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RESTRUCTURING THE BANKING SYSTEM: POSSIBLE APPROACHES[1]

The banking system is a major element of the economic infrastructure of any state. Traditionally, the key tasks of the banking system include settlements between economic entities within and without the country, and also the accumulation of savings and their conversion into investments. Banking crises usually cause malfunctions in the operation of the banking system, rendering it wholly or partially incapable of performing its functions. Clearly, any halt in the implementation by the banking system of its intrinsic functions may entail devastating consequences for the economy as a whole. That is why nations always pursue vigorous policies aimed at rehabilitating their banking system, occasionally spending considerable resources for the purpose.

The policy of overcoming the aftermath of the banking crisis generally includes the following package of measures:

- anti-crisis measures aimed primarily at supporting the liquidity of the banking system and rebuilding its function of intermediary in settlements, at calming down panic among lenders and depositors and at stopping the “raiding” of banks;
- restructuring and revitalization of the banking system with a view to “cleaning up” the banking sector, to which end the state pushes for the bankruptcies of insolvent banks and encourages and initiates banking mergers and acquisitions;
- re-capitalization aimed at rebuilding the primary function of the banking system, that of financial intermediary, to which end the state makes efforts for increasing the capital of the banking system and upgrading its quality.

The above categorization, it should be noted, is arbitrary as it is based on an attempt to define the goals pursued by the state and, therefore, the tools employed by it. Of course, in practice no country grappling with the aftermath of a banking crisis has sought to draw rigid dividing lines between such measures. On the contrary, more often than not practice demands that very different tasks be addressed simultaneously.

1. Reactions of the Government and the Central Bank to the Crisis

Of all the goals making up the program for restructuring the banking system, the Russian authorities have fully carried through only those related to the initial, ***anti-crisis measures,*** including stopping the raid on banks and restoring the functions of the banking system as the vehicle of settlements. One principal and absolutely obvious way of achieving these goals was a dramatic enhancement of the liquidity of

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the banking system that was engineered through several methods employed simultaneously:

- From the start the Bank of Russia took the decision to lower the rate of mandatory reserves for those banks which kept a considerable part of their assets (over 20 percent) in GKO-OFZ. According to our estimates, the banks' gain from that decision amounted to some 4,000 million rubles;
- The Bank of Russia substantially supported the liquidity of Russia's Sberbank to make sure that its continuous servicing of withdrawals by private depositors would help rebuild public trust in the banking system. That support took various forms (including asset buyout and lending), and the authors estimate it at 25-30,000 million rubles over August-September 1998, out of which Sberbank returned around 15,000 rubles as loans matured by early November;
- In late September – early October 1998, the Bank of Russia initiated a largely spontaneous lowering of the rate of mandatory reserves[2] by allowing banks to use part of the respective funds for making payments. The monies released as a result of that decision, according to our estimates, amounted to some 12,000 million rubles. A similar reduction in the mandatory reserves deposited by commercial lending institutions with the Central Bank was introduced by Malaysia. However, it cut the rate from 13.5 to 4 percent for all the banks;
- Following the ruble devaluation, in the second half of September 1998 the Bank of Russia began to extensively purchase foreign exchange on the market. We estimate that by late September the Bank of Russia had bought around 2,000 dollars, having issued some 30,000 rubles to finance foreign exchange purchases;
- In late September 1998 the Bank of Russia began to extend credits to finance the federal budget deficit; by late October these credits amounted to 10,500 million rubles.

In September-October 1998 the Bank of Russia made available to the banking system additional liquidity of 80-90,000 million rubles, or 8-9 percent of bank assets (3-3.1 percent of GDP). As a result, while in early September 1998 the clients' payments entered in the balance sheets but not executed by the banks amounted to 4,200 million rubles, by early October the respective figure rose to 14,700 million rubles, and by early November it shrank to 7,600 million rubles. Therefore, by late October 1998 the banking system had regained sufficient liquidity for the restoration of the normal operation of the payments mechanisms[3].

At the same time, starting with October 1998, the Bank of Russia began to issue "stabilization" credits to individual banks, among them SBS-Agro, Bank of

[2] This measure could be viewed as spontaneous because the Bank of Russia only capped the use of mandatory reserves by banks (at 30 percent) without instituting any practical controls over the application of outgoing payments. The banks seeking to meet their clients' orders through asset disposal found themselves at a disadvantage: having no backlog of clients' payments, they could not have their rate of mandatory reserves lowered.

[3] Undoubtedly, a considerable part of these monies was used to swell money supply on the market (which rose by 33,000 million rubles over the same period), which roughly corresponded to household withdrawals from the banking system within the same timeframe.

Moscow and Most-Bank. However, such credits were aimed at helping these banks cope with their liquidity shortages and insolvency rather than at resolving the liquidity crisis of the banking system as a whole. It is possible, though, that the respective banks used part of the funds thus made available to execute deferred client payments.

As early as September 2, 1998, the Central Bank announced the launch of ***bank restructuring*** operations.

The first step here was to become an audit of bank assets. Under a directive of the Bank of Russia all banks were given one month to assess the losses they had suffered from the dip in stock quotes, and also their obligations under term foreign exchange deals, and to calculate the requisite increase in reserves to offset possible losses from bad loans and promissory notes resulting from the deterioration of borrowers' financial circumstances. The Bank of Russia planned to use the assessment of the impact of the crisis on the banks in order to take further steps that would involve international financial consultants, auditing firms and investment banks. Without waiting for the results of capital revaluation, the Bank of Russia decided to install temporary management in two major banks, SBS-Agro and Inkombank[4], which had become virtually insolvent and sustained grave financial losses as early on as the end of August. Acting in roughly similar circumstances, the government of South Korea applied an even more radical measure, nationalization, to the country's two major "dead" banks.

However, in the final analysis the Central Bank's policy in the sphere was not sufficiently resolute, which was especially obvious against the background of the vigorous steps taken by authorities in Southeast Asian countries.

The rationale for the need to promptly revoke the licenses of ailing lending institutions was that, hit by the crisis, quite a few of them resorted to unlawful practices that multiplied their clients' losses. Meanwhile, as many critics pointed out, the Bank of Russia, far from speeding up liquidation procedures, even slowed them down in 1999. In the fall of 1998 the Bank of Russia publicly announced its intention to forge ahead with revoking the licenses of ailing lending institutions in order to bankrupt 200-300 banks by the end of 1999. Throughout 1999, the number of lending institutions was diminishing on average by one percent per month, which was roughly half the dropout rate in the second half of 1998[5]. Meanwhile, during the banking crisis in Southeast Asia the authorities were far more resolute in recalling banking licenses. For example, the crisis-hit Korea and Indonesia suspended the operations of 7-17 percent of their lending institutions (the respective figure for Thailand was as high as 44 percent). Eventually, 27-37 percent of such institutions (45 percent in Thailand) went out of business[6].

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[4] Although these decisions were called in question and eventually suspended by the courts, we believe that these actions graphically demonstrated the intentions of the Bank of Russia.

[5] According to recent statements by spokesmen for the Bank of Russia, as many as 50 lending institutions may have their licenses revoked before the end of 1999. Therefore, the number of operating lending institutions may amount to about 1,330 by the beginning of 2000.

[6] Estimates based on *Financial Sector Crisis and Restructuring: Lessons from Asia*. IMF, September 1999.

The Central Bank abandoned quite a few of its initial crisis-management actions. For example, as early as mid-September it gave up its efforts to arrange for negotiations between Russian borrowers and foreign creditors on restructuring the debts under the credits affected by the moratorium announced on August 17, 1998; the temporary management installed in the SBS-Agro bank was recalled; and the Bank of Russia failed to make use of its right of claim to SBS-Agro's pledged stock following the latter's default on credit and, moreover, gave the bank new credits totaling over 5.2 billion rubles.

Later on, conducting talks with non-residents on the terms of GKO-OFZ restructuring, the Bank of Russia missed a unique opportunity to "buy out" virtually all the Russian banks' forwards debts to non-residents: it would only have taken a slightly larger amount of the initial (cash) payment under the restructuring scheme. As a consequence, in discharging their obligations to non-residents the government-controlled banks alone paid several tens of millions of dollars.

In late June 1999 the Bank of Russia took the surprise decision to strip six major Russian banks of their licenses. Undoubtedly, there were more than enough formal grounds for that measure. Many other banks, however, are in similar circumstances, but they are not subjected to such treatment. Moreover, in the fall of 1998 there had existed far more substantial reasons for revoking the licenses of most of the above six banks; since then two of them – Mezhkombank and UNEXIMbank – had conducted quite successful debt settlement negotiations with creditors, while still another, Mosbiznesbank, was taken over for restructuring by the Bank of Moscow with the support of the Moscow Government and the municipal budget. The main reason for the decision was most likely the tough stand of the IMF, which demanded that the Russian authorities live up to the commitments they had assumed in April 1999.

The Fund's approach is clear enough: the banking crisis in Russia is a fact, and the experience of other countries shows that the quicker and more resolutely the authorities deal with the aftermath of the crisis, the less damage to the economy. The failure of the Russian authorities to take timely action in pursuit of a coherent strategy prompted the IMF to formulate its tough requirement, which is quite justified if taken out of context: insolvent banks must have their licenses revoked.

The problem caused by feet-dragging on the liquidation of the banks stripped of their licenses has grown far worse over the past year. As a result, the number of "dead" banks keeps growing: in early December 1999 there were 1,025 such banks as compared with 1,004 at the beginning of the year. Clearly, the liquidation mechanisms cannot cope with the large number of defunct banks. Previously most of such banks lacked creditors with a stake in their liquidation, or the pace of liquidation procedures was slowed down by a shortage of funds needed for the implementation or completion of liquidation. Today the focus has shifted to the legal and technological deficiencies of liquidation mechanisms, enabling the owners and managers of the bank to be liquidated to put off its ultimate demise indefinitely. This is demonstrated especially graphically by the largest banks subjected to liquidation procedures, such as Incombank, Imperial and MENATEP, where hundreds and even thousands of legal entities and natural persons are injured parties and, therefore, have a stake in the speedy dispatch of business. The practice of liquidation procedures shows, however, that the owners and managers of bankrupt banks have virtually inexhaustible opportunities for slowing down and even blocking these processes.

> The Bank of Russia revoked Incombank's license on October 29, 1998. The bankruptcy procedures, initiated in November of the same year, were suspended on May 27, 1999. Since then, four court hearings were held, and the latest of them, on October 7, 1999, upheld the revocation of the bank's license; this ruling should be followed up with the reopening of bankruptcy procedures. MENATEP lost its license on May 17, 1999, and had bankruptcy procedures initiated against it by a court of law on September 29, 1999. It had taken over four months and as many as 5 court hearings to declare MENATEP bankrupt. However, the example of the Imperial bank shows that the fight could go on even after a bank has been declared bankrupt. Imperial lost its license on August 25, 1998 and, following dragged out litigation, was declared bankrupt on May 25, 1999, but on June 4, 1999, the Bank of Russia suddenly suspended its decision to revoke the bank's license. Three more court hearings followed, and the bank's legal status is still not defined.

The policy of the Bank of Russia and the law-makers in this matter looks defensive and continuously belated. In view of the same problems cropping up in the course of liquidation procedures every now and then, it would seem advisable to draw general conclusions from past experiences and amend the legislation in a way that would prevent procedural delays to the detriment of the creditors' and depositors' interests[7].

Seeking to adjust banking regulation and oversight practices at a time when a considerable part of the banks' assets had been lost, the Bank of Russia introduced certain ***changes in the regulatory framework***. Clearly, most of these changes were related to the capitalization of lending institutions. The blow dealt to the capital base of the Russian banks in the fall of 1998 made it necessary for the Bank of Russia to revise its stand on the methods of formation and calculation of the banks' assets. The following decisions were taken for the purpose:

- In November 1998 shareholders were allowed to pay for increases in the authorized capital of their lending institutions with physical assets in the

[7] The banking community has taken a rather short-sighted approach aimed at shifting the bulk of the crisis costs onto the shoulders of the state, while the banks themselves are not taking any practical cooperative steps to cope with the post-crisis problems. After a number of major banks had had their licenses cancelled, in July the Association of Russian Banks addressed the President of Russia, claiming, inter alia, that "instead of revitalizing the banks which have lost their assets, primarily through the fault of the RF Government and the Bank of Russia, the RF Central Bank has started to summarily revoke banking licenses." In the Association's view, the RF Central Bank's support for commercial banks was short-lived and limited to granting some of them costly short-term credits in amounts that were not sufficient for restoring their solvency. Apart from that, the Association contended that major banks had become "problem-ridden through the fault of the Government and the Bank of Russia" and suggested that "the President of the Russian Federation should decree the RF Government to submit to the State Duma a law converting the non-repaid credits received by Russian operating commercial banks from foreign banks into government debt."

form of bank premises[8]. The measure does not in any way help increase the actual assets available to the bank; moreover, few shareholders are likely to part with their property in order to keep their floundering bank afloat – rather, the reverse is true.

- By March 1999 procedures were put in place to govern the payment of contributions to the authorized capital of lending institutions through the conversion of the liabilities of such institutions[9]. We think that decision was right, though somewhat belated. According to our information, Avtobank is the only institution implementing these procedures in practice.
- In May 1999 the requirements to the minimum equity of banks[10], with the exception of those having branches or subsidiaries abroad (which complies with the established international practices), were dropped. That decision had been fought over by the banking community and the Bank of Russia for several years previously as the latter had been seeking to fix the banks' minimum equity at one million ECUs. Although in 1997-1998 about half the operating lending institutions in the country did not meet that requirement, the Bank of Russia believed that their impact on the national economic condition was close to zero[11].
- By June 1999 procedures had been drawn up for the payment of the authorized capital of lending institutions with government securities (OFZ-PD)[12]. That was a sensible measure as well, although the low liquidity level of the respective segment of the securities market did not promise much yield to the banks.

At the same time, in October 1998 the Bank of Russia took the decision to introduce special bank regulation procedures at a time of financial crisis – procedures that effectively obliterated any oversight requirements. Under the new decisions the banks were given till July 1, 1999 to assume risks based on their equity as of August 1, 1998. In our view, there was little sense in the calculation of the economic regulators of commercial banks' operations on the basis of fictitious equity or in the application of the pre-crisis dollar exchange rate (according to the RF Central Bank's respective instructions) to such calculations. Clearly, as a result of reliance on pre-crisis regulations in bank oversight at the time, virtually all the banks could find themselves consistently violating all or almost all the regulations, and this is a typical situation for countries in the grip of banking crises. In such circumstances the supervising authorities usually suspend some of the regulations for a certain period of time, or convert some of the mandatory targets into performance indicators, or slacken up some of the requirements. However, the supervising authorities invariably used real data in assessing the banks' status.

For example, Malaysia introduced a more lenient definition of default on credits; Thailand lowered the equity sufficiency requirement and re-defined rescheduled outstanding debts as actual assets; and Indonesia also revised its oversight and loan classification regulations. At the same time these countries tightened up their

8 Directive No. 417-U of the RF Central Bank of November 23, 1998.

9 Directive No. 527-U of the RF Central Bank of March 25, 1998.

10 Directive No. 567-U of the RF Central Bank of May 27, 1998.

11 See the response of the Bank of Russia to the Association of Russian Banks, Biznes i Banki, Nos. 21-22, May 27, 1998.

12 Directive No. 571-U of the RF Central Bank of June 8, 1999.

requirements to the rate of reserves against bad loans, loans to affiliated parties and open currency positions. It should be noted, too, that following the crisis the Southeast Asian countries introduced more stringent requirements to the investment banks' equity sufficiency.

We estimate that as many as 80-90 percent of operating banks are complying with the effective economic regulations (which means that the share of problem banks does not exceed 20 percent of the total; moreover, the share of the problem banks' assets in the aggregate assets of the banking system is not higher than 20 percent either, which testifies to the equal representation of large and small lending institutions in the category of problem banks). Just as before the crisis, the application of the rate of maximum risk per borrower or group of affiliated borrowers (N6) and the rate of maximum risk per creditor (depositor) (N8) are a matter of contention: with the given capitalization levels, these regulations substantially restrict the lending operations of banks, especially medium-sized ones.

It should be noted that in this sphere, too, the Southeast Asian countries went considerably further, seeking to boost the active operations of the banking system. For example, after the crisis Malaysia cut the respective rate from 30 to 25 percent and simultaneously announced the target of expanding the banks' credit portfolio by 8 percent in 1998, while the Thai authorities set their sights on a 7 percent expansion in 1999. One more important factor worth noting is government policies for rescheduling corporate debts to banks in those countries. A consultative committee for restructuring corporate debts is operating in Thailand, and Malaysia has formed a similar committee as well. In addition to offering methodological support, Indonesia's debt restructuring agency mediates between debtor companies and their creditors.

2. Bank Restructuring Through Regionalism

The Bank of Russia formulated a certain philosophy for restructuring the country's banking system. The first such attempt was made way back in the fall of 1998, when the Bank of Russia put forward a concept of a new structure of the banking system. That approach was eventually expounded in the *Program of Urgent Measures to Restructure the Banking System of the Russian Federation*, which was submitted to the Government in October 1998. The key idea was to identify banks of federal importance (subdivided into government-owned and private ones) and core regional banks, which the Bank of Russia thought it necessary to support. The attitude to all the other banks (large ones which were not considered important from the federal point of view, and also medium-sized and small ones) was based on the principle of their full autonomy and the authorities' indifference to their fate. Those banks were either to survive or to perish depending on their own approaches and efforts, could not count on government support and were to seek out and take over specific market niches (such as services to specific groups of clients or operations on individual financial markets).

The rationale of that approach was that the Bank of Russia suggested the fastest possible categorization of banks into viable and non-viable with the identification of banks which could carry on business (and had sufficient assets or could mobilize such assets for the purpose), and also those banks which deserved government support and those which should be liquidated. However, the Central Bank lacked clear criteria for placing banks in a certain category, administrative mechanisms for the speedy liquidation of insolvent banks, or a constructive stand on sources of financial support for banks and on principles governing the provision of such support.

> The Bank of Russia suggested that the operating banks be subdivided into the following groups:
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> Group 1: Stable banks that have no substantial difficulties in managing current liquidity and are capable of doing business without additional government support and tackle their day-to-day problems on their own;
>
> Group 2: Regional banks that are to become the “core” of Russia’s future regional banking system;
>
> Group 3: Individual large banks which are unable to carry on business on their own but which should not be shut down because of prohibitively high social and economic costs;
>
> Group 4: Banks suffering from substantial liquidity or equity shortages.

The above groups were actually identified according to three criteria, the first of which was relatively objective (namely, the financial condition, with all banks subdivided into stable and problem ones), while the other two were absolutely subjective. Of all the banks, stable regional banks (those which were to become the “core”) were grouped together, as were those large banks the liquidation of which could entail “extremely unwelcome implications for the entire national economy.” Individual restructuring strategies were suggested for such banks. As a result, the Bank of Russia was confronted with the need to take a multitude of case decisions as to which of the banks which were in approximately the same circumstances were to stay afloat and which were to bow out. The entire work to identify the groups of banks and reach agreement on the “core” banks dragged on into the spring of 1999, and the time for taking concrete decision had been lost.

If we turn anew to the experience of other countries, in March 1999 Indonesia categorized its banks, solely on the basis of their financial status, into stable (74), viable (9) and non-viable (24). Mergers of stable banks were encouraged, while almost all the viable ones received government investment in the first half of 1999 through the bank restructuring agency.

Based on the work done by it, the Bank of Russia proposed that the “core” banks of the regional banking network should be 81 banks in 59 regions, accounting for a total of 5.4 percent of the aggregate assets of the banking system and about 10.8 percent of the aggregate household deposits with commercial banks (not counting Russia’s Sberbank). Out of those, 55 banks were qualified as financially stable and capable of doing business without government support, while the other 26 were in need of such support. According to the Bank of Russia, no “core” banks should be identified in 22 regions in view of the “ample supply” of banking services in them, and also in view of the position of the executive authorities[13].

[13] Report *On the Situation in the Banking System and Restructuring Problems* by Viktor Gerashchenko, Chair of the Bank of Russia, to the 9th Congress of the Association of Russian Banks.

The worst weakness of the proposals of the Bank of Russia, one that made them impracticable, was failure to produce solutions to the key problem of sources of financing for the program of re-capitalization of the banking system. Way back in the fall of 1998 the Bank of Russia estimated that altogether 120 billion rubles were needed to rebuild the banking system, and it reaffirmed that estimate in the spring of 1999. However, no financing sources were identified. The Government believed that this work should not be financed from the budget; the Bank of Russia did not propose any revolutionary ideas regarding the use of its own resources; and no possibilities were identified for tapping outside sources of financing, such as international financial institutions. Of course, there can be no simple or clear answers, especially in the case of Russia, which has to find enough money to service its foreign debts and support social stability following the economic meltdown.

So far government agencies have perceived their role in restructuring the banking system in the form of participation in the formation of the authorized capital of medium-sized banks[14]. The Bank of Russia believes that[15] “the shareholders of banks with foreign participation in equity could contribute 7.5 billion rubles to re-capitalization, while another five billion rubles would be received from internal sources." Certain hopes for a role in banks’ re-capitalization (to the tune of 2.5 billion rubles) are pinned on the regional authorities, but this is doubtful in view of the countless financial problems of the regions. Therefore, the identified financial sources cover only 25-30 percent of the banking system’s capital shortages. Moreover, judging by the structure of the planned sources of financing, the government authorities are prepared for the minimum participation of banks’ shareholders in the re-capitalization of the banking system and even look to foreign investors for the bulk of contribution to this effort.

3. ARCO: Policy or Simulation?

Up until now the main efforts of the state entities (the Bank of Russia and ARCO) have been aimed at providing temporary financial support for and assistance in the restructuring of some banks in Moscow and in the regions. Until April 1999 -- before ARCO really became active -- the Bank of Russia granted so-called low-interest "stabilization loans" to some banks. As of July 1, 1999, the total debts of banks to the Bank of Russia were estimated at 12.2 billion rubles, but the Bank of Russia did not publish either the principles of selecting the banks to be supported or the conditions it put forward for granting assistance. The financial status and the prospects of the banks which obtained Central Bank loans differ widely, and their profits are often less than the gains from the difference of interest rates (Bank of Russia loans were issued at one-third of the refinance rate, while the market interest rates were 2-2.5 times higher). Loans were issued for a term of one year (the maximum period for which the Bank of Russia is allowed to grant loans under the law), and by the fall of 1999 the Bank of Russia

[14] Some government officials believe that one significant step forward would be the establishment of a Russian Development Bank with an authorized capital of three billion rubles out of the budget. However, the incorporation of such a bank would hardly make any sense unless a coherent development strategy is formulated, responsibility for its implementation identified and potential sources of financing (except the budget) determined. Over the past few years the state has already established several banks to pursue similar missions, such as Roseximbank, the Bank for Support of Entrepreneurship and the All-Russia Regional Development Bank, but none of them has proved viable.

[15] Proceedings of the Moscow Banking Forum, October 6, 1999.

effectively recognized that the credits had not been paid back and decided to grant deferment. Considering the situation we believe it is absolutely necessary that the Bank of Russia should transfer the claims towards such loans to ARCO so that the Agency should be able to control the process of rebuilding these banks along with those banks to which the Agency itself issued credits.

The Agency for the Restructuring of Credit Organizations began its work in the spring of 1999[16], although the early government decisions on its creation were taken in the fall of 1998. By comparison, in Southeast Asian countries the time lag between acute manifestations of the crisis and the creation of institutions similar to ARCO was much shorter: 3 months in Thailand and 5 months in Indonesia; Malaysia alone took 10 months to implement the measure. What with prolonged debates in the executive and legislative branches on the status and goals of ARCO (which only ended in the summer of 1999 with the adoption of the law On the Restructuring of Credit Organizations) and feet-dragging over organizational, financial and personnel aspects of its functioning, it was not until the middle of 1999, when the bulk of the financial resources allocated for the Agency under the budget had been used up, that the guidelines for the Agency's activities emerged with any clarity. It should be noted that in Southeast Asian countries restructuring agencies were financed by the government and the national bank, but essentially through the mechanism of bond loans, which is extremely difficult in Russian conditions.

Under the federal law On the Restructuring of Credit Organizations a bank may come under ARCO management if over the previous six months:

-- the share of household deposits was at least one percent of the total share of household deposits with the lending institutions in the Russian Federation;

-- and/or the share of its assets was not less than one percent of the total share of the assets of the lending institutions in the RF in the form of loans made available to legal entities;

-- and/or it had the share of household deposits of at least 20 percent of the total household deposits with the banks located on the territory of the respective subject of the Russian Federation;

-- and/or it had the share of assets of at least 20 percent of the total assets of the banks located on the territory of the respective subject of the Russian Federation;

And also if its equity sufficiency as calculated under the law On the Central Bank of the Russian Federation (the Bank of Russia) did not exceed two percent.

[16] After ARCO began its activities, the Bank of Russia effectively abandoned the issues of restructuring of the banking system, retaining only the function of coordinating the plans of financial rehabilitation developed by lending institutions at the level of territorial agencies. The banking system includes 252 lending institutions which fit the criteria of the Law on Bankruptcy. By now 195 banks have submitted plans of financial rehabilitation, and about 50 banks have either submitted impracticable plans or taken no action whatsoever.

These criteria are met by just 7 (sic!) banks (2-3 major banks and several smaller ones, according to our assessments). It is high time the criteria be revised.

ARCO now works mainly with small and medium-sized banks and implements modest projects while the main part of its assets is used to meet the financial needs of banks, in other words, the financial needs of the owners of the banks, and not to increase the capitalization of the banking system.

The federal budget earmarked 100 billion rubles for the restructuring of lending institutions in 1999. That sum constituted the authorized capital of ARCO. At this writing, ARCO has already decided on how to spend 7.5 billion rubles: work has begun on 14 projects, covering 19 banks from 10 regions; some banks have been transferred under the Agency's management (among them SBS-AGRO, AvtoVAZbank, Rossiisky Kredit, Investbank, Kuzbasugolbank, Peter I Bank, RNKB and Chelyabkomzembank). So, ARCO "controls" about 7 percent of the assets in the Russian banking system.

Available information does not reveal any logic or purpose in the actions of ARCO. To this day the Agency has not formulated its goals and tasks or the criteria for selecting banks and regions to which assistance is to be targeted. Moreover, we believe that ARCO has no clear idea of the problems which face Russian banks.

Even more questions regarding the overall direction of the Agency's actions are suggested by the Agency's choice of banks for restructuring. For instance, one of the first to come under ARCO's control was AvtoVAZbank -- perhaps the most problem-ridden bank in the Samara Region, which, incidentally, has enough banking institutions. AvtoVAZbank was in a deep financial crisis since 1996; its shareholders chose not to assist it, moreover, they withdrew all their financial business from it. At about the same time distress signals started coming from the Eurasia Bank, energetically lobbied by the authorities of the Republic of Udmurtia, which themselves categorically refused to help the bank with their own assets, and also from Tveruniversalbank, a review of whose financial status is currently being completed by ARCO. In the Chelyabinsk Region, which has no shortage of banks either, ARCO has taken "under its wing" Chelyabkomzembank, which has accumulated losses of 11 million rubles and outstanding obligations worth 68 million rubles. Obviously, in this situation the 100 million rubles allocated by the Agency will mainly go to cover the accumulated losses without substantially changing the bank’s status.

ARCO's decisions on rendering assistance to (and not restructuring) Moscow banks raise even more eyebrows. While one can see some sense in the extension of a loan to Alfa-Bank – it is going to expand its regional network (however, the choice of region is up to the bank rather than the government authorities, which have pledged help to the regions which are short of banking services) -- the plan to restructure another Moscow bank, RNKB, can only be described as weird. First, it is obvious that Moscow has no dearth of banking institutions. On the contrary, there are too many banks for the Bank of Russia to be able to supervise them adequately. Secondly, ARCO is engaged in the RNKB rehabilitation project jointly with the Bank of Moscow, which itself was unable to keep afloat in the fall of 1998 without obtaining a credit from the Bank of Russia, which it has not yet paid back. Third, while sharing the financial burden of restructuring the RNKB with the Bank of Moscow on a fifty-fifty basis, ARCO is getting a minority share in the capital of the bank being restructured.

Another ARCO project -- involving SBS-AGRO -- can hardly be treated without irony. Obviously, the losses suffered by the bank are so great and its own real assets so insignificant that restoring the bank is not a viable proposition. But under the pressure of the Government and the Bank of Russia, ARCO has “resolutely” attacked the bank’s problems and begun paying back its creditors out of its own assets. Considering that the financial gap between SBS-AGRO's assets and liabilities is variously estimated at between 30 and 50 billion rubles, the federal budget may be paying off the banks liabilities for many years ahead. It appears that the only real goal of this ARCO project was to enable the owners of the bank to dodge liability and avoid bankruptcy.

On the whole, ARCO has by now made decisions on the use of just 650 million (0.015 percent of GDP) out of the total 10 billion rubles it has received from the budget in order to increase the capital of banks, mostly small and weak ones. Meanwhile, 2.5 billion rubles has been used... to credit the federal budget (sic!).

4. What Could Be the Main Task?

Prospects of restructuring "through regionalization" were dubious not only because the financial sources were unclear, but also because the goals of the concept were vague. As it was developed at the height of the banking crisis, when the banking system was not coping with its payments function, that task was treated as a priority. While not underestimating the importance of uninterrupted operation of the payments system, it must be said that the state policy of restructuring the banking system cannot treat the restoration of normal payments as its only goal. If that function of the banking system is made the cornerstone, then it can be assumed that the cheapest way to restore the banking system would be to confine payments to the Central Bank and Sberbank of Russia, which are capable of providing payment services throughout the country's territory. Moreover, reliance on regional banks in creating a workable payments system would give rise to a host of problems in the sphere of payments between regions: banks in one region won't have sustained links with counterparts in another region, with mutual risks growing and interregional payments slowing down.

It is obvious that from the point of view of the economy, the most important function of the banking system is that of financial intermediary arranging for the accumulation of savings and their transformation into investment, and it is to restore this function that the state assets should be directed at above all. It is equally obvious that banks are unable to perform that function without sufficient assets of their own. Otherwise they would constantly come up against prudential restrictions on attracting the assets of their clients and on lending.

After the crisis and bankruptcy of a number of major banks having vast networks of branches, the regional component of the Russian banking system substantially increased. The restoration of the banking sector is impossible without creating fairly large interregional banks that can cut through region isolationism, link regions into relatively independent economic communities and ensure capital mobility across the territory of Russia.

To step up the process of transformation of savings in the post-crisis period, it is necessary to restore client confidence in the banking system. The law On Guarantees of

Private Deposits has yet to be adopted and it is doubtful that the positions of different branches of power can be brought to a common denominator any time soon. Southeast Asian countries took much less time to make similar decisions: one month in Thailand and 3-4 months in Malaysia and Indonesia. These countries continue to develop elaborate schemes to ensure deposits. Indonesia highlights the need to thoroughly develop such plans. The authorities there, having shut down 16 major banks, guaranteed the safety of deposits under 20 million rupees (about 5,000 dollars). As a result, following massive withdrawals from commercial banks, only part of the monies returned to government-controlled banks and government lending institutions, while the rest of the money fled the Indonesian banking system.

But the crucial question in the government strategy of restructuring the banking system must be the creation of large banking institutions in Russia. Banking institutions are essential if national-scale companies are to operate effectively and major business projects are to be implemented. The question of the concentration of banking capital is highly relevant to Russia considering its vast natural resources and commensurately large companies.

From its inception the Russian banking system was characterized by a relatively low level of capital concentration. In the early period (1992-1994) the Central Bank set minimum requirements to newly created banks, which, along with the attractiveness of the banking system, led to the formation of a large number of small banks with insignificant equity. The change of the macroeconomic situation in 1994-1995 prompted a change in the requirements of the Bank of Russia which, instead of encouraging the creation of new banks, toughened the requirements to the newly created and existing banks. Above all, the minimum authorized capital requirements were increased[17] and the criteria of equity sufficiency revised in line with the international standards[18].

Undoubtedly, the economy needs small lending institutions, which in many cases can play a very important role. The events of the past year have shown that small and medium-sized banks have been far less exposed to a number of banking risks, which proved to be the undoing of large banks. To some extent small (and sometimes even medium-sized) banks have less need of capital than large banks. Most small banks are controlled by a small group of owners, including the enterprises which are simultaneously their main clients. The main resource base of such banks is the assets in the accounts of clients; credits are as a rule granted for short periods of time to cover cash gaps. Under such conditions the banks in effect operate as cash and settlement centers or "mutual assistance funds" and are not exposed to serious credit risks. We believe that for such banks the role of bank capital as a source of reserves is not very great because of their low risk exposure. It would be practicable to transfer them into the category of non-banking lending institutions by curtailing their licenses to some extent along with relieving them of the duty to comply with certain standards or establishing different standards for the assessment of their operations.

[17] Beginning from March 1994, the equity requirement for newly created banks was an equivalent of $1 million.

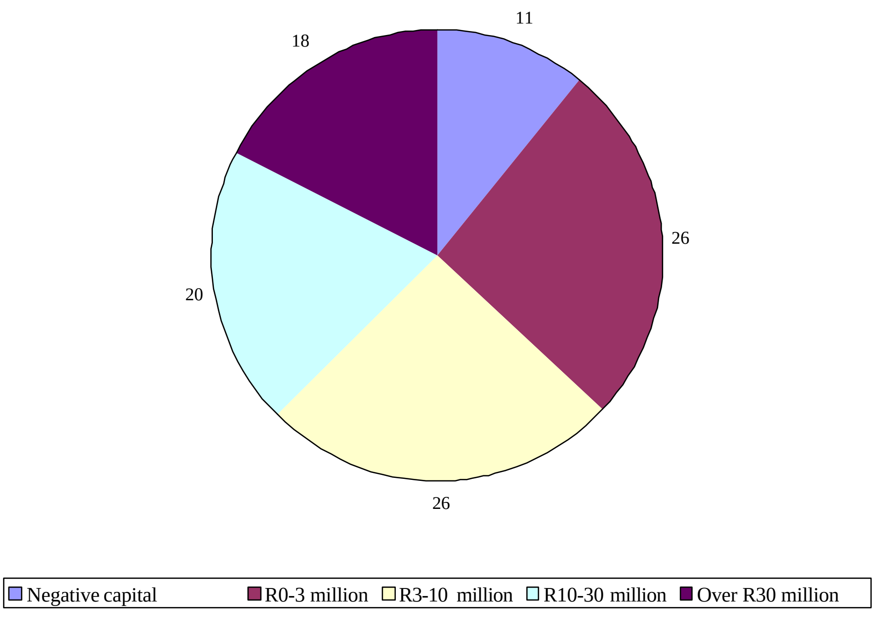
[18] This was manifested mainly in enlarging the list of asset risks, toughening risk rates as well as in additional record-keeping requirements with regard to the assets made available to shareholders and insiders.

The overall economic situation, on the one hand, and the actions of the regulatory agencies, on the other, have encouraged the trend towards an increase in the amount and concentration of banking capital. From 1996 to the middle of 1998 these processes were proceeding in parallel. The aggregate banking capital increased 1.9 times (1.4 times in dollar terms) from early 1996 to mid-1998 to reach 139 billion rubles (22.5 billion dollars). The number of operating credit organizations in the same period dropped by 30 percent to 1,598.

With the current state of affairs Russian banks with an equity of under 30 million rubles at par value can also be referred to the category of small banks. Their share of the total number of banks remained constant and fairly high (about one-half) throughout 1997-1999 in spite of all the macro-economic upheavals.

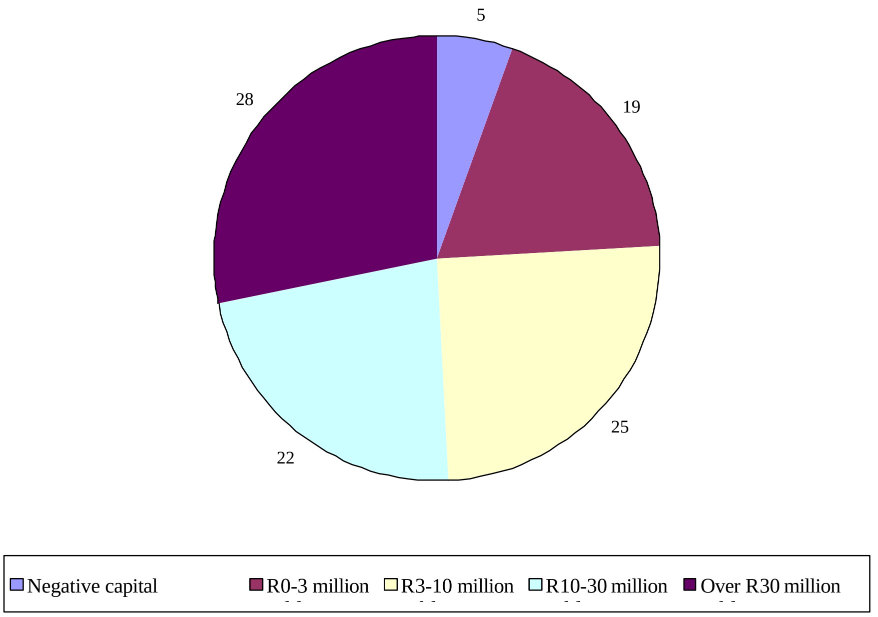
The share of medium-sized and large banks with a capital of over 30 million rubles at par value increased from 22 to 28 percent from early 1997 to the middle of 1998.

Pie-chart 1. Breakdown of banks by size of capital as of January 1, 1997



The number and the share of banks with a capital of 30 million rubles does not adequately reflect the level of bank capital concentration, especially if one bears in mind substantial changes in the value of the ruble. Capital concentration is better reflected by the share of the capital of large banks in the total capital of the whole banking system and by assessing the maximum lending potential of the largest banks.

Pie-chart 2. Breakdown of banks by size of capital as of July 1, 1998



The data in Table 3.1 testify to the steady growth of banking capital concentration in Russia. The share of large banks in the total capital within the banking system grew significantly[19] in spite of the banking crisis, which hit the hardest the larger banks, some of which (Inkombank, TOKObank and Imperial[20]) lost their licenses. They were replaced by new leaders, which managed to increase their capital and dramatically expand their activities (Gazprombank, MDM-Bank, Gutabank, Rosbank and others).

It is equally obvious that in spite of the increased share of large banks in the capital in the banking system as a whole, their lending potential diminished significantly after the crisis. In fact, as compared with early 1997 (at the peak of activities of Russian banks) the credit potential of major banks has dropped almost three times[21].

Table 1. Scale and dynamics of banking capital concentration in Russia

	1.01.95	1.01.97	1.01.99	1.12.99
Share (%) of large banks in the total capital of the Russian banking system				
50 largest banks	48.8	45.6	65.4	64.6

[19] The dramatic drop in the total number of banks undoubtedly contributed to the sharp growth of that indicator in 1997-1998 because it automatically increased the share of a fixed number of large banks.

[20] At the beginning of June 1998 Inkombank ranked second in Russia in terms of the size of assets and 6th in terms of equity, Imperial ranked 10th and 16th, and TOKObank 19th and 17th, respectively.

[21] It is not by chance that we have chosen the indicator of the possible size of credit in foreign currency because the largest and most reliable borrowers in Russia are major players in foreign trade, whose credit potential is best assessed, of course, in foreign currency

100 largest banks	56.5	51.7	72.4	72.2
Maximum size of credit[22] a bank may issue to one borrower, million dollars				
Average for 50 major banks	25.4	56.1	20.3	22.3
Average for 100 major banks	14.7	31.2	11.2	12.4

Source: Bank of Russia, authors' calculations

It will be seen that in terms of the fulfillment by banks of their main economic function of accumulating and redistributing cash resources, the potential of major Russian banks and the whole banking system dropped significantly after the crisis.

The competitive positions of Russian banks in the world also changed dramatically: while in early 1997 10 Russian banks had a capital of more than 250 million dollars, putting them in the top 30 banks in Eastern Europe, by early 1999 only 3 banks met that criterion: Sberbank of the RF, which remains the biggest lending institution in Eastern Europe in terms of assets and equity, as well as Gazprombank and Mezhprombank.

A comparison of capital concentration in Russia and Eastern Europe shows that concentration is higher in most East European countries than in Russia. For example, in Poland the share of 10 major banks in the total capital of the banking system in 1998 was more than 46 percent and in Hungary 52 percent, while in Russia a little over 40 percent. One of the main reasons for this is that East European countries paid much more attention to the problem of capitalization of banks at the time of the transformation of the state bank systems there. Typically, the state was much more active in the formation of lending institutions, providing them with initial capital, retaining a stake in banks' equity for a long time and granting non-residents broad opportunities for investment in the banking sector[23]. It can be argued that the rapid privatization and liberalization of the banking sector in Russia (when the state renounced active participation in the equity of banks except Sberbank and Vneshtorgbank) coupled with low exposure to competition from foreign banks predetermined in many ways the low capitalization level of the Russian banking system.

Considering the current situation, the strategy of restructuring and re-capitalization of the Russian banking system should be geared to the creation of large and diversified banks. In terms of assets and equity such banks could be among the top 500 banks of Europe (which means that their minimum equity should be 200-250 million dollars and their assets -- 1,000-1,200 million dollars). The emergence of lending institutions of such a scale would substantially change the relations between the banking and the production sector in Russia and between the Russian banking system and the world financial markets.

[22] Under Central Bank Instruction No. 1 the maximum loan issued to a single borrower or a group of related borrowers may not exceed 25 percent of the bank's own assets.

[23] Privatization of government stakes in lending institutions is a key source of budget revenues in Poland. In 1999 the country's budget got 1.6 billion dollars from the privatization of government interests in two banks (48 percent and 52 percent).

Only major banks are able to render the whole range of modern banking services to a large number of clients, accumulate sufficient financial resources and redistribute them between economic sectors, meet the credit needs of major Russian enterprises, ensure the flow of money between regions and attract foreign investment into the Russian economy.

6. What Can the State Do?

Moreover, the current situation suggests that we can realistically talk not about a program with regard to all the banks or groups of banks, but about the actions of the authorities with respect to individual banks. In order to implement the above strategy, the state can and must use the following methods of making lending institutions larger and increasing the concentration of banking capital:

- measures to restructure individual large banks whose financial problems are not insuperable[24];
- participation of the state in re-capitalization of major banks which managed to remain financially stable during the crisis but lost a significant part of their capital. World practice shows that the use of state assets to capitalize banks should be accompanied by harsh requirements to banks in order to deter them from risky operations and from unjustifiably meeting the interests of shareholders and managers;
- initiating mergers and associations of banking institutions, including coercive measures, especially with regard to government-controlled institutions. Indonesia, for example, has brought in numerous foreign advisers to effect a merger of four state banks, with their overdue credits handed over to the bank restructuring agency. The new bank, which accounts for one-third of the assets of the whole system, is expected to be privatized when costs are reduced. In Malaysia the authorities also pursue a policy of encouraging mergers of major banks. In Russia’s case it would make sense to consider a transition from the current practice of financial support (by the Finance Ministry, ARCO or the Bank of Russia) and restructuring of regional banks with government resources to the transfer of such banks into the management of existing stable banking structures or their takeover as branch offices by such banks;
- a concerted effort to attract foreign capital to the restoration of multi-purpose banks which have gone bankrupt but whose outstanding liabilities are not large. Examples of such banks may be Promstroibank and Mosbiznesbank. The size of assets required to cover the damages of each of these banks is 60-100 million dollars, which is incomparably less than the amount any investor would have to spend to create a banking network of the same scale.

[24] ARCO started on such a program with regard to the Rossiisky Kredit bank. At the initial phase the program was mainly designed and executed by the owners and managers of the bank while ARCO played the role of an "umbrella" in this process. (In world practice such programs are accompanied by barring the former owners of the bank from decision-making.) The fact that the launching of the program was delayed by more than a year makes it doubtful that the bank can be restored to a workable condition even after a settlement with the creditors. As a result the owners of the bank have "shirked" the problem, leaving it to ARCO to clear the logjam.

> Obviously, before attracting foreign investors, the state should guarantee the safety of the assets of the banks and prevent any actions of the managers and owners of the banks that may increase their obligations.

The growth of the capitalization of Russian banks and their performance of the functions of transformation of savings into investment in the medium term can be ensured by a substantial expansion of the activities of foreign banks in Russia and by resumption of interaction between the domestic banking system and the world capital market. At a time of a shortage of assets the government agencies can and must allow greater participation of foreign capital in the Russian banking system and be more aggressive on that issue. On the one hand, the Bank of Russia may present higher requirements to the capitalization of subsidiaries of foreign banks operating in the Russian market which lost capital in the financial crisis. On the other hand, the state may offer foreign banks to go shares in the process of restructuring the Russian banks. Furthermore, the state may demand that the foreign banks operating in Russia should take more vigorous action to expand their business which will confront them with the need to build up bank capital and be more aggressive in the market of banking services.

The Bank of Russia at present welcomes the increase of the share of non-residents in the capital of the Russian banking system through the capitalization of the debts of Russian banks to non-residents, that is, by transforming the claims of foreign creditors into stakes in the authorized capital of banks.[25] But foreign investors do not show much enthusiasm for such actions especially since the mechanisms of converting debts proposed by the Bank of Russia have yet to prove that they are workable.

Thailand is simultaneously implementing several strategies in handling the assets of problem banks. The agency for the financial sector restructuring is trying to quickly sell the credits and the basic assets of problem banks. The more liquid assets were sold for approximately half of their balance value, while the less liquid assets were sold at 20 percent, and then only with difficulty. An organization for the management of collateral credits was set up to buy out and raise the value of construction project credits. Besides, in Thailand a new bank was organized, financed by international financial institutions, to purchase high-liquidity assets which subsequently absorb one of the largest banks which have gone bankrupt. All the above mentioned structures were state financed. A "bad" bridge bank was set up to manage the outstanding credits of the Bangkok Commercial Bank. The state is encouraging private banks to use similar mechanisms. A bridge bank for major investment banks which are being liquidated was also created in South Korea.

In Malaysia a state-owned and financed company was buying the assets with the bonds redeemed by the Central Bank. The activities of the company go beyond the framework of managing problem bank assets and also includes promotion of credits to key sectors, notably exports. In addition, a subsidiary company of the Central Bank is supervising the management of banks which have already sold all acceptable credits to the state company and is re-capitalizing them.

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[25] Report by the Chair of the Bank of Russia, Viktor Gerashchenko, at the 9th congress of the Association of Russian Banks "On the Situation in the Banking System and Restructuring Problems."

The Indonesian Agency for Bank Restructuring works on pre-sale preparation and sale of the assets of problem banks. Major insolvent banks with wide networks of branches came under the Agency's management.

In Russia the state, including ARCO, is limited in the choice of instruments it can use in the process of bank restructuring. The nature of the Russian banking crisis and the causes of the losses suffered by the Russian banks (exchange rate risks and term of transaction) will prevent the use of "traditional" methods of re-capitalization of banking system used in other countries, namely buying bad assets[26]. The Russian authorities should be more precise in "diagnosing" each bank with which they are going to work, determining the causes and character of its insolvency and selecting, if possible, corresponding instruments for overcoming the situation. Obviously, the set of instruments cannot be the same since different problems faced by banks require different methods to deal with.

Considering the actual conditions in which Russian banks operate, one can identify the following typical problems of banks that may enable them to "catch the eye" of ARCO, and the corresponding instruments[27].

Problem and causes	Possible tools
Insufficient banking capital. It may be a result of sustained losses and may not necessarily render a bank insolvent. The bank is capable of complying with all of its current obligations and its problems "boil down" to the violation of prudential norms.	1. Establishing, for a fixed period of time, individual prudential norms based on the realistic but strained equity growth. 2. The acquisition by the state of a share in a bank's capital (giving it a subordinated credit) in order to restore its capital to the level where it can comply with the established requirements. To prevent inflationary effects, a bank uses these funds to acquire long-term low-interest government securities. Additional terms (options) may enable a bank's owners/managers to buy shares before the redemption of government securities. If they refuse to use this option, the state sells its share in the bank's capital.

[26] Usually banks suffer losses from the deterioration of the quality of assets which drives prices down or due to insolvency of the borrowers. In such situations government bodies buy out assets at (or close to) their balance evaluation and assume all the risks connected with the fate of these assets. Not infrequently, the price of part of such assets rebounds after a while and their sale enables the state to recoup some of its expenditure. In Russia, banks have been faced with a dramatic increase in the value of their obligations because of the fall of the rate of the ruble or suffered losses as a result of term transactions. In this case the banks do not have assets which they could sell to improve their financial status. They can only do so by making the state shoulder the losses.

[27] This is not to suggest that these instruments should be applied to all the problem banks. An assessment of the scale of financial outlays in each concrete case against their possible effect and making a decision on such actions should definitely be the task of state bodies. We are merely trying to offer our recommendations on whether this or that instrument is workable in this or that situation.

Problem and causes	Possible tools
Current shortage of liquidity. It may result from mistakes made by the bank management in exercising control over the terms of assets and liabilities or from the sale by the bank of its liquid assets in order to meet sharply grown demands from its clients. In this case the bank retains long-term stability, its assets remain good and can ensure its normal operation.	1. The state purchases operating assets with their subsequent resale to other banks. 2. The state invites banks, in which it has dominating participation, to contribute to the financing of good long-term assets. 3. Disbursement of credits to support liquidity.
Lack of current revenues. This is a result of the loss of part of the bank's operating assets or the need to fulfill its obligations to the clients or the sharp deterioration of the assets (inability of borrowers to pay interest to the bank).	1. Inviting the bank to participate in government programs (providing credits for the agro-industrial complex, servicing the accounts of the State Customs Committee, providing credits for financing exports by state-owned companies, such as Rosvooruzheniye... 2. Transferring state enterprises and organizations located in the region to this bank for servicing. 3. Buying part of the bank's subsidiaries, whose maintenance expenses do not correspond to the bank's revenues from operations with its clients in the region, while preserving corresponding "regional" assets in the subsidiary. In the future the state may incorporate the subsidiary in the banks which it wants to be actively operating in the region. 4. Buying assets the efficiency of which has sharply decreased. 5. Providing direct financial assistance (one-time subsidies, low-interest credits, issuing special high-yield securities for acquisition by the bank...)
The bank's losses incurred by the sharp increase in the price of obligations (exchange rate reevaluations, forward operations) or loss of assets (borrower's bankruptcy).	1.Transferring part of the bank's obligations to other banks controlled by the state, which guarantees the problem bank's obligations to the bank which assumes its obligations to clients (scheme used for the transfer of private deposits to Sberbank in the fall of 1998). 2. Direct financial assistance (one-time subsidies, low-interest credits, issuing special high-yield securities for the acquisition by the bank...)

At the same time, we believe that in all cases when the state provides financial aid to a bank in the process of its rehabilitation, the bank's owners should assume stringent obligations concerning the speed with which its capital will be restored. If the bank receives credits at below market rates, all the profit it gains from the difference between interest rates should be used for increasing its capital. The same may also be true when banks participate in government programs. Owners' failure to comply with their obligations should lead to the transfer of their ownership of the bank to the state (a mechanism of such a transfer may be guaranteed by mortgaging shares or convertible bonds which should be handed over to the state in the beginning of the restructuring program).

In determining ways of restructuring some problem banks, it is important to take into account all nuances. If ARCO's activity aims at creating interregional banks, many small and medium-sized banks may survive only if they merge with viable banks. On the other hand, when dealing with large banks, restructuring procedures should apply not only to a bank itself, but to the entire banking-industrial complex. The refinancing of an insolvent bank's losses may not be turned into a goal in itself because the purpose of re-capitalization is to provide the basis for further restoration of the bank's vigorous operation. ARCO's limited resources restricts the provision of credits for covering losses and shifts priority to credits for improving the quality of assets and increasing their yield. We can say that ARCO should not so much salvage insolvent or problem banks as to help reduce risks in their operations with assets and liabilities and facilitate (direct) banks' negotiations with their creditors and borrowers.

7. Assessing the Russian Banking System's Restoration Rate

The years to come should see the restoration of the Russian banking system, which presupposes not only maintaining high revenues, but also expanding operating assets and improving their quality. National economic interests require this process to be completed as soon as possible, for the absence of an efficient banking system may endanger economic growth in Russia.

We believe that the restoration of the banking capital to the pre-crisis level -- 5.5-6 percent of GDP (combined capital of Russian banks in 1997) -- may serve as a criterion to measure success in the restoration of Russian banks. Given the losses sustained by the Russian banking system during the crisis, we can say that the Russian banks will have to at least double their capital from the current level of about 3 percent of GDP[28] in order to achieve this level.

In order to determine a time-frame for this process, we have outlined an optimistic scenario which is based on an assumption that the restoration and development of the Russian banking system will be quite rapid. The main factors that make this hypothesis rather probable are as follows:

[28] It should be noted that the loss or growth of capital in the banking system consists of the loss or growth of capital in individual banks. This is why assessments based on general data for the entire banking system are most accurate following the end of the acute stage of the crisis and the liquidation of bankrupt banks.

- Industrial production will continue to pick up in 2000-2002 (average annual growth rate will be not less than 3 percent), which will make it possible to say that the Russian economy is overcoming its crisis but is still far away from sustainable growth;

- Economic revival will be accompanied by rather moderate (declining) inflation which will boost demand for the national currency and reduce interest rates. The persistent tendency toward re-monetization of the real sector will mobilize additional resources for the banking system and therefore increase its ability to credit the economy. The reduction of the effective interest rate (although it will remain positive) will limit bank profit requirements but will encourage demand for bank credits;

- The securities market will begin to get out of its stagnation caused by the 1998 crisis, but it will still be dominated by speculative investors for the next few years. The market of corporate obligations will develop more vigorously, but at the same time the government's borrowing will be quite moderate, if the policy of maintaining the primary budget deficit is continued, which will prevent the government securities market from returning to the pre-crisis level;

- The fate of large insolvent banks may be on the whole decided by the end of 2000, which will result in the write-off of their losses and in an increase in the banking system's capital.

In projecting the development of the banking system, a rather optimistic macroeconomic scenario was used: GDP growth of 3-3.5 percent a year in real terms. With ebbing inflation, the nominal value of GDP looks as follows. The year 2000 -- 6,000 billion rubles; the year 2001 – 7,050 billion rubles, the year 2002 -- 7,900 billion rubles. The dynamics of credits in the economy was linked to growth in industry and foreign trade and to the growing balance on enterprises' bank accounts. The expected decrease in credits for the government is based on an assumption that the primary federal budget surplus will be kept at a substantial level and that no active borrowing will be made on the market. The projected increase in deposits reflects growing industrial production and a stronger tendency toward monetization in the real sector, as well as gradual restoration of private savings as people's incomes grow. The dynamics of the banking system's equity is based on an assumption that the restructuring of debts will be completed in 2000 and banks' equity will continue to grow in proportion to the norm of profitability in banking operations.

Table 2. Dynamics of the banking system's key indicators (%% GDP[29])

[29] As of the end of the year, in percentage to annual GDP. All indicators are calculated by the methodology used in Russian banking supervision, which accounts for some differences from similar indicators in IMF reports. Credits for the economy include credits in rubles and foreign currency, taking into account overdue debts. Credits for the government include investments in ruble and foreign currency government securities at their market value. Liquidity includes cash, funds on correspondent accounts in commercial banks and the Bank of Russia, inter-bank credits.

	1996	1997	1998	1999	2000	2001	2002
Assets	28.4	30.3	39	35.1	37.6	43.7	47.8
Liquid assets	5	4.1	6.4	7.6	8.4	10.1	12.5
Credits for the economy	8.2	9.6	12.5	10.4	12.3	14.2	15.3
Credits for the government	6	6.5	6.7	4.9	4.4	5.2	4.9
People's deposits	6.9	6.8	7.8	7.0	7.5	8.7	10.4
Enterprises' deposits	5.2	5.8	8	9.3	9.1	10.4	10.8
Equity	5.7	5.1	3.2	3.2	3.2	4.7	5.8

Source: Bank of Russia, all calculations made by the authors.

Banks may increase their capital by using either their earnings or their shareholders' contributions. It should be noted that these sources of capitalization may be intertwined. Often a bank which has made a profit does not report it in order to avoid taxes and gives it to shareholders in the form of expenses so that they would return it in the form of their contributions to the authorized capital.

The authorized capital of Russian banks increased by more than 40 billion rubles (about 0.9 percent of GDP) in the 11 months of 1999, with the state contributing 10 billion rubles (about one-fourth). Leaving aside major one-off transactions[30] the authorized capital was growing at the rate of 0.1-0.15 percent of GDP per quarter, that is, at the same rate as on the eve of the crisis. The potential of the state to replenish the capital of banks depends on the financial potential of the budget and the policy of ARCO (we leave aside the policy of the Bank of Russia whose build-up of the capital of subsidiary banks is to a large extent an accounting operation pursuing a range of goals unconnected with the process of restoration of the banking system). The draft 2000 budget earmarks just 1 billion rubles (and 4 billion rubles in guarantees) for the needs of ARCO. The only way to increase that sum can be credits granted by international financial institutions estimated at 200-300 million dollars. But considering ARCO's policy in the allocation of resources[31] even obtaining that money would not increase the capital of banks by more than 0.05-0.1 percent of GDP.

One can assume that if the same trend holds until 2002 the total growth of the authorized capital contributed by shareholders may amount to 1-1.5 percent of GDP.

Prospects for obtaining bank profits are optimistic for now. At the end of the three quarters of 1999 the Russian banking system sustained net losses of about 2 billion rubles. However, if one leaves out several loss-making banks which are headed for bankruptcy (the biggest of which is SBS-Agro) the picture becomes fundamentally

[30] Mezhprombank got over 8 billion rubles from various shareholders and Vneshtorgbank received 7.5 billion rubles from the state.

[31] So far ARCO has been granting credits and not taking equity positions with banks: of the 7.5 billion rubles used by the Agency in 1999 less than 10 percent was contributed to bank capital.

different and the forecast is a profit of 25-30 billion rubles. Thus, even if one takes into account the inevitable expenses involved in the bankruptcy of some major banks the Russian banking system may in the coming years earn and capitalize 0.5-1 percent of the GDP a year.

But looking at the structure of the incomes of Russian banks doubts arise as to their stability and quality: one is struck by the prevalence of currency reevaluation whereas the interest margin, although positive, is very low.

Table 3. Assessment of principal bank income (percent of GDP)

	1996	1997	1998	1999	2000	2001	2002
Net interest income	-0.19	-0.1	-0.24	-0.12	0.63	0.57	0.44
Net income from securities	3.32	1.86	0.04	0.70	0.78	0.71	0.68
Net income from currency transactions	0.15	0.15	1.65	1.29	1.18	1.13	1.06
Net income from other transactions	-1.63	-1.1	-2.5	-2.10	-1.51	-1.31	-1.43
Total profit	1.65	0.81	-1.04	0.11	1.0	1.1	1.3

Source: Bank of Russia, calculations by the authors.

The above picture of bank incomes is due to a large extent to the structure of the assets and liabilities which changes under the impact of the new economic environment.

In 1998 the assets of the Russian banking system increased to 39 percent of the GDP because of the advance reevaluation of currency assets. As the real exchange rate stabilized and the banking system adapted to new risks the statistical volume of activities on all types of banking operations diminished. With the current macroeconomic assumptions bank assets will be restored to the 1998 level and exceed it by 2002.

The structure of the assets and liabilities of the Russian banking system in the coming years will substantially differ from that before the crisis and will be reminiscent of the 1994-1995 structure. This will occur due to a dramatic drop in the share of transactions with the state (from 21-22 percent of the assets to 10-11 percent) and the growing share of credits to the real sector and high-liquidity assets. It is noteworthy that in spite of the acute deficit of income the relative volume of working assets in the banking system reveals a downward trend because the banks had to compensate for the absence of the financial market by increasing the level of liquidity (to 22-26 percent of the assets versus 16-18 percent in the pre-crisis period).

Table 4. Structure of assets and liabilities in the banking system (percent)

	1996	1997	1998	1999	2000	2001	2002

Liquid assets	17.4	13.6	16.4	21.6	22.4	23.2	26.2
Credits to the economy	28.7	31.8	32	29.6	32.6	32.5	32
Credits to the government	20.9	21.6	17.2	13.8	11.6	11.9	10.2
Household deposits	24.3	22.3	19.9	19.9	20	19.9	21.8
Enterprise deposits	18.2	19	20.5	26.6	24.2	23.7	22.5
Equity	20.5	17.1	8.5	9.3	9.5	9.1	9.8

Source: Bank of Russia, calculations by the authors

To sum up, given the assumptions made above, by 2003 the banking system may be earning independently about 2.5-2.7 percent of the GDP. Considering the contribution of shareholders to the authorized capital (up to one percent of the GDP) the Russian banking system may by that time have compensated the loss of capital and reach the pre-crisis level of 5.5-6 percent of the GDP. Let it be stressed that this scenario is premised on favorable conditions of the development of the Russian economy and rational behavior of the managers and owners of banks. "The stark reality of life" will inevitably prolong the period of recovery threatening more economic problems.

The experience of many countries attests that insufficient capitalization of the banking system prevents it from launching large-scale transactions, above all, crediting of the production sector. Unless a quick recovery of the banking sector occurs, Russia's potential for economic development will be extremely limited. Given an insufficient level of capitalization, the banking system may in the coming years be struck by a crisis even worse than the current one. That this is a possibility is borne out by the experience of a whole number of Latin American countries (Argentina, Brazil, Venezuela, Mexico and Chile).

A possible economic upsurge should not take the state by surprise and find it with a banking system that does not match the requirements of economic growth. To avoid such an unpleasant scenario it is necessary for the state entities to step up their efforts in overcoming the aftermath of the banking crisis. Determining the role and methods of participation of the state in the re-capitalization of the Russian banking system is a particular priority.

Considering the situation in the country one should look not only at the needs, but also the possibilities of the state to support the banking sector. The first important step was made when the problem was recognized as a priority.

Obviously, resources should be allocated from the federal budget for the activities of ARCO. The sole condition of such assistance should be a clear-cut strategy of the Agency and transparency of its operations. One can dismiss out of hand such methods of "making resources available" to ARCO as tax payments "stuck" in problem banks (that money can only be obtained as part of bank restructuring, which requires a long time) or the issue of ARCO bonds guaranteed by the budget (ARCO doesn't have any steady income or credit history, so it will have to settle for a higher interest rate which will again place a burden on the federal budget).

Financial participation of the state in the restoration of the banking sector on the basis of a compromise of the needs and possibilities is absolutely imperative. This would be a large-scale trade-off (between different economic policy goals) in order to solve the key problem of resuming economic growth and assuring the crediting of the investment process.