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HOW BIG IS THE VISIBLE HAND OF THE STATE IN THE RUSSIAN BANKING INDUSTRY?

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Abstract

This paper tackles state participation in the Russian financial sector. We take the case of the banking industry to suggest criteria for a more accurate definition of public sector boundaries and an assessment of the actual scale of state presence in the national banking market. The approach for the assessment of the extent of state participation is based on the analysis of the peculiarity of the Russian banking industry due to the high extent and institutional specificity of government intervention in the financial system. The results presented in this paper provide evidence that the existing channels of state influence over banks are not limited to equity ownership with governance and other methods of control being employed as well and prove the hypothesis about the presence of downward bias in official estimates of the existing scale of state penetration.

Key words: public sector, banks, Russia, ownership, state control, state-owned companies

JEL codes: G21, G28, P31, P34.

1. Introduction

In many emerging markets the key players in the banking industry are fully or partially controlled by the state. The state-banking phenomenon is believed to render national financial sector less efficient due to politically-motivated credit decisions and to hinder bank intermediation.

In the case of Russia, analysis of state participation in the banking industry requires a more in-depth analysis with special regard to its institutional basis such as bank ownership control. An accurate re-definition of public sector boundaries is crucial for all kinds of further analysis, e.g. the impact of direct state presence on performance indicators and relative efficiency of banks and the nature of their activities. An attempt to provide an approach to the evaluation of the size of public sector in the Russian banking market is provided in this paper.

We put forward the hypothesis that the actual scale of state presence in the national banking system may differ substantially from most official estimates based on combined market shares of largest «official» state-owned banks. Ownership-based estimates might have a downward bias, i.e. they miss chunks of the industry that are not formally owned by the state.

The paper is organized as follows. *Section 2* reviews existing approaches to the assessment of the boundaries of state-banking sector and mentions some of the estimates of public sector size in Russia. *Section 3* describes our data and sample. *Section 4* contains the definitions that we introduce to arrive at a more comprehensive classification of state-influenced banks. *Section 5* describes our empirical results and suggests their interpretation. *Section 6* concludes with the main findings and directions for further research.

2. Review of literature

In the recent years a number of research papers on state participation in the banking industry have been published. They shed light on various aspects of state-banking phenomenon such as the stimuli and reasons for state presence, relative efficiency of state-controlled banks as well as their impact on the development of financial intermediation and economic growth.

La Porta, López-de-Silanes and Shleifer [2002] define a *state owned bank* as a bank with state share (both direct and indirect – with state-owned enterprises acting as a stockholder) of above 50%, or 20% if the state is the largest known shareholder. The criterion of at least 50% of federal, regional and/or municipal ownership is followed by absolute majority of authors, e.g. [Barth, Caprio, Levine, 2002; EBRD, 2006]. Iannotta, Nocera and Sironi [2007] consider a bank as government-owned if either national or local government is

its ultimate owner, i.e. a holder of more than 24.9% of the bank's equity capital with no other single shareholder owning a larger share.

Russian scholars also tend to follow the mainstream in terms of ownership type classification. Analysis of public sector in the banking industry is usually limited to a few largest banks fully or majority-owned by the state. Handruev *et al.* [2000] regard a bank as state bank if government stake in its charter capital exceeds 50%. Babayev [2007] defines state banks as banks with 100% government share in registered capital and state controlled banks as banks with 50-100% state ownership.

In sum, most of the literature assesses the scale of state participation solely on the basis of ownership structure of banks. Barth, Caprio and Levine [2002] limit state ownership of banks to the fraction of the banking system assets that is 50% or more government-owned.

Vernikov [2007] tried to offer a more comprehensive approach to the assessment of state presence in Russian banking by putting forward the notion of «broad state» as bank stockholder or beneficiary, which included public authorities and state-owned enterprises at all levels, as well as prominent political figures.

Estimates of the scale of state presence in the Russian banking industry vary broadly. Following Russian official statistical sources, Raiffeisen [2006] and Moody's [2007] argue that the state accounts for just about 35-40% of total assets. RosBusinessConsulting [2007] put the share of top state-owned banks at 43% of total banking assets. Vernikov [2007] estimated the scope of presence of the «broad state» in the banking industry to total some 45% as of the year-end 2005. Ivanter [2009] claims the overall asset share of state banks and quasi-state banks (those controlled by state enterprises, public authorities, etc.) to total some 54% as of 01.04.2009, having soared from 46.5% at 01.09.2008.

3. The data and sample

Our empirical analysis covered some 150 top Russian banks in terms of their book value of assets as of 01.01.2009. Along with those, subsidiary banks with lower positions in asset ranking but with one of the top banks as a parent company were taken into account as well. At the first stage we searched through all publicly available information on each bank in the sample that might appear relevant in identifying «state relatedness» of a bank, i.e. information on current or former owners and top managers, subsidiary and associated companies (both domestic and foreign), affiliated persons, etc. We relied on data collected from banks' web-sites, rating agencies' analytical surveys and statistical reviews on the national banking market and relevant media sources. At this stage banks for which none of these criteria has been discovered were excluded from the sample. The remaining ones were

analyzed more thoroughly in order to detect all existing channels of a «with state relation» and their possible combinations. The final sample consists of **64 banks**. We then attempted to arrange several basic preliminary groupings of sampled banks based on identified similar characteristics, i.e. participation of state-connected entities / authorities / individual officials among owners / executives / affiliated persons and develop the overall classification of banks as described below.

We consider it reasonable to extend our analysis to the State Corporation «Bank for Development and Foreign Economic Affairs (Vnesheconombank)» (hereinafter – VEB). Despite the legal status of a State Corporation the nature of VEB activities is in some cases similar to that of state-owned banking entities in our sample. Our objective here is a substantive evaluation of the actual extent of state penetration in bank-type activity, regardless of formalities whether VEB does or does not possess a banking license from CBR. Financial support provided by the state and directed at backing tiny and «thin-skinned» private banks is realized both via VEB financing programs as well as by the means of purposive funding of key state banks. VEB loans to Russian non-financial enterprises belong to the fraction of financial assets under state control; therefore leaving VEB banking assets out would lead to underestimation of state presence.

State-owned and state-controlled banks often operate in the form of multi-tier vertical structures where the mother company (either bank or non-bank enterprise) is owned or controlled by the state and in turn owns or controls several enterprises and banks below. In Gazprombank, the third largest bank, the state-controlled Gazprom corporation acts as the largest shareholder directly and via affiliated companies, and the bank in turn controls several subsidiary banks that have their own subsidiaries. The same goes for the Russia's second-largest bank, government-owned VTB. Hence, the existing structure of the national banking industry requires a thorough analysis of all layers of hierarchy.

Thus a bank formally classified as private may be subject to considerable influence of the state, both public authorities and individual officials at federal, regional and municipal levels. Such influence is executed via control over banks' decision-making on credit allocation, and involvement in politically-motivated activities like acquisition of assets, providing services to priority industries, sectors or types of borrowers, etc. Dozens of Russian banks face a trade-off between profit-maximization and the desire to retain loyalty to public authorities in order to ensure from the state consequent support of both financial and non-financial nature. Those banks that choose to operate following political guidelines may be regarded as more or less state-related.

4. Scope and definitions

Thus we argue that, to draw a more realistic boundary of state presence in a country's banking, one must go beyond the analysis of banks' ownership type. Correct identification and classification also requires an analysis of other possible channels of control over banks that the state and its representatives can exercise through governance and otherwise. This is particularly relevant in the Russian context and in view of the institutional environment. This, unlike ownership type, remains the least examined aspect. We also believe that constructing a more relevant definition of public sector is vital for accuracy of subsequent empirical research.

We distinguish three potential channels of state participation: *ownership, governance and other forms of control*.

Firstly, we have explored the ownership structure of the banks in the sample, penetrating through as many levels of each bank's ownership hierarchy as it was possible given publicly disclosed information. We relied chiefly on official data provided in issuers' quarterly reports (*kvartalnyi otchet emitenta tsennykh bumag*), information on affiliated persons published on bank web-sites as well as other relevant information that was publicly available. All banks with state participation regardless of the ultimate equity share of the state have been divided into two broad groups: (a) directly state-owned banks, and (b) banks that are indirectly state-owned. Group A consists of banks with federal, regional governments, local administrations, the Central Bank of Russia (hereinafter - CBR) and federal or regional property funds acting as a stockholders. Group B comprises banks whose capital is owned either in full or partly by non-financial enterprises, non-bank financial institutions or by banks that are in turn state-owned.

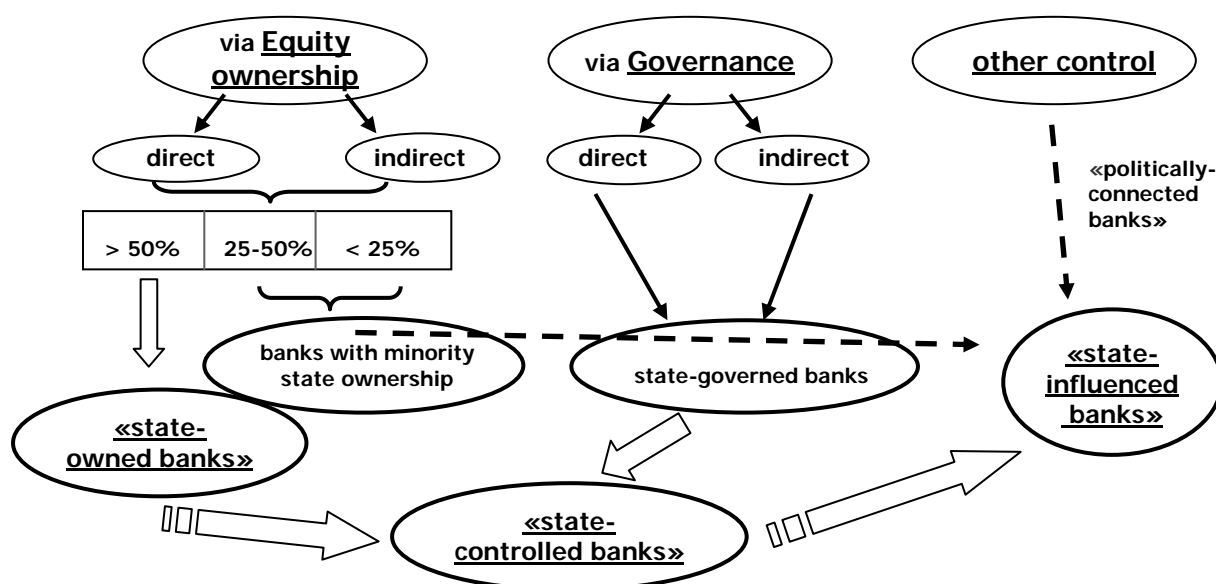
Secondly, state influence on banks may be realized via its participation in governance. We have identified two broad sub-groups of banks: (a) those with the presence of representatives of legislative and executive bodies (federal, regional governments, local administrations) in the Board or Supervisory Council – we called them «directly state-governed banks»; and (b) banks where executives of state-owned or state-governed enterprises (i.e. non-financial enterprises, non-bank financial institutions or banks) act as members of the Board or Supervisory Council. These latter were defined as «indirectly state-governed banks».

The *third* criterion of classification as state-related is focused on other existing channels of bank-state interaction *besides* ownership or governance. Banks to which this applies are broadly defined as «politically-connected». Here we rely upon the definition of «politically connected firms» provided in [Faccio, 2006] for companies «in which top officials or politicians act as shareholders or members of the board or good friends of main owners» with regard to national banks' operating specificity. To be more specific, this may be the case if:

- representatives of legislative and executive bodies are among bank shareholders, former or current;
- CBR representatives are authorized to control a bank's funds placement decisions;
- Deposit Insurance Agency acts as arbitration manager in a bankruptcy process;
- the bank is appointed as official provider of financial services to key industries/sectors/groups of borrowers of the region;
- the bank is empowered by the state to manage local administration's or regional government's accounts.

The resulting classification of banks in the sample is presented in **Fig.1**.

Figure 1: State participation in banking



All banks with state participation may be aggregated into three broad categories. The narrowest category includes **«state-owned banks»** whose equity is majority-owned by the state, e.g. when state authorities of all levels act as a direct shareholder or a majority stake in a bank is owned by state-owned enterprises.

The second category that we defined as **«state-controlled banks»** includes, in addition to **«state-owned banks»**, also banks with minority state share in equity but with identified state participation in governance, either direct or indirect.

We should admit that taking the presence of individual officials - representatives of legislative or executive bodies', i.e. federal, regional governments', local administrations' - in the Board or Supervisory Council of a bank as a criterion for a bank's being regarded as state-controlled might induce a twofold bias in authors' estimation of the existing scale of state

influence. On the one hand, presence of government officials in a bank might reflect the phenomenon of «state capture», i.e. the desire of the state to execute control over bank's activities as described above. On the other hand, promoting bank's affiliates to authorities of any level might result from the desire of its owners to obtain a kind of «special treatment », i.e. state loyalty and support, procured by contiguity with corridors of power – the so called phenomenon of «business capture». Despite the two-way ambiguity of this aspect we insist on the expedience of including this factor into our analysis lest we should underestimate the existing scale of state presence.

Finally, «state-owned banks» and «state-controlled banks» as well as all other banks that are neither majority-owned nor governed by the state but for which any of the above-mentioned criteria of being «politically-connected» applies comprise the broadest group of «state-influenced banks».

5. Empirical results and interpretation

According to our classification, the category of «state-controlled banks» contains 44 institutions of which 33 are the banks with identified state majority ownership and the remaining 11 are not state-owned but with elicited state control via governance. The breakdown of 64 «state-influenced banks» in our sample is shown below in **Table 1**.

Table 1: Breakdown of «state-influenced banks», by 01.01.2009

Category	Number of institutions
«State-influenced banks», total,	64
<i>of which</i>	
«state-owned banks»	33
«state-controlled banks», other than «state-owned banks»	11
<u>other «politically-connected banks»</u>	<u>20</u>

As of 01.01.2009 we estimate that 5 largest state-controlled banks accounted for 52.1% of total banking assets (**Table 2**).

Table 2: Asset-share of 5 largest state-owned banks, %:

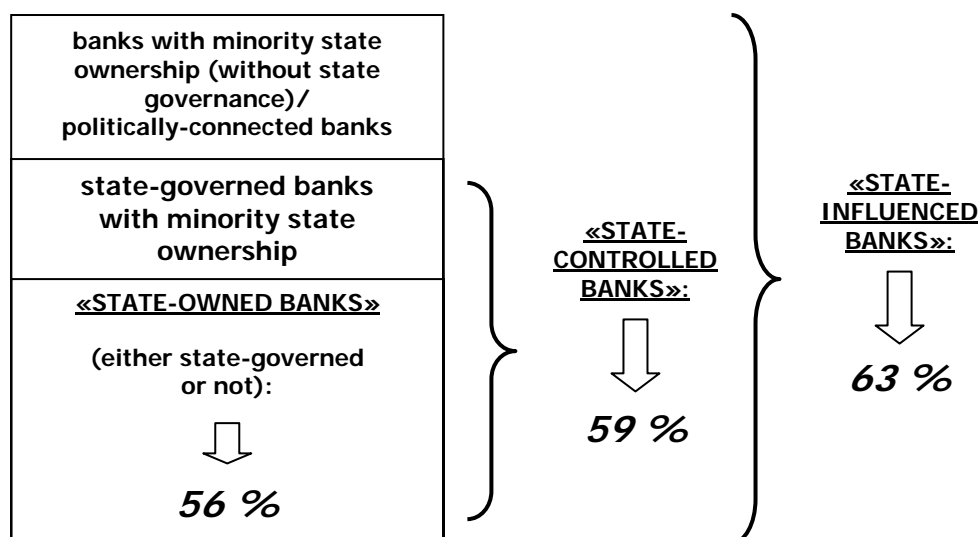
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Sberbank	24.9	23	24.2	23.8	24.7	23.5	22.9	27.9	25.6	24.7	24	29.9
VTB Group*	3.9	6.7	7.1	6.8	6.6	6.1	6.3	7.4	8.3	7.7	8.7	11.3
Gazprombank	1.3	3.3	3.1	3	3.2	3.4	3.7	4.7	4.5	5.1	6.4	5.6
Rosselkhozbank	0	0	0	0	0.3	0.2	0.2	0.3	0.6	1.7	2.2	3.0
Bank Moskvyy	0.7	1.1	1.5	1	1.3	1.8	1.6	1.9	2.2	2.5	2.6	2.3
Sub-total	30.8	34.1	35.9	34.6	36.1	35	34.7	42.2	41.2	41.7	43.9	52.1

* including VTB, Bank VTB 24 and Bank VTB North-West.

Source: RosBusinessConsulting [2007], authors' calculations for 2009 and 2008.

We found that 63% of all banking assets were under certain degree of influence of the state, out of which some 59% were under quite a decisive influence. The ultimate market share of each group of banks measured as proportion of total banking assets in Russia is displayed in Fig.2.

Figure 2: Banks with state participation*, as a percentage of total assets, by 01.01.2009



* adjustment for the value of VEB’s banking assets provides an additional 2% to each of the combined asset shares

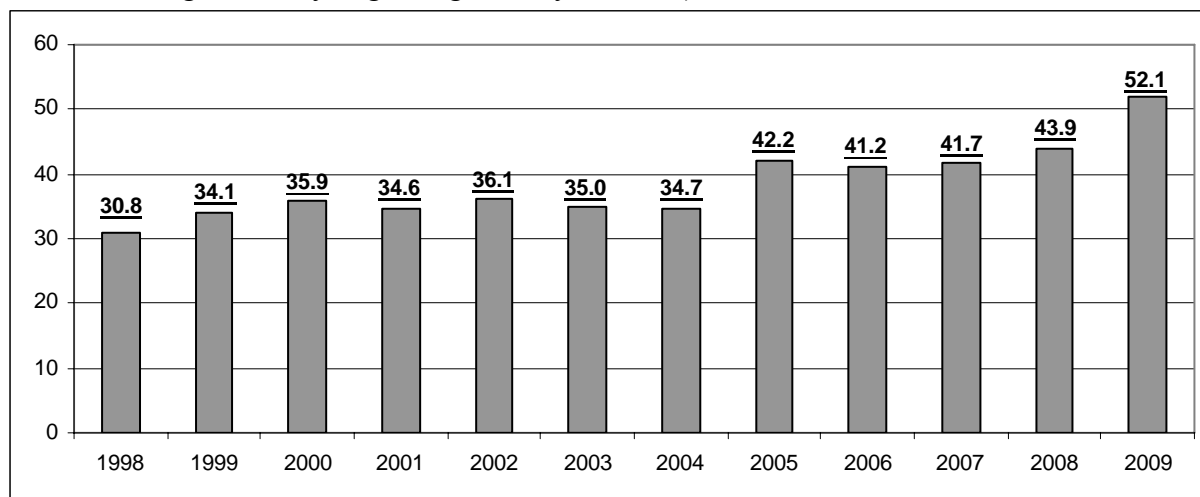
Source: authors’ calculations and estimates

We see two major trends concerning the scale of state participation. While the overall asset-share of key state-owned and state-controlled banks tends to increase (**Fig. 3**), at the micro level a reverse dynamics (i.e. the decrease of state share in some banks in our sample) has emerged. This trend of state ownership of banks being diluted might result from either initial or secondary public offerings (as in the cases of VTB and Sberbank with the state’s maintaining hold of majority stake) or, more frequently, from a more scant and contingent strategy of private individuals gradually taking over state share in a bank’s equity. The examples of this scenario concern major Russian state-controlled banks:

- Bank Moskvyy, with direct equity share of Moscow government having decreased from 62.7% in 2004 to 46.5% at the beginning of 2009; and
- VTB, with its announced sale of additional share issue in Russian Commercial Bank (Cyprus-located VTB subsidiary) to an entity controlled by the bank’s top-management.

Above-mentioned empirical evidence provides room for further research of cyclicity of nationalizations and privatizations in Russia, as well as of the role of top-managers and other influential insiders in bank ownership and control.

Figure 3: Combined market share of top-5 state-owned banks* (as percentage of total banking assets, by beginning of the year, in %)



* Sberbank, VTB-group (including VTB, Bank VTB 24 and Bank VTB North-West), Gazprombank, Rosselkhozbank and Bank Moskvyy.

Source: RosBusinessConsulting [2007], authors' calculations for 2009 and 2008.

6. Conclusions and directions for further research

Our analysis of the existing channels and extent of state participation in the Russian banking industry has provided several findings.

First, we find empirical evidence that the channels of state influence over banks are not limited to equity ownership. Governance and other methods of control and influence are employed as well. Hence an analysis of ownership structure alone would not suffice to draw correct boundaries of the public sector. In a society like Russia, *property* is inseparable from *power*, so the two normally co-exist in some combination. Therefore the phenomenon of state banking requires a more extensive investigation due to high extent and institutional specificity of government intervention in the financial system.

Second, we suggest a new classification of banks with state participation: (a) «state-owned banks»; (b) «state-controlled banks»; and (c) «state-influenced banks». The former category is based on the criterion of controlling ownership and includes banks owned directly by the Governments itself or its various bodies and indirectly by state-controlled industrial companies. «State-controlled banks» category is broader and includes, in addition to (a), also those banks that are minority-owned by the state but governed by the state. Finally, «state-influenced banks» is the broadest category that includes (a), (b), plus the banks that have fallen under state influence through close political connections or via other, ‘softer’ forms of control.

Third, according to our own estimations based on the book value of banks in the sample, the actual scale of state presence is much higher than publicly declared 40% and falls

within the range between 56% and 63%, depending on the definition chosen. This proves the hypothesis about the presence of downward bias in official estimates and reports.

Fourth, criteria and definitions presented in this paper provide a framework for further analysis of state banking phenomenon in Russia and other countries with institutional setup somewhat similar to Russia's – e.g., in China, Vietnam or India. Newly defined boundary of state sector in the banking industry might raise accuracy of econometric research of relative efficiency of state-connected banks, nature of their activities, and the impact of state participation on banking sector development.

We envisage three broad directions for future research. At macro level the impact of the extent of state presence on the depth of financial intermediation and stability of the banking sector will be analyzed. At micro level we intend to investigate behavior patterns as well as the operating efficiency and other performance indicators of Russian banks depending on their ownership structure. The third avenue of further study deals with the direction of influence between the state and banks that are not directly or indirectly owned by the state. More specifically, we plan to find out whether in the financial sector 'business capture' prevails over 'state capture' at this stage of Russia's transformation.

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