptcy includes not only legislation and its enforcement, but also out-of-court mechanisms and the possibility for economic agents to apply several interpretations of the law (Podkolzina, 2006). Bankruptcy in Russia often serves as a tool for hostile takeover or seizure of assets rather than its classical role of ensuring orderly work-out procedure enhancing overall economic efficiency. So far banks have avoided hostile takeovers and bank failures have been worked out by a government entity (initially ARKO, currently the Deposit Insurance Agency) that has given priority to private individual depositors and the state over corporate claimholders.

## 3.5 Corporate governance

Russia has borrowed its models for formal institutions of corporate governance from various developed market economies (Puffer & McCarthy, 2004; Radygin et al., 2004; Kape-lyushnikov, 2005). The shaping of a national model of corporate governance in the banking sector is hindered by the high degree of property concentration. The sheer number of banks registered in the legal form of “open joint-stock companies” (public companies) is misleading. Shares of an absolute majority of “joint-stock company” bank are not publicly traded. Thus, there is no single corporation in the banking sector with a sufficiently dispersed ownership structure. Each organization is typically led by a blockholder that oversees in the operational management. Naturally, such a blockholder sees little need for the mechanisms of corporate governance to protect their interests. In the absence of dynasty-run banking businesses in Russia, the role of blockholders is performed by single private individuals, a tightly-related group of individuals, or the state. Sberbank has the most diversified ownership structure among banks, despite the presence of the Central Bank of Russia as the leading blockholder with a 60.6% capital stake and a 63.8% voting share. Sberbank stock is actively traded on the stock exchange.

Most banks have no unaffiliated minority shareholders. If there is a pool of minority shareholders, they typically keep a low profile. Practical workings of legal institutions of corporate governance leave little chance to minorities to make an impact on strategic decision-making. Foreign strategic investors do not rely on the institutional framework in Rus-

sia and avoid buying minority stakes without a solid call option for the controlling stake.<sup>16</sup> The share of foreign capital contributions into 100%-owned subsidiary banks in the total amount of foreign capital contributions in the Russian banking sector fell from 82.6% to 73.7% during January-October 2006, reflecting both an improved perception of the institutional environment and a large acquisition by the French Société Générale of a minority share with an option to buy the controlling stake in Rosbank. Unlike in most CEE countries, foreign investment in Russia has so far failed to produce a change in the national model of corporate governance among Russian banks. Foreign bank subsidiaries are stand-alone corporations only nominally; they actually represent organizational units of global structures and are governed as branches of parent banks, not independent corporations (Vernikov, 2005, pp.186-199).

The model of corporate governance based on highly-concentrated property entails the problem of entrenchment of the blockholder against other shareholders. To entrench itself and retain control, the state as blockholder develops pyramid-shaped holding structures with a broad foundation and narrow summit (Kapelyushnikov, 2005), e.g. a network of subsidiaries and affiliated banks with their own subsidiaries and affiliates.

### 3.6 The direction of institutional change

Development of market-economy institutions has passed from an initial stage of brisk reform to slow incremental change. The danger today is an institutional trap created by the prevailing equilibrium between “old” and “new” institutions. Winners from partial reform and partial privatization of banks now have incentive to invest resources in preserving the *status quo* (Yakovlev, 2004). Moreover, existing agents have a relatively low demand for law and high-quality institutions (Yakovlev, 2006). Weak state and imperfect markets do not promote proper function of market institutions, and the traditional institutions of hierarchical subordination and centralization are permitted to survive. This bad equilibrium suppresses innovation and competition and fosters inefficiency. State banks, not being wholly subject to market discipline, fortify their oligopolistic position and maximize their “profits” at the expense of the economy as a whole.

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<sup>16</sup> The experiences of the EBRD and IFC in 1998-1999 provided a hard lesson that a minority stake in a large Russian bank does not necessarily provide the right to participate in control of the bank or even access to complete information about the bank’s financial condition. Several authors have considered the threshold for

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In our opinion, competition between institutions in the Russian banking sector favors “old” institutions backed by a vast reserve of public property. Today’s creeping re-nationalization of the banking sector promotes the shifting of the institutional equilibrium away from market institutions toward traditional networks. Interestingly, this situation forces the transition researcher to consider the question of how market institutions might function when state property returns to dominate the banking sector. We know banking is a factor of development provided that there is no overwhelming command force in control of the socio-economic process (Schumpeter, 1961). Moreover, old institutions are likely to absorb new institutions and force them to function in a fashion other than envisioned.

Breaking out of this bad equilibrium will require that the state, the only actor strong enough to implement change, take an active role in active institutional and structural reforms. On the other hand, there is considerable political resistance to privatization of core banks.

The revamp of the banking sector in CEE countries involved actor imports, whereby a critical mass of banking market participants were “imported” to populate the new institutional setup (Vernikov, 2005). Accession for EU membership and the harmonization of national laws do not fully explain why CEE countries pursued bank privatization strategies with such rigor. Countries that joined the EU prior to CEE membership (e.g. Spain, Portugal, and Greece) also liberalized their banking sectors, but to nowhere near the same degree. Bank privatizations were extended over a long period of time and no preference was given to foreign investors. We believe that the institutional paradigm provides an explanation to CEE banking phenomenon. Thus, while mass-scale import of foreign actors worked for CEE countries, it is likely not feasible for Russia.

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control over a bank in a transition economy (Grigoryan, Manole, 2002; Bonin et al., 2005) and the interplay of the degree of foreign participation, bank governance, and performance (Choi, Hasan, 2005).

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## 4 Conclusions

We draw five overarching conclusions from the above analysis:

- The withdrawal of the Russian State from commercial banking sector has been inconsistent and limited in scope. Core banks were not subject to privatization. Since the 1998 crisis the share of public sector banks in total assets has expanded and reached 44%, or roughly the same share as domestic private sector.
- Partial privatizations may not produce large shifts in the structure of the banking system when the state retains control over four core banks. Instead, the incoming flows of investment, technology, and management skills reinforce the dominant position of state-controlled banks. As a result, Russia's strategy for banking sector development has more in common with the Chinese strategy than with the course of reforms implemented in Central and Eastern Europe.
- Creeping renationalization of banks threatens to create a leading public sector backed by a strong, but loyal, foreign sector and a weak, eroding domestic private sector. The result in the medium term would be an imperfect, intervened market with insufficient competition.
- Institutions imported to regulate finance and banking (rule of law, competition, corporate governance, deposit insurance, bankruptcy, confidentiality, etc.) clash with traditional norms and in most cases cannot beat the competition. This creates a bad equilibrium between old and new institutions that favors non-market patterns of centralized allocation and redistribution and suppression of competition. This bad equilibrium trap is typical of an economy that has only managed to implement partial reforms.
- Demand for high quality institutions is limited. Many economic agents have developed strong vested interests in maintaining the current setup. Some private banks have learned to survive (and benefit from) paternalism and state intervention. Bank owners that cannot adapt must sell their property and exit the market.

Departure from what we tentatively see as a baseline scenario will require an active role of the state, primarily via privatization of core banks and enhancement of competition. Ironically, the likelihood of progress toward a healthier arrangement is contingent on its political feasibility.

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RosBusinessConsulting: [www.rbc.ru](http://www.rbc.ru)



## Appendix

Table 3 Russian public sector banks, 01.01.2006

<i>Bank</i>	<i>Blockholder</i>	<i>Assets, RUB million</i>	<i>Market share,%</i>
Sberbank	CBR – 60.6%	2 500 820	25.6%
Vneshtorgbank group, of which	Federal government	3 967 238	8.4%
VTB	Federal government	632 034	6.5%
Promstroybank	VTB	139 515	1.4%
Bank VTB 24	VTB	43 591	0.4%
Gazprombank	Gazprom JSC	434 585	4.5%
Bank Moskvyy	City of Moscow	216 693	2.2%
<i>sub-total (“Big Four”)</i>		<i>3 923 647</i>	<i>40.7%</i>
Ak Bars group (incl. Naratbank)	Tatarstan government	70 704	0.7%
Rosselkhozbank	Federal government	63 002	0.6%
Khanty-Mansiyskiy	Regional government	50 538	0.5%
Transkreditbank	Russian Railways JSC	47 749	0.5%
Evrofinans-Mosnarbank	VTB	44 376	0.5%
Tatfondbank	Tatarstan government	20 733	0.2%
Rossiyskiy bank razvitiya	Federal government	17 631	0.2%
VBRR	Rosneft	17 454	0.2%
Gazenergoprombank	Gazprombank	13 854	0.1%
Bank Orenburg	Orenburg regional govt.	4 915	0.1%
Sovfintrade	Gazprombank	4 809	0.0%
Almazergienbank	Alrosa JSC	4 351	0.0%
Mezhdunarodny akcionerniy	Federal government (68%)	4 186	0.0%
Krayinvestbank	Krasnodar regional govt.	4 110	0.0%
Moskovskoe ipotechnoe agentstvo	City of Moscow	3 654	0.0%
Novokuznetsky municipalny	Municipal authorities	3 504	0.0%
Roseximbank	Vnesheconombank	3 258	0.0%
Municipalny kamchatprofitbank	Regional government	2 075	0.0%
Novosibirsky municipalny	Municipal authorities	1 834	0.0%
Sibsotsbank	Altay regional government	1 414	0.0%
Chuvashkreditprombank	Regional government	1 370	0.0%
Moskva-City	City of Moscow	909	0.0%
Khakassky municipalny	Municipal authorities	572	0.0%
Yoshkar-Ola	Mariy-El regional government (71%)	525	0.0%
Onego	Karelia regional government	491	0.0%
Rinvestbank	Ryazan regional government	411	0.0%
Ivanovskiy oblastnoy	Ivanovo regional government	336	0.0%
<i>Total</i>		<i>4 356 130</i>	<i>44.7%</i>

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