

Fundamental Problems Faced by Russian Commercial Banking

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Abstract

This paper examines the origin, development, and condition of the current Russian banking system. Russian banks serve various economic functions, notably in providing payments and related financial services but do not yet provide significant financial intermediation. While the 1998 banking collapse made certain problems very visible, Russian banks failed to serve as financial intermediaries both before and after the crisis.

The absence of financial intermediation severely impedes the development of a market economy. This failure occurs because of the absence of a strong legal environment and administrative environment and the existence of a burdensome and inequitable tax system. However, using banks as a means of redistributing wealth and to collect taxes also impedes its growth. The Russian banking system neither has the confidence required to attract voluntary deposits nor an effective means of prudent lending. As a result, a large portion of transactions occurs outside banking channels, through barter and through offset. This increases transaction costs and reduces economic efficiency. In the absence of fundamental reform, financial intermediation cannot emerge.

An early test of the new Russian administration's commitment to market economics will be the degree to which it improves the legal and administrative environment for banking. Without such reform, neither Russian nor foreign banks can serve as financial intermediaries. The lack of financial intermediation restricts economic growth in the market economy.

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Introduction

Financial intermediaries mobilize savings and rationally allocate those savings to productive investment. The Russian banking system does not do either very well. Russia's banking system confronts fundamental problems that must be solved before it can regain confidence and perform the essential economic task of financial intermediation. Russian banking suffers from fundamental flaws resulting from its birth, its development, and the environment in which it has attempted to root and grow.

A Russian joke sums up the banking systems credibility problem:

“What is a short-term deposit?
Money-under-the-Pillow.
And a long-term deposit?
Money-under-the-Mattress.¹

This paper describes the birth and development of banking in Russia during the transformation since the demise of the former Soviet Union. It explains why a credible system of financial intermediation failed to develop. The major problems of Russian banking system are the legacy created by the overall transformation of the Russian economy, the fundamental reform of its social structure, large-scale privatization of industry, repartition of property. This reform engendered deep economic, social, and governmental fissures and with it great expanded of criminal activity.

The Origins of Russian Banks

In the former Soviet Union, Gosbank controlled all banks. This single system included three major divisions: the Stroibank (state enterprise credits), Vneshtorgbank (foreign currency, debt, and trade), and Sberbank (the state savings bank). The system channeled

funds to state enterprises according to government decisions and, thereby, controlled enterprises, financed government debt, and foreign trade.

The birth of banking rapidly produced a large quantity of institutions. During the transition, Gosbank became the Russian Central Bank. The Stroibank divided into specialized banks by industry, whose separate regional offices divided again. This formed many independent banks. The Vneshtorgbank – Vneshekomombank managed Russia's foreign debt, and the Sberbank became the state savings bank. Numerous additional small banks formed in response to a policy of low initial bank capital requirements, the need of former government enterprises for banking, and very inexpensive credit that the Central Bank of Russia, CBR, provided to banks. These newly formed banks made quick, high arbitrage profits for their owners. They obtained credit from the CBR at below market rates and then lent these funds, mostly to the government, at substantially higher interest rates.² Probably, criminal elements originated some of the smaller banks. Profits required neither private depositors nor business borrowers, but did require political connections.

By January 1993 the number of credit organizations amounted to 1,700 and increased to 2,600 by January 1996. Most banks operated with a small capital base and were unhealthy. Although increased capital requirements and some bankruptcies have decreased absolute numbers somewhat, the large number of weak financial institutions remains the legacy of the origination.³ In May 1998, just before the financial crisis, there were 1650, although the largest 250 of them held 90% of all bank assets. Recently, the total has fallen to 1350, with some 70 banks accounting for 80% of all assets.^{4 5} While the quantity has fallen, the transition to quality has remained elusive.

Development of Russia's Banks

The infant banks fed on easy profit opportunities created by government policies. When they did lend, they acquired large portfolios of non-performing loans that were the result of decisions based more on relationships and on political considerations rather than on credit worthiness. They generally failed to develop a clientele of credit worthy borrowers.

Russian banks quickly lost the trust of the Russian population as depository institutions in the early 1990's. In order to attract funds from the then trusting public, many banks promised depositors extremely high interest rates on deposits. These banks did not pay interest from earnings on loans, but paid them from fresh deposits. Such financial pyramid schemes were common, and the depositors' funds soon vanished.⁶ Most Russian households suffered from such deceptions. In St. Petersburg alone, the scheme deceived over 1.2 million depositors (25% of the adult population). Much later, some offending banks were officially closed, and some small fraction of the deposits was returned.⁷ Trust of the banking system has not returned. The resulting loss of trust remains a major obstacle to banking to this day. Of Russian households that do make deposits, nearly 80 percent are in the state savings bank, Sberbank, whose deposits are guaranteed by the government.⁸

Total household deposits in the Russian banking system remain small. At the end of June 1998, total household ruble and foreign currency deposits equaled only 249 billion rubles (\$40 billion). The average depositor held only 3,500 rubles in banks.⁹ At the end of December 1999, the total household deposits in Russian banks equaled 325 billion (\$12.1 billion).¹⁰ An estimated 92% of household deposits in St. Petersburg banks today are less than 1,000 rubles.¹¹ However, most long-term deposits are outside of Russia. According to

the Swiss federal prosecutor in 1998, Carla del Ponte, Russian nationals had deposited around \$40bn in Swiss bank accounts alone.¹²

A Russian Joke characterizes current attitudes: “God saves - those who are safe.”

However, the inflationary period of 1992-1995 was highly profitable for many Russian banks. Although banks could not attract very many household depositors, well-connected banks had commercial deposits, mostly from former state enterprises and accounts of state agencies. Often the managers of these enterprises were also owners of the banks. As explained below, banks paid almost no interest on these accounts, called current accounts. Thus, during inflationary periods, they easily made a large spread over these “free” accounts and market interest rates. They exchanged rubles for dollars, lent dollars to those with licenses to export commodities. These short-term loans proved extremely profitable. When the exporters repaid the loans, these banks gained foreign exchange profits because of the rapid depreciation of the ruble.

When inflation declined in 1995, a deep banking crisis ensued as inflationary profits disappeared. Many large banks` failed (Mytishinski, Mejrregionbank, National Credit, Gloria-bank etc.). Some hoped that the surviving banks would learn from their mistakes, recognize the danger of “free lunches”, and start investing the real sector. However, a frightened government chose to subsidize the banks. Bank of Russia fed inexpensive credits to selected banks with political connections. These credits assisted the now infamous “oligarchic” banks in creating their vast networks of branch offices. Through political connections, they acquired an exclusive right to service state accounts and programs. This legacy put an emphasis on seeking “free funds” through connections, rather than through

solid business practice. Money in Russia means less than connections – in this case, with the regional governors.

The GKO (short term state notes) and OFS (long term bonds of federal loan) provided Russian banks with their most recent source of effortless profits. A large 1996 budget deficit and a tight monetary policy left the government with large borrowing requirements. The Russian government financed its deficits primarily using short-term ruble denominated treasury bills – GKO's. The CRB and the Sberbank held more than half of these. Other Russian banks, attracted by the high yields, the high liquidity, and the seemingly low risk of Russian government paper, invested heavily in government notes as well. Many borrowed dollars, bought GKO's and left their currency exposure unhedged. Russian banks also invested in ruble and external currency denominated government obligations. By certain estimations, they held 10% of the outstanding eurobonds and more than 40% of the currency bonds of Ministry of Finance.

By 1996, Government bonds had become the largest source of income for the banks: in 1996 returns on state securities formed about 40% of all their receipts. Thus, Russian banks, pumped full with seemingly safe and liquid assets, appeared strong and healthy. Meanwhile, the share of interest payments received on “real” loans made up about 35% of income, many from loans of dubious quality. Many banks disregarded lending to the real sector. With government help, they concentrated on purely financial activities, arbitrage and speculation.

Initially, few questioned the credibility of the Russian government's obligations, whose only source of repayment was new and larger borrowings, since it could not collect sufficient taxes. Since many Russian banks looked healthy to outside creditors, they became

active borrowers in euro-bond financial markets. The seemingly stable exchange rate also favored increased borrowing in foreign currency. When the GKO-market liberalization allowed foreign investors to participate, Russian banks provided these investors with forward obligations, as such investors wanted to hedge the currency risk of their investments. Foreigners invested in GKO's as well, usually covering the exchange risk with forward currency contracts. At the time of well-known "default" in summer 1998 foreigners held about 40% GKO's. Former Prime Minister Mr. Chernomyrdin, president of the powerful and half state-owned natural gas company GASPROM, is credited with this government-financing scheme that ended with a default.

The Financial Crisis

Large Russian banks gradually came to depend on foreign sources for capital, exposed to the risk of exchange rate fluctuations and to depend on government finance for income. The diversification of risk was practically absent. Few banks had taken into account the high level of exchange and political risk involved. Some major banks considered themselves too large or too well connected to fail and expected government rescue.

Although the world financial crises received much blame for the banking collapse, the absence of trust in the financial system and the tax system is one of the principal reasons for the vulnerability of the Russian currency to such problems.¹³ In the spring of 1998, investors' confidence waned in response to the Asian crisis and to sharply lower oil prices. They sold GKO's, driving their yields sharply higher, increasing costs to the government. With declining revenues and increasing costs, the government eventually defaulted. The simultaneous default on the GKO's and the devaluation of the ruble precipitated the banking crisis. The default on the GKO's reportedly affected many large banks with large amounts of funds in Russian treasury bills.

However, most top banks reportedly had inside information about an imminent default and sold most GKO's on their balance sheets before the market collapse on Aug. 17. For most, the weak quality of their loan portfolio was in many cases the principle cause of their demise. Indeed, a 1999 World Bank audit last year of 18 of Russia's top banks found that the greatest damage to their capital was dealt not by losses on securities but by extending risky loans, many of which have never been returned. Loan-loss provisions amounted to \$64.3 billion and accounted for 34 percent of net charges to capital of these banks. Foreign exchange and

translation losses accounted for 28 percent of net charges, while losses on government debt were only 13 percent.¹⁴

An investigation of 18 large banks, made at the behest of the World Bank showed that, based on international accounting standards, the banks total liabilities were Rb348 while their total assets were only Rb137. "The due diligence confirmed the view that some of the bigger Russian banks are so deficient in capital, and have so compromised their reputation with creditors, both foreign and domestic, that their situation is beyond repair," the audit said. However, in spite of enormous short falls, many continued to operate, received special government credits, and participated in government directed credits.¹⁵

Some medium sized banks that had large exposures neither in GKO's nor in foreign currency debts. They were able to pay creditors and maintain depositor access to funds. For these banks, the crisis actually improved their position as competition fell away and depositors increased.¹⁶

Current Accounts

Special commercial accounts, called current accounts, provide banks with a major source of free funds. Banks charge fees on them and pay zero or very low interest rates. The Russian government requires enterprises and other legal entities to deposit all income into these current accounts and to conduct all large transactions a non-cash basis by transferring funds from these accounts. Companies may convert balances in these accounts into cash only for specific purposes, such as paying wages, repairs, business trips, etc.

The government requires banks to verify compliance by their customers. Government can access the information these accounts provide, so it can determine what funds are available. The government collects taxes directly from these accounts. Russian banks help the government collect business taxes.

While these bank accounts requires banks to verify compliance by their customers by using unrecorded cash transactions, the system is not tight. For example, since individuals can hold cash, companies can convert non-cash rubles into cash rubles by paying physical individuals for services such as repairs. These individuals then return the money to the enterprise. These ‘expenses’ reduce the companies’ incomes and allow them to hide cash from view for use in off-the-books transactions. Nevertheless, in order to avoid trouble with authorities, enterprises must channel much of their funds through these accounts. In addition, the inefficiency of the payments system means the enterprises will hold considerable amounts in banks. Since the law allows enterprises to choose their own banks, and since the banks have some discretion in monitoring, the degree of oversight provided by a bank in part determines customer loyalty to it.

This free source of deposits has been an obvious benefit for many banks, especially, as noted above, during periods of high inflation. For example, it has been estimated the use funds from these “current accounts” with negative interest rates, allowed bank profits in 1994 – beginning of 1995 to reach of 10% GDP.¹⁷ However, it compromises the information a client will provide. Using the banking system for tax collecting, limits the formation of large-scale deposits, since this role by banks precludes them from attracting voluntary deposits. Depositors may provide tax authorities with information about wealth that will result in higher, perhaps confiscatory, levels of taxation. Additionally, criminal elements, connected with some banks, reputedly can access such information for purposes of extortion. Thus, banks have limited deposits from which to lend, even to the relatively few creditworthy borrowers. There is always a liquidity shortage.¹⁸

The Difficulty of Making Good Loans

Three fundamental questions any lender should ask of a potential borrower are:

Will the client repay?
Can the client repay?
What can the lender do if the client fails to repay?

For a Russian banker, the answer to the first question in many cases is probably not. In systems where a good financial reputation is a valuable economic asset, unwillingness to repay debts when possible seems shortsighted economic behavior. However, the question of Russian borrowers' willingness to repay loans is part of a general legacy of attitudes resulting from seventy-four years of an ineffective state-monopolized planned economy. This rule not only retarded the economy for decades, but also tragically devalued a major economic component – human capital. Many people lost respect for the art of earning their living and considered theft of state property to be acceptable behavior. Again, a Russian joke succinctly sums up a common attitude:

You'll never steal back from the state as much as it stole
from you.

Many Russians, including both the banks' clients, and the bankers themselves, are hostages of such a mentality. Widespread economic illiteracy and the survival of communist ideology in peoples' minds further complicate matters. "Thieves in law" (those, who never worked for the soviet regime), the respected criminal bosses, won the sympathy of people in the USSR in the capacity of dissidents and today control many businesses as well as banks. Given a general sense of severe economic injustice, in the absence of strong personal ties, many borrowers feel no strong moral obligation to repay debts to a bank that is often perceived to be part of the state. The following dialogue from a popular Russian writer about Russian youth characterizes their attitude towards credit:

" Here is the way things are: A man takes a loan, rents an office, buy a Jeep Cherokee and 8 cases of "Stolichnaya" (Russia vodka). When the Stolichnaya is finished, he discovers the jeep is wrecked, the office is a pigsty, and the loan is due. He then takes out another loan that is three times the size of the first one. He repays the original one, buys a Jeep Grand Cherokee, and 16 cases of Absolute.

And what happens in the end?

There are two outcomes. If the bank is gangster-owned, they murder him. (As we have no other kinds of banks, this usually happens.) If the man is a gangster himself, he declares himself to be bankrupt, and after sometime begins the process again.”¹⁹

Criminals, who previously operated in the shadow economy of the former Soviet period, started many businesses. They had the certain skills that allow them to obtain financing, distribute goods, and obtain licenses. Their business methods, however, include extortion, contract killing and other use of force, and other illegal activities. Such customers are hardly the kind of clients a legitimate bank would seek.

Former government functionaries started other businesses. Through political connections, they obtained economically valuable privileges. By acquiring export licenses, they were able to purchase raw materials in Russia at a fraction of their market value and sell them on the world market. With these arbitrage profits, they were able to acquire other state resources at a fraction of their cost. Political power is the primary advantage such “economic rent” seekers. Unfortunately, they are normally much better at gaining wealth through political means than in managing it.

As far as a borrower’s ability to repay, often the answer is probably not. Although Russian industry needs huge capital injections to improve conditions, Russian banks have few reliable customers who can repay loans. Assets are worn out. Desire for capital investment is huge.

However, outside the natural resource sector, Russian industries are mostly insolvent, unprofitable state enterprises that obtain state credits and subsidies. At the same time they prevent the redeployment of resources to other potentially more productive economic spheres. Privatization of these industries faces severe political obstacles, and certain industries may never become profitable in their current form.²⁰

Credit worthy borrowers are likely not willing to divulge accurate financial information to a bank. Russia's businesses diligently disguise their true condition and seldom reveal reliable information, required to assess a firm's financial condition and to make a credit decision about its capacity to repay. Russia has not yet adopted international accounting standards. This makes small business lending problematic. Russian entrepreneurs worry most of all about hiding profits. They must hide from officials to avoid excessive taxation and from criminal eyes to reduce incentives for extortion. For them banks are first of all structures of state financial and tax control, so, they are afraid of dealing with them. Enterprises do not have clean financial statements. Businesses prefer to credit each other, of the books.

When a borrower does not repay, creditors have few legal protections. Banks often cannot collect payment from unwilling borrowers. Current bankruptcy law is inadequate and Russian courts exercise substantial, and arbitrary, discretion. Russians characterize this with a joke:

Why is law like a pole?
It can be turned in any direction.

The creation and implementation of effective bankruptcy law is a recent priority for the Russian government. Current bankrupt laws and their enforcement are still inadequate. As is widely recognized, bank lending cannot emerge without effective bankruptcy legislation. Creditors must have confidence in the value of a loan contract in order to lend money.

Enforcement must give priority to the interests of the lender over those of the owners or equity holders. However, even if an adequate legal framework emerges, effective enforcement may remain illusive.

While there are relatively few bankruptcies, a danger to any borrower is the use of bankruptcy law as a means of acquiring assets very inexpensively. Effective bankruptcy law must also prevent the liquidation of companies that simply lack liquidity. A famous example is BP Amoco's recent loss of its interest in Chernogorneft Oil Company to Tyman Oil. The European Bank for Reconstruction and Development, who also lost because it was one of Chernogorneft's creditors, described the sale as a sham and a perversion of justice. They noted:

“Chernogorneft is a viable and profitable company and is fully able to meet its obligations to creditors. The bankruptcy process has been manipulated to enforce the sale of property against the wishes of shareholders and major international creditors to a third party at a fraction of its value”.²¹

While the importance of BP Amoco as a company and its ability to use political leverage eventually allowed it to protect its financial interests in a settlement with the new owners, its original Russian partners certainly lost. Companies less visible and politically powerful probably could not protect their interests. Whatever the merits of the case, certainly bankruptcy protection may work two ways.

However, genuine Russian entrepreneurs and professionals somehow manage to exist and attempt to build and operate small enterprises based upon providing real economic services. These people could potentially develop Russia's future businesses and could lead Russia economic towards prosperity. These customers need access to bank intermediated funds and could serve as base of commercial clients for a banking. However, the few businesses that do operate must manage in extremely hostile conditions. Perhaps the high level of taxation and the

arbitrary matter of its enforcement may be removed by the new regime. However, they face extortion by criminals, forced bribes, cumbersome bureaucratic obstacles and regulations that can change unpredictably.

Relationship Lending

Russia's economic life depends heavily on relationship-based dealing.²² Personal connections counterbalance otherwise impersonal relationships that can be neither trusted nor enforced by law. A relationship-based system either permits lending when such relationships give the lender some form of power over the provided funds or requires lending when the power goes in the other direction. Such power may be based on mutual interests, on extra legal means of coercion, on monopoly power, or on explicit or implicit ownership.²³ The Russian economy, including its financial institutions, operates on such a relationship system.²⁴

A Russian saying illustrates the importance of connections and influence:

“Don't have 100 rubles but do have 100 friends”

Relationship systems limit information and business decisions; they lead to favoritism, unfair trading, insider trading, and various types of corruption. If financial transactions are limited to small, inefficient networks of trustable personal relations, financial intermediation will remain too small for a high level of economic activity. An economy based on relationships can provide a high level of living to the clever and fortunate few, but most members of such a system can achieve only a low standard of living.

Since such a system can raise capital that is limited to the capital resources of a single group, most entrepreneurs can only create firms that require small amounts of capital, such as distribution and trading firms. They prefer short, high return business strategies to more

productive, but slower, strategies. The amount of capital belonging to a small group limits the size of any enterprise.

Many important the relationships involved the state. In fact, the poorly performing enterprises are more likely to use bank credit. Such credit does not finance expansion of output or capital investment, but is a means to survive. ‘It may be that large credits to declining industries are issued under pressure from regional governments and thus boil down to government subsidies, or that, alternatively, these credits are issued by enterprises “pocket” banks who care more about the survival of enterprises, not about profits.”.... The Russian banking system redistributes funds not from declining towards growing industries, as it normally happens in mature market economies, but vice versa, in favor of declining industries. In a sense it performs the role more appropriate for the government social protection agency than for the banks.”²⁵.

Former state enterprises receive state funds channeled through many banks, especially those created from the specialized banks. As central authority disbursements have diminished, local authorities' disbursements increased. The desire to gain access to these credits also motivated many enterprises to set up their own “pocket” banks. These banks seem more concerned with their balance sheet size and the interests of their industry or enterprise that they serve, than with the profitability of the bank. However, since enterprises often fail to repay these credits, these banks face portfolios of non-performing loans.

An example of a bank that continued to receive credits even though its agricultural clients seldom repay was Agro-prom bank. Stolichnyi Bank Sberzhenii (SBS) acquired a controlling interest in Agro-prom bank to form SBS-Agro. SBS’s motivation for the merger appeared to be more for political influence than for economic reasons. The new SBS-Agro channeled a

majority of government credits to the agro-industrial complex and financed other programs of state support for the agricultural sector. While the government did not formally guarantee SBS-Agro deposits, some thought that a powerful agrarian lobby would mean that SBS-Agro might be difficult for the government to not support the bank. Ultimately, the world community seems to have carried the credit risk, as the majority of SBS - Agro creditors were foreign.²⁶ The group that owned SBS-Agro limited its own losses by reportedly shifting the bank's good assets to another bank in Moscow, which apparently serves SBS-Agro's best clients.²⁷

FIGS

In a relationship system, large-scale enterprise is possible. However, small groups must acquire control over massive sums of capital. To do so in a short period requires actions that many would consider corrupt. Necessarily, the rapid accumulation of large amounts of capital by small groups occurs at the expense of the less clever and less fortunate.²⁸

In Russia Financial Industrial Groups, [FIGS], obtained their original capital through cashing in on political connections. Many acquired the best enterprises for absurdly low prices during first stages of privatization. They made fortunes from low interest loans from the central bank during periods of high inflation and high interest rates on government borrowing. They used rights obtained from political connections to purchase government owned natural resource assets for prices a fraction of their value. They obtained export permits that allowed them to arbitrage artificially low domestic prices on commodities such as gas and oil with the higher world market prices. Using that same political influence, these groups have avoided paying even reasonable taxes, leaving the government chronically short of revenue required.

There are both official FIGS and illegal ones. The number of illegal FIGs reportedly exceeds by several times official ones. These groups often maintain their own banks, some of them

major Russian banks, as a means of channeling government funds to their enterprises and control their enterprises.

FIG's are vertically integrated empires with captured banks. Similar to the Japanese kereitsu and the South Korean chaebols, they have established the monopoly power that relationship finance requires to function on a large scale.²⁹ Such banks have been more concerned with their balance sheet size and the interests of their industry or enterprise that they serve, than with the profitability of the bank and the quality of its loan portfolio.

FIG's can use their considerable political power to protect their wealth.³⁰ After the banking crisis, these groups appear to have been able to transfer most of their good assets out of their bankrupt banks to new ventures. While the climate may change, so far these well-connected groups have managed to get others, both Russians and foreigners, to cover much of their losses. Effective discipline on these banks on imprudent lending does not yet exist.³¹

Channeling of State Funds

Many Russian banks were created from former government specialized banks whose previous principal activity was channeling state funds (directed credit) from both central and local governments to state enterprises. Enterprises often established banks, "pocket" banks, in order to gain access to these state directed credits from central as well as regional governments. Such banks often regarded political connections that would allow the continuing receipt of government credit to be more important to the long-run solvency of the bank than the credit worthiness of the loans. Such banks often paid little attention to traditional evaluation of credit. These banks seem more concerned with their balance sheet size and the interests of their industry or enterprise that they serve, than with the profitability of the bank. The former state enterprises to which these

banks extend credit often had bad credit and very little will to repay these loans. Predictably, these banks accumulated large portfolios of non-performing loans.³² One reason for the relative lack of concern for credit standards is that the bank owners can escape much of the losses by shifting funds out of a failing bank to a new bank.

What do Russian Banks do?

Since Russian banks neither attract deposits nor make performing loans to any significant extent, what do they do? When 5th-year Russian business students at the St. Petersburg State University of Economics and Finance were asked by one of the authors about functions of the Russian banking system, the only useful thing they mentioned was servicing transactions. However, this purpose requires only a few of the hundreds of Russian banks that still exist. Currency dealing is limited. Banks store and distribute budget funds using them for private purposes. The banks also take the part of a “fence” for corrupted politicians. The banking system serves as one means for absorbing Russian capital and sending out of the country, escaping currency controls. Total volume of the capital leakage abroad in 1998 made up one to one and a half billion of dollars a month.³³

For many banks, the chief purpose has been the personal enrichment of their owner with scant regard for ethical dealing. Some have been financial pyramid schemes, paying high interest rates for the initial deposits and then collapsing. Other banks lend to false firms that disappear soon after obtaining funds. Such practices have destroyed the trust of population. Half of official savings in Russia is in cash. The volume of cash dollars “in stockings”(stored at home for “the black day”) is estimated to be between 60-300 billions of dollars.³⁴

Conclusions

The worst of the crisis that began in August 1998 appears to have passed in the Spring 2000. Rising world commodity prices, a return of economic growth, reduced rates of inflation, and improved government revenues argue for improved outlook. However, the fundamental problems for Russian banks remain. They cannot effectively attract a significant amount of savings and cannot provide great amounts of credit to worthy borrowers. A functioning banking system attracts funds by assuring their safety and liquidity and adequate return. The history of deceptions and failures has undermined that assurance for both Russian and foreigner. To regain it will be a challenge. Rebuilding confidence must be a priority if a banking system is to emerge to fund Russian economic growth and prosperity. The relatively greater importance of political connections to business skill and the opportunistic nature of the previous banking activities, distorted the talent pool of experienced banking personnel. The hostile and uncertain environment for the operation of any business restricts entrepreneurship and results in a paucity credit worthy borrowers.

The lack of financial intermediation means that those Russians who could employ savings effectively and productively cannot obtain it. However, Russian savers have strong incentives to avoid investing in Russia. Russians who do not trust their banks and who keep their savings in foreign currencies effectively lend them, interest free, to the foreign central bank that issued the currency. Russians who deposit funds in overseas banks at least earn interest. Both deprive domestic borrowers of funds.

A necessary condition for the banking system to perform well is adequate legal, administrative, and regulatory processes. The new Russian government appears to be taking many initiatives to correct problems delineated in this paper. It has developed programs for

structural and institutional reform, and aims to increase the investment climate of Russia. The announced aims of the program are lower, simpler, and less discriminatory taxes, deregulation of small and medium businesses, and the reduction in the opportunities for corruption and increase penalties for corruption. It is also revising commercial law, adopting international accounting standards, and trying to improve the judiciary. The new government, the current Duma, and Russian public opinion all appear to favor for the passage of beneficial reforms for banks and the clients alike. These reforms appear to respond in a general way to deficiencies that has made banking, as well as other economic activities difficult. The details and implementation remain unknown. These reforms and others are necessary. However, given a legacy of distrust and mismanagement the results may come slowly and intermittent missteps are likely.

Endnotes

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- ²⁰ According to a recent study, the average level of fixed assets depreciation exceeds 60%-70% while threshold of the economic safety is 50% and in developed countries does not exceed 25%. In spite of all this the amount of core capital reinvested is insignificant - only 1.5% a year of the fixed assets value i.e. total renovation of the production capacities is delayed in Russia for 70 – 100 years (in Germany, for example, it takes 4-5 years). These industrial capacities are used only for 20-40 % (*Expert* – vol. 33 – September, 6, 1999)
- ²¹ Whalen, Jeanne and Bhushan Bahree. "How Siberian Oil Field Turned Into a Minefield --- BP Amoco Learns Bruising Lesson on Investing in Russia." *The Wall Street Journal*. February 9, 2000. p. A21.
- ²² Dinello, Natalia. "The Russian F-connection." *Problems of Post-Communism*, Jan/Feb99, Vol. 46 Issue 1, p24 – 35.
- ²³ For a discussion of arm's length and relationship financing in the Asian context, see: Rajam, Raghuram G. and Luigi Zingales. "Which Capitalism? Lesson from the East Asia Crisis. *J. of Applied Corporate Finance*. Fall 1998. Pages 40-48.
- ²⁴ Yavlinsky, Grigory. "Russia 's phony capitalism." *Foreign Affairs*. May 01, 1998. Pp. 67.
- ²⁵ Popov, Vladimir. "The Financial System in Russia Compared to Other Transitional Economies: The Anglo-American versus the German-Japanese Model." *Comparative Economic Studies* Spring 1999. p42
- ²⁶ Tompson, William. "Old Habits Die Hard. Fiscal Imperatives and State Regulation." *Europe Asia Studies*. November 1997. P1159-86.
- ²⁷ "The First Society of Mutual Credit (FSMC), A New Banking Project of A.Smolensky and His "Soyuz" Banking Group" August 31, 1999 *Banks and Exchanges Weekly*. Page 8
- ²⁸ Dinello, Natalia. "The Russian F-connection." *Problems of Post-Communism*, Jan/Feb99, Vol. 46 Issue 1, p24 – 35.
- ²⁹ Popov, Vladimir. "The Financial System in Russia Compared to Other Transitional Economies: The Anglo-American versus the German-Japanese Model." *Comparative Economic Studies*. Spring 1999. p42
- ³⁰ The press reports on seven oligarchs, associated with FIG's, who allegedly bankrolled Yeltsin. While the recent crisis may have reduced their political power somewhat, they have been able to limit the damage through political power. The most commonly cited oligarchs and their related banks are: Potanin, (Uxeimbank, Interros), Smolensky, (SBS-Agro) Vladimir Gusinsky (MOST bank), Petr Aven (Alfa bank), Mikhail Fridman (Alfa Bank) and Mikhail Khodorkovsky, (Menatep, Rosprom-YuKOS). However, leader of other FIG's, Chernymirdon (Gasprom) control a third of the world's natural gas reserves but is not considered an oligarch. Berezovsky, controls Sibneft and Promstroibank as well as the large state television network, ORT, and other media does not control them using his own bank

holding company. See “Business: Russia's oil-powerful rulers: Energy tsars have got the country over a barrel.” *The Observer* August 08, 1999 Page. 4 and “Russia, The waltz of the living dead” September 10, 1999 *Euromoney* 295 and “Russian Banking, Twilight falls on Russia's tycoons.” *Central European* November 10, 1998. Page 26

³¹ Aron, Leon “Crisis of Confidence” *Russian Outlook, American Enterprise Institute*. www.aei.org/ro/rofront.htm Summer 1998.

³² Johnson, Juliet. “Banking in Russia: Shadows of the Past.” *Problems of Post-Communism*. May/Jun96, Vol:433, Pp. 49-60. Data base: Academic Search Elite

³³ *Expert*. Vol. 39. 1998. p.12)

³⁴ *Kommersant – Dengi*. Vol 26.-1998.-c.16