

# RESOLVING THE BANKING CRISIS

Rouble devaluation and the default on government's domestic debt were followed by the collapse of Russian banking sector. By the end of August, almost half of the commercial banks, including Sberbank, were experiencing problems in meeting their obligations. The payment system began to fall apart and many people were refused access to their savings.

While a banking system reform is an expensive undertaking, the need for an urgent restructuring is evident. In this report we briefly discuss the causes of the problems in the banking sector and its current state, and focus on the restructuring program proposed by the Central Bank.

## Causes of the banking sector crisis in Russia

The most important step in solving any problem is to correctly identify its causes. In Russia, widespread expectations of a future state bailout and weak law enforcement resulted in excessive risk taking behaviour of bank managers and asset stripping of credit institutions by their major shareholders. Poor property rights enforcement and reluctance of authorities to bankrupt insolvent enterprises made extension of bank credits to the real sector very risky and difficult. Lack of professional experience and necessary training in project evaluation among bank managers also contributed towards deterioration of portfolios of Russian credit institutions.

As a result of these fundamental problems, Russian banks entered the critical month of August 1998 with the following flaws in their books:

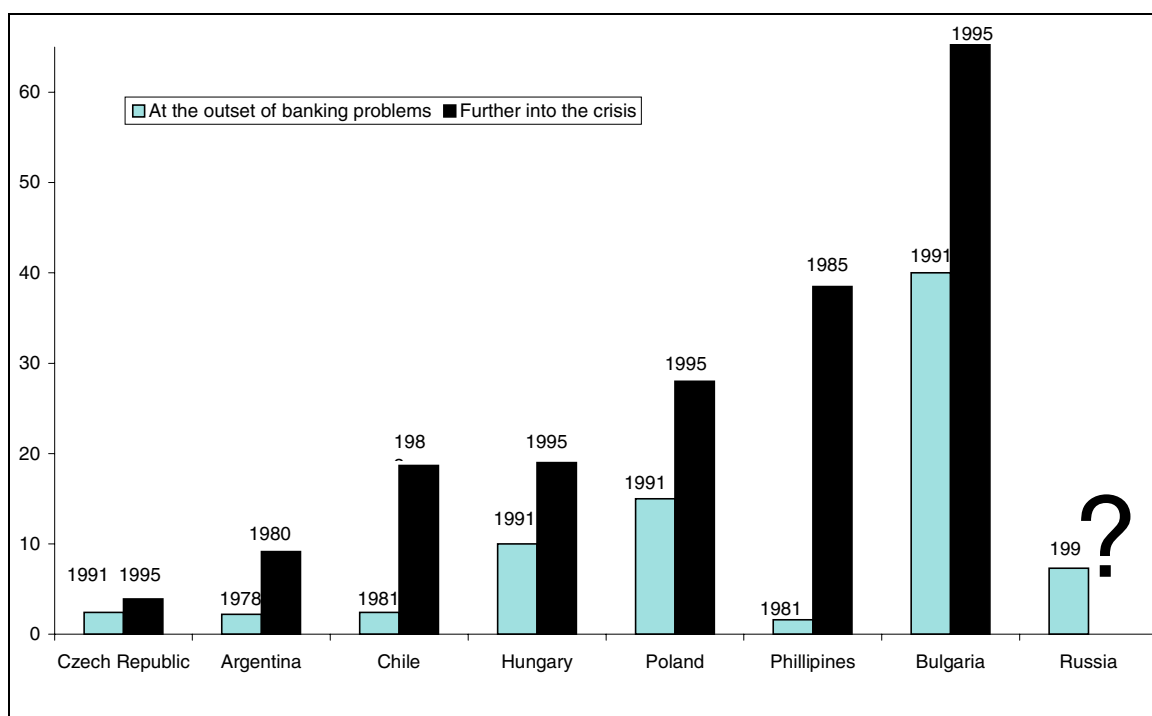
- large number of non-performing enterprise loans<sup>1</sup>
- concentration of risk, with large amounts of loans given to one borrower, including the government of Russia. At the end of July, Sberbank held about 50% of its assets in GKO's, and the rest of the banking system in total held 10% of its assets in government bonds.
- large amounts of unhedged off-balance sheet forward contracts
- rapidly increasing foreign currency liabilities, unmatched by foreign currency assets. At the end of July, foreign liabilities of commercial banks, including deposits, exceeded their foreign assets by R115 bln and accounted for 30% of all liabilities.

The events of August 17 highlighted the extreme vulnerability of the banking system. The downturn in debt and equity markets and freezing of the government's rouble denominated debt resulted in a significant depreciation of banks' assets. Simultaneous rouble devaluation made a large portion of banks' obligations significantly more expensive to service and resulted in additional, often large and not budgeted liabilities from the forward contracts.

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<sup>1</sup> Central Bank estimates that the amount of overdue loans in commercial banks on September 1, 1998 was just over 7% of total lending. The evidence from the banks which were audited after serious liquidity problems had surfaced shows that the CBR is likely to be underestimating the amount of bad loans in the economy. In addition, there seems to be a dangerous concentration of bad loans: half of them are on the books of 5 largest banks, which account for 1/3 of total lending to the economy. Bad debts of banks lending to agriculture are estimated at 60% of their total loans.

**Figure 1: Bad loans in countries, which experienced a banking crisis, at the start, and towards the end of crisis, % of total loans**



Source: *Oxford Review of Economic Policy*, Vol. 13, No. 2, Summer 1997; *Banking Crisis: Cases and Issues*, International Monetary Fund, 1991; *Bulletin of Banking Statistics*, Central Bank of Russian Federation, No. 10, 1998

## Current state of the banking sector in Russia

Failure of the banks to make payments on some of their obligations resulted in a run on deposits of major retail banks. In August, the amount of savings withdrawn from 30 largest banks rose to R17 bln (which is over 10% of total retail deposits in these banks), compared to R2 bln in the previous month. Banks started to experience severe liquidity shortages and in the third week of September the amount of stalled payments in 30 largest banks reached R7 bln (on August 1, 1998 only R0.001 bln worth of stalled payments was registered).

In order to help restore the payment system, the Central Bank conducted three consecutive off-sets of liabilities between banks on September 18, 25 and October 2, which allowed for R30 bln of R40 bln of stalled payments to go through. Central Bank gave loans to banks and allowed them to draw on their obligatory reserves in order to make payments.

To stop the run on bank deposits, the Central Bank allowed depositors of banks which hold over R300 mln in retail accounts (about 32 banks), to transfer their savings to Sberbank (the largest, state controlled bank which holds 80% of all retail deposits). The Central Bank gave a guarantee on these accounts. In return the depositors had to forgo the opportunity to withdraw their money before the end of November. Foreign currency deposits were to be exchanged into roubles at September 1 exchange rate. The results of this operation, available for the six largest participating banks, showed that approximately 50% of rouble deposits and 10% of foreign currency deposits were transferred to Sberbank, which added about R9 bln to Sberbank liabilities. The transfer of deposits was done by signing an agreement between the transferring bank and Sberbank; there is no sign, however, of banks transferring assets to Sberbank to compensate it for assuming their obligations. This implies that the liabilities of Sberbank

towards the population now amount to approximately R124 bln, while its assets total about R200 bln, half of which is frozen government debt.

So far the efforts of the Central Bank were directed at re-establishing a functioning payment system and allowing depositors to access their savings. Official Central Bank statistics showed that in the month of August alone the Central Bank gave R23 bln worth of credits to commercial banks (for comparison, monthly average for January-July 1998 was R7 bln). Victor Gerashchenko, the Chairman of the Central Bank, said that in the last three months monetary authorities gave R55 bln worth of stabilisation loans to banks. At the same time, assets of the insolvent banks have not been seized and only a few licences have been withdrawn. The Central Bank took away 28 bank licences in August and September, which is close to its average level of activity in 1998, with 1503 banks continuing to operate legally in Russia. By assuming or postponing banks obligations, the state often gave time to the shareholders to transfer remaining valuable assets elsewhere.

Liquidity assistance measures so far implemented by the CBR are not sufficient to resolve the current crisis, since its reasons are much more serious than a temporary shortage of liquidity. A fundamental restructuring of the banking sector is in order. The authorities realising the need for such reform, submitted a proposal of a banking sector restructuring program to the Duma on October 19.

## **Banking sector restructuring program**

The objective of a banking sector reform is to create a trustworthy properly functioning banking system by addressing the problems underlying its prior poor performance. At the same time, policymakers face serious constraints, since such a reform requires substantial funds and a large number of highly qualified specialists, neither of which may be available. Obstacles to restructuring may also be embedded in the existing legal or regulatory set up.

These constraints are especially severe in developing and transition economies, such as Russia. At the moment the sources of financing for the program proposed by the Central Bank are very limited:

- (i) Russian government has a significant budget deficit, making it hard to finance bank restructuring with budget revenues unless painful expenditure cuts are implemented;
- (ii) economic crisis and political instability have encouraged substantial capital flight, making domestic private savings virtually unavailable and depressing asset prices;
- (iii) after the rouble devaluation, the government's default on rouble denominated debt and failure of banks to pay their foreign liabilities, Russia have become virtually cut off from foreign financing;

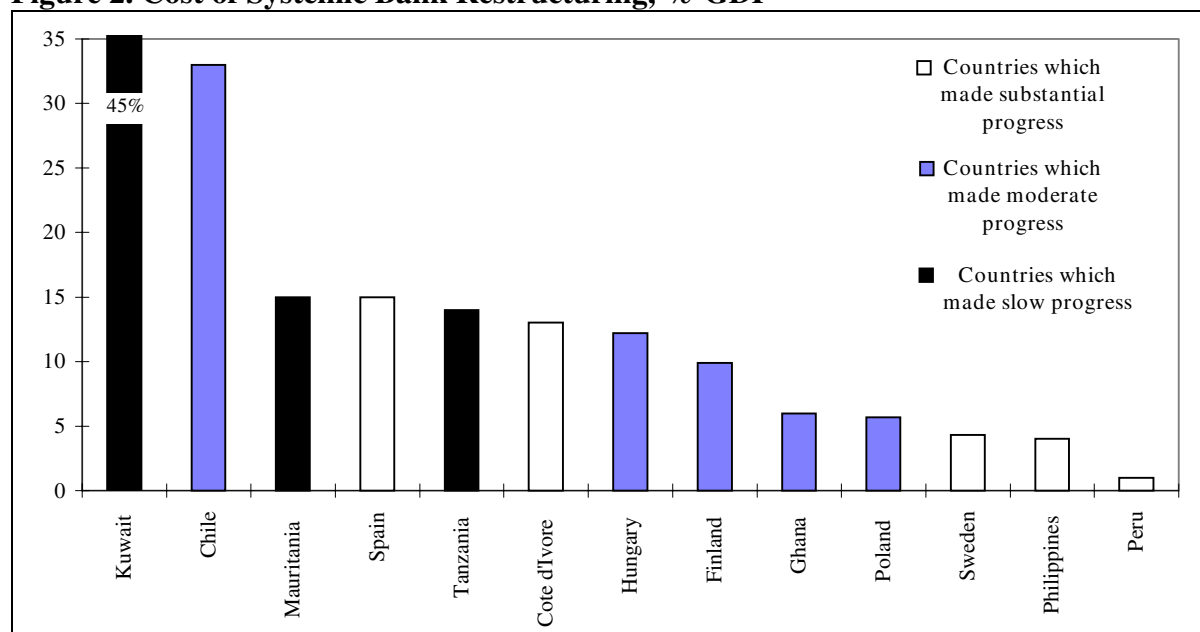
Given that funding is so scarce, it is extremely important, *firstly*, to minimise the costs of Russian bank restructuring program. International experience showed that countries, which spend large amounts on banking system reform often make less progress towards their goal.

*Secondly*, it is crucial both for equity reasons and for the stability of the newly restructured banking system that policymakers ensure that those who took high risks and contributed to the deterioration of the credit institutions bear a large share of restructuring costs. It is difficult to adhere to this principle, since at the outset of a banking crisis it is often hard to distinguish between insolvent banks and those which are temporarily illiquid. To put a stop to the run on banks, the state often supports existing banks by giving new money to them (what we are observing right now in Russia). This often leads to so-called moral hazard problems,

when in advance the government cannot make sure that its funds will not be misused. When money is given to banks, which are responsible for their troubles, inefficient behaviour of managers and owners is *de facto* rewarded, expectations of future bailouts are fostered and further mismanagement of resources is promoted.

Experiences of such countries as Argentina (1979-83, reform cost - 14% of GDP), Venezuela (1994, reform cost - 13-17% of GDP), Hungary (1991-94, reform cost - 8-12% of GDP) and others showed that when liquidity support and enforcement of bank restructuring (which includes removing inefficient managers and taking equity away from asset stripping owners) do not go hand in hand, governments will find themselves facing banking crises again and again.

**Figure 2. Cost of Systemic Bank Restructuring, % GDP**



Source: *Systemic Bank Restructuring and Macroeconomic Policy, International Monetary Fund, 1997*

*Thirdly*, inflationary financing of banking sector reform can be detrimental for achieving the goals of such reform and for overall stability of the country. Experience of Argentina in early 1980s and Russia in 1993 clearly showed that financing of the bank restructuring program with monetary emissions cause inflation and

- (i) shift costs of restructuring onto depositors away from bank owners and managers and debtors of the banking system
- (ii) further destroy the trust in the local currency and credit institutions, undermining the stability of the 'restructured' banking sector
- (iii) shaken the credibility of the government's commitment to a one-off reform of the sector, encouraging expectations of a continued bail-out
- (iv) further undermine macroeconomic stability in the country.

The single greatest shortcoming of the proposed Central Bank of Russia bank restructuring program is that it does not specify the way in which it will be financed (although it does list as one of its and government's priorities to estimate the costs of the program and find sources of funding for it). So far, by default the Central Bank has been using money emissions to give large loans to banks. If the state proceeds to finance its program in a similar way, full restructuring is unlikely to be achieved and high inflation will become inevitable.

The main points of the program of Urgent Measures to Restructure the Banking System proposed by the Central Bank of Russia are summarised below. Drawing on experiences of other

countries we attempt to analyse how well this program is designed to resolved the problems facing Russian banking system and how closely it adheres to the three principles mentioned above.

<i>Program proposal</i>	<i>Comment</i>
<p><u>I. Evaluating solvency and future potential of the banks</u>            For the purposes of financial analysis and before a restructuring program is assigned to a banks, CBR divides all banks into four groups: (i) banks with sufficient capital which are not experiencing difficulties with liquidity management (862 banks); (ii) banks which are experiencing problems mainly due to the financial crisis (398 banks); (iii) banks which are experiencing problems mainly due to reasons other than financial crisis (15 banks); (iv) insolvent banks with insufficient capital, liquidity problems and lack of potential (275 banks). As a result of the financial analysis of the banks, they will be further divided into four categories, according to a restructuring program which will be applied to them:</p>	<p>Separating the banks according to their financial standing is central to the restructuring program. The usual approach is to divide banks into (i) solvent banks which do not experience liquidity problems; (ii) solvent banks which are experiencing temporary liquidity problems; (iii) insolvent banks. Determining <i>a priori</i> which banks are having difficulties due to crisis and which are not, with an implicit notion that there will be more lenience towards the first type, introduces an intransparent, open to interpretation criterion into one of the most important stages of restructuring and therefore opens doors for lobbying and manipulation of the program. The fact that a large number of banks were included into this category is alarming.</p>
<p>(i) Stable banks with sufficient capital, which are not experiencing difficulties with liquidity management and can continue to operate without government support and solve their current problems with support of their owners, by attracting additional capital in the market and by negotiations with investors. Banks experiencing minor liquidity problems can also be included in this category. The Central Bank may provide liquidity support to such banks, given that they have a viable financial recovery plan. If such a plan is not carried out on schedule, the banks are transferred to group (iv) below.</p>	<p>(i) Short-term Central Banks loans to help liquidity of the viable banks are often necessary to allow these banks to restructure. Over 80% of countries, which faced banking sector crisis, have used short term Central Bank support as first anti-crisis measures. In countries where most successful in restructuring was achieved, the Central Bank loans were collateralised by bank shares or contingent on bank performance in order to avoid moral hazard problems and shift the burden of costs onto bank owners as much as possible. In Chile (1981-83), for example, central bank loans which had not been repaid were converted into bank shares held by the state and later resold to new owners, creating the foundation for a healthier banking system.</p>
<p>(ii) Stable regional banks, which will become the basis for the future of the of Russia's regional banking system. The list of criteria for these banks is attached. It includes large number of branches, a significant share of all regional household deposits, large market share in other banking services, high professionalism of managers and low degree of participation in financial industrial groups. Opinion of regional authorities will be taken into account during the selection process. To these banks, the CBR will prescribe a revaluation of their assets, write-offs of losses, restructuring of assets and liabilities. The CBR will contribute to the capital of such banks as a shareholder, and will provide other support. These banks will take on deposits and assets from insolvent regional banks. After 3 years, the CBR will sell its shares in these banks to new investors.</p>	<p>(ii) The danger of selecting some regional banks to be supported according to the criteria indicated is that considerations of size and closeness to local authorities would outweigh efficiency criteria, allowing non-viable banks take over more efficient institutions. This approach opens a lot of room for lobbying on the local level. CBR ownership of shares in the banks to be restructured may result in a conflict of interests, since CBR's primary task with respect to the banking sector is arm's length supervision. If shares were held by an agency like ARCO (see below) on behalf of the state the problem would be avoided.</p>

<i>Program proposal</i>	<i>Comment</i>
<p>(iii) Large banks, which lost their capital and cannot continue to operate on their own, but closure of which would be too costly socially and economically. An individual approach will be developed towards each of these banks. It will normally involve creation of a 'new' bank owned by the state and the creditors of the bank to which most assets are transferred. The 'old' bank would have most liabilities and industrial assets left in it. The banks may receive liquidity support from the CBR, their shares maybe transferred to the CBR for temporary management. The capital of old owners may be reduced by the amount of the banks' losses. The rights of the owners of old banks will be minimised as a result of restructuring and will not be restored. Bank management will be put in the hands of creditors (who can exchanged their claims for shares) and in the hands of new investors.</p>	<p>(iii) The approach 'some banks are too large to fail' creates adverse incentives for banks, promoting the belief that squandering of money will not be punished as long as the bank is big. Effects of such CBR intentions are already observable: SBS-Agro, the third largest retail bank, which has defaulted on its foreign obligations and failed to pay to many of its depositors, and which has now obtained large loans from the CBR and has been relieved of some of its obligations, is currently announcing that it is buying branches of banks which are going bankrupt. Not by restructuring its operations, but by using depositors' and state money to acquire more assets it is hoping to stay afloat. Moral hazard problems can in part be avoided if creditor claims on the bank are exchanged for its equity, which is included into the Central Bank proposal. Such a strategy is most appropriate for banks, which have a limited number of large creditors, who may be able to establish proper governance over the banks.</p>
<p>(iv) Insolvent banks with too little capital, liquidity problems and lack of potential. These banks will be liquidated by July 1999. Depositors and creditors of banks of groups (iii) and (iv) will be assisted in solving their problems by transferring deposits to other banks and using proceeds from sale of banks' assets after liquidation. Banks of all groups will be required to limit their involvement in financial industrial groups.</p>	<p>(iv) Selective sale of insolvent bank assets has proven to be a good way to cover depositor claims in the presence of financial constraints in some countries. For example, in Argentina, for some banks the central bank was able to pay up to 75% of bank deposits by selling only 10% of their assets. However, a careful approach is needed since implementing this strategy on a large scale over a short period of time may further depress asset prices and cause more banks to suffer from liquidity problems.</p>
<p>An Agency for Restructuring of Credit Organisations (ARCO) will be set up jointly by the Central Bank and the government. It will acquire controlling stakes of decapitalized banks on behalf of the government and the CBR, participate as a shareholder in restructuring banks, develop restructuring plans, manage bad assets acquired from banks, initiate bankruptcy procedures against banks and raise funds for its activities. Transparency is one of the most critical principles of ARCO's activities.</p>	<p>The idea of creating such an agency has been successfully utilised in many countries, taking advantage of the Central Bank's knowledge of the banking sector and avoiding a conflict with its supervisory role. The agency should be made independent from outside influences, staffed with professionals who will be compensated on an incentive basis. The costs of the agency should be recorded as fiscal costs.</p>

<i>Program proposal</i>	<i>Comment</i>
<u>II. List of measures, which can be implemented in the process of restructuring a bank.</u> These measures can be implemented in different combinations towards the four groups of banks defined above:	
1. Increasing bank's capital by transferring government or central bank bonds to the bank, converting creditor claims into shares, attracting new capital from shareholders	1. This is one of the best ways to recapitalize a bank. It both improves the balance sheet in the bank and transfers ownership of the bank to new owners. Ownership stakes should be calculated based on market share prices whenever possible.
2. Improving bank's assets by exchanging shares for government or CBR bonds, exchanging bad assets with ARCO for good assets or ARCO notes payable, swapping assets across banks, revaluation of assets, writing off bad assets against provisions	2. Putting bonds onto a bank's balance sheet will improve bank's income and liquidity only if they pay market rate of return. Transferring frozen GKO-OFZ onto a bank's books would not improve its standing. Bad asset swap should be strictly one-off to discourage propagation of more bad loans in the economy. Any subsidy involved should be tied to restructuring conditions.
3. Restructuring bank's liabilities by converting creditor's claims into shares and notes payable, transferring deposits into other banks, lowering the share of old owner's capital by the amount of losses, attracting CBR credits. CBR will cease giving stabilisation credits after April 1, 1999, by which date most of earlier credits should be repaid.	3. Deadline for cutting off the CBR tap adds credibility to a one-off nature of liquidity support.
4. Cost cutting, including no dividend payments to old shareholders	4. Money which would be allocated for dividends to old shareholders are best used to pay back CBR loans.
5. Splitting a bank into a 'new' bank and an 'old' one. All assets (except industrial holdings), branch and client network, all operational staff, all retail deposits, a share (for instance, 25%) of other liabilities (except those affiliated with industrial holdings) will be transferred to the new bank. Claims of creditors on the old bank can be converted into equity in the new bank. Management of new bank to be selected from creditors of the old bank and new shareholders. The old bank will be liquidated or will continue to function as an asset management unit in order to sell remaining assets and repay the creditors.	5. This kind of approach can be successful if the bank has large creditors who are willing to participate in its governance, and if old shareholders loose their stakes in the banks. Industrial holdings of banks, which are likely to be the most valuable assets of it, should be transferred to ARCO, which would then resell them to new owners and raise money to pay off bank's creditors and depositors.
6. Offsets of forward contracts between banks. Transfer of all obligations under forward contracts to non-residents onto the books of the CBR.	
7. Changes in operational structure of banks, including mergers, consolidations, splits, sales of branches, etc. Attracting new managers, including foreign professionals, to help restructure banks.	

<i>Program proposal</i>	<i>Comment</i>
8. Tax forbearance to banks which adopt a restructuring program; one-off tax exemptions for losses incurred in restructuring	8. It is best if such treatment is offered to banks with new management. Although tax exemption for losses may give wrong incentives, similar practices have been used before. For instance, Chilean government successfully used fiscal incentives to attract new buyers for banks' shares.

In addition the program

- requires changes in some legislation for its implementation
- makes plans to estimate its costs, locate sources for their financing, including possible loans from international organisations, and make appropriate changes in fourth quarter and 1999 budgets
- makes plans to establish a CBR Credit Bureau which would collect and make available the credit history of bank debtors
- makes plans to divert foreign credits disbursed earlier for needs of banking system restructuring
- makes plans to revise CBR supervision requirements towards banks

Overall, the program above plans a serious attempt to tackle the fundamental problems present in the banking sector. It makes the right emphasis on punishing inefficient bank managers and rent-seeking owners and on the transparency of the restructuring process. It has, however, several major weaknesses:

- (i) Its recommendations are not made with a spending constraint in mind, suggesting that large amount of inflationary finance is to be expected
- (ii) By not committing to a set of objective requirements in determining which banks should be supported and which liquidated, it leaves room for lobbying and bailouts of inefficient banks
- (iii) By not tying some of the support measures with restructuring requirements it runs a risk of moral hazard
- (iv) It does not propose a program to deal with bank debtors. Inefficiency and lack of restructuring of enterprises has been a serious problem in Russia and has contributed substantially to the banking crisis. Experiences of Poland and Czech Republic showed that a reform of the banking sector in transition brings results best when done together with the restructuring of enterprises. As one of the targets of the program, the CBR states that it is designed to create a base for real sector lending in Russia. This will not be achieved until tougher enterprise bankruptcy procedures are in place and property rights are enforceable.

Because of these shortcomings, there might be difficulties in implementation of this program, and, like in other transition countries, the restructuring process could take several years. Still, this kind of plan of action is urgently needed to put a stop to the chaos which reigns in the banking sector at the moment, with shareholders continuing to asset strip their banks and Central Bank policies being ad-hoc and intransparent. International experience has shown that it is critical for the authorities to produce bank restructuring measures promptly. IMF survey demonstrated that countries, which introduced reforms within nine months after the problems, had surfaced made more substantial progress in restructuring their banking sector<sup>2</sup>. It is therefore essential that the Russian government adopts the program and begins the process of banking sector restructuring as soon as possible.

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<sup>2</sup> *Systemic Bank Restructuring and Macroeconomic Policy, International Monetary Fund, 1997*