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Andrei Vernikov

Institute of Economics, Russian Academy of Sciences, Moscow

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The impact of state-controlled banks on the Russian banking sector¹

Andrei Vernikov²

Abstract

This paper examines the structure, governance, and balance sheets of state-controlled banks in Russia, which accounted for over 55 percent of the total assets in the country's banking system in early 2011. The author offers a credible estimate of the size of the country's state banking sector by including banks that are indirectly owned by public organizations. Contrary to some predictions based on the theoretical literature on economic transition, he explains the relatively high profitability and efficiency of Russian state-controlled banks by pointing to their competitive position in such functions as acquisition and disposal of assets on behalf of the government. Also suggested in the paper is a different way of looking at market concentration in Russia (by consolidating the market shares of core state-controlled banks), which produces a picture of a more concentrated market than officially reported. Lastly, one of the author's interesting conclusions is that China provides a better benchmark than the formerly centrally planned economies of Central and Eastern Europe by which to assess the viability of state ownership of banks in Russia and to evaluate the country's banking sector.

JEL codes: G210, G280, H820, L800, P520.

Key words: Russia, Russian banks, government control, state-owned banks, public sector, bank assets, bank deposits, bank loans, Chinese banks, private banks.

Introduction

State-controlled banks are now reclaiming their role as the backbone of the Russian banking system as well as the main external source of financing for the economy as a whole. Since the 1998 financial crisis, far-reaching changes have occurred in the institutional structure of the banking industry. The calculations presented in this paper suggest that banks that are either directly or indirectly controlled by the state now dominate practically all segments of the banking market, whereas genuine commercial banking based on private initiative is in decline. These changes affect market concentration and competitiveness as well as bank efficiency.

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² Institute of Economics, Russian Academy of Sciences, Moscow, and National Research University Higher School of Economics, Moscow. Email: vernikov@inecon.ru. The author wishes to thank Anna Anisimova, Zuzana Fungáčová, Hubert Gabrisch, Suren Gomtsyan, Marina Grusevaja, Svetlana Kirdina, Iikka Korhonen, and Laurent Weill for constructive comments and suggestions. Parts of this paper were discussed earlier at the 11th Bi-annual Conference of the European Association for Comparative Economic Studies, the 6th Biennial Conference of the Czech Economic Society, the 12th International Academic Conference on Economic and Social Development (in Moscow), the seminar at the Halle Institute for Economic Research, and the Russian Banking Forum (London, 2011).

Government banking has attracted considerable academic attention. For example, an influential paper on the political economy of state banking by La Porta et al. (2002) reviewed the causes and consequences of direct state ownership of banks, with a focus on developing countries. The comparative efficiency and competitiveness of state-controlled banks versus domestic private and foreign-owned entities has been the subject of a number of empirical studies (Bonin et al., 2005; Fries et al., 2006; Fungáčová et al., 2010; Karas et al., 2010; Anzoátegui et al., 2012). Efforts have been made to re-test the macroeconomic effects of government ownership of banks, using recent empirical data. Some scholars (e.g., Andrianova et al., 2011; Körner and Schnabel, 2011) have challenged the notion that the impact of government banking is uniformly negative (La Porta et al., 2002) on the financial development and economic growth of developing countries. They posit that in reality the impact can be either negative or positive, depending on the initial level of economic development, the nature of local institutions, and other parameters as well.

In addition to the ongoing debate about the impact of state banking on economic growth and development, another source of support for the research in this paper came from the transition economics literature, especially that dealing with convergence of European emerging markets with “old” Europe. It becomes increasingly difficult to assume that Russia is following a similar trajectory of convergence with Europe. One can find growing similarities between the models of banking in Russia and in China, although Speranskaya (2009) has argued that divergence is actually more prominent than convergence. In the recent past, this author has more than once questioned the direction of structural change in the banking industry (e.g., see Vernikov, 2009, 2011) of Russia.

This paper continues to assess the viability of state ownership of banks in Russia, by presenting an alternative estimate of the public sector’s share in the country’s banking industry, as well as discussing some distinctively Russian characteristics, such as the paradoxically high profitability of state-controlled banks (which contradicts predictions based on theory) and the replacement of direct government ownership by less transparent forms of indirect ownership and control. I also suggest a different way of measuring market concentration in Russia by consolidating the market shares of core state-controlled banks, which substantially increases the indices of concentration. Finally, it is argued here that Russian banking should be compared with that of China rather than with the banks of Central and Eastern Europe (CEE) that had formerly been under state control under socialism.

The section of the paper that follows focuses on developments within the public sector of Russia’s banking system, such as replacement of direct government ownership and control by indirect

control and the relative profitability of different types of banks. A third section examines changes in the structure of Russian banking and places them in an international context. This is followed by a fourth section that discusses policy implications and a final one, which presents my conclusions.

2. Recent developments

2.1. The scope of the public sector

This study distinguishes two types of state-controlled banks, namely those directly and indirectly controlled.³ In the former, the controlling proportion of shares is owned by federal- or subfederal-level governments. In the latter, the controlling stake (at least half of equity) is held by companies or banks whose equity is formed with public funds. I have reviewed the annual and quarterly reports of banks and their parent companies (whose issuance is required by law) to determine the presence of public-sector institutions among bank shareholders (and among shareholders of shareholders). Because official sources do not break down companies by the form of property in a substantive manner (Sprenger, 2010, p. 68), the banks were segregated by the author into two categories on the basis of official designations detailed in **Table 1**, which incorporates all banks that could be identified as either directly or indirectly state controlled.

Table 1. Sample of state-controlled banks used in the study

Entity holding over 50 percent of bank equity	Number of banks ^a				
	2000	2007	2009	2010	2011
Directly state-controlled banks	17	17	19	17	16
Federal executive authorities or the Central Bank of Russia	6	4	4	4	4
Regional authorities and federal city ^b governments	10	10	12	11	10
Municipal authorities	1	3	3	2	2
Indirectly state-controlled banks	18	22	28	24	22
“State corporations” (ASV ^c and VEB ^d)	0	2	8	8	6
State-controlled banks	11	13	13	10	9
State-owned companies other than banks	7	7	7	6	7
Total	35	39	47	41	38

^aBy year end. ^bMoscow and St. Petersburg. ^cDeposit Insurance Agency. ^dVneshekonombank.

Sources: Author’s calculations based on annual quarterly reports of banks or their parent companies, statutory disclosures, and CBR, 2012.

³The term “state-controlled bank” is more precise than “state-owned bank.” Even if the government owns 100 percent of bank equity it still cannot claim to “own” the institution as a whole because in strict legal terms a joint-stock company cannot be “owned.” The notion of ‘state-owned’ seems less appropriate yet where the government exercises control through *minority* ownership, as is provided for by the OECD definition of state-owned enterprises (Sprenger, 2010, p. 64).

After peaking at a level of 47 banks in December 2009, the number of state-controlled banks in our sample had shrunk to 38 institutions by the beginning of 2012, of which 16 were directly controlled by the authorities and 22 were governed by the state indirectly. The latter category includes the offspring of public sector banks (VTBs), “state corporations,”⁴ industrial companies (Gazprom, Rosneft’, RZhD—Russian Railways, and Alrosa), and indirectly state-controlled banks (Gazprombank, TransKreditBank, VBRR, and Bank Moskvyy).

Expansion of the market share of state-controlled banks in Russia began from a low level of 36 percent in 1999, and was driven by a combination of organic growth and takeovers of private banks. My calculations indicate that from the first quarter of 2000 through the first quarter of 2011, the assets of state-controlled banks grew by 62 percent,⁵ whereas those of all other Russian banks grew by 29 percent. Since the outbreak of the global financial crisis in 2008, the market position of public banks has been strengthened thanks to liquidity support and equity contributions by the government. The 2008 crisis also pushed some of the weaker private banks to accept state control. The share of assets of state-controlled banks⁶ in the country’s total exceeded one-half in 2008, and reached 55.8 percent by the beginning of 2012 (Fig. 1).⁷ As shown in **Figure 1**, the increase in market share was neither uniform, nor continuous, with a slight decrease occurring in 2010 before a resumption in growth in 2011.⁸

⁴These include ASV (the deposit insurance agency) and Vneshekonombank (the state development bank). “State corporations” are established as non-profit entities and are governed individually under federal law. They are neither state bodies nor corporations (joint-stock companies) in the conventional sense.

⁵Unweighted average of assets in nominal terms in national currency.

⁶The assets of banks in which public participation exceeds 50 percent are counted fully. Policy lenders without a banking license such as development banks are beyond the scope of analysis in this paper, because banking data do not capture their lending operations (mainly corporate lending and pre-export financing). We do, however, include the subsidiaries of Vneshekonombank (Svyaz-Bank, Globex, MSB-Bank, and Roseximbank).

⁷By the end of 2010 the Central Bank of Russia (CBR, 2011, p. 21) reported the share of “state-controlled banks” according to its own definition at 45.8 percent. I attribute the discrepancy between my number and the estimate of the CBR to the difference in coverage, because the methodology used in this study embraces a broader range of indirectly state-controlled banks.

⁸In 2010, impaired assets worth hundreds of billions of rubles were written off or transferred from balance sheets of state-controlled banks to their subsidiary companies, which are free of public scrutiny and which disclose little, if any, financial information (e.g., Sberbank-Kapital, the Sberbank subsidiary). This may account for the statistical decline in the market share of state-controlled banks in that year.

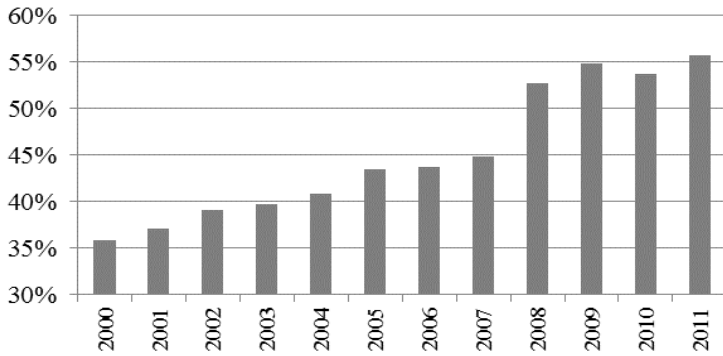


Fig. 1. Market share of state-controlled banks in Russia (percent of total assets at year end).

Sources: Author’s calculations based on bank data reported in CBR (2011, 2012), and RBK (2012).

2.2. Direct Versus indirect government ownership and control

By 2011, the share of banks controlled indirectly by the state (the category “banks controlled by state-owned companies and banks” in Fig. 2) had grown to one-fourth of the total for the public sector. Some banks (Rossiyskiy Bank Razvitiya, currently MSB Bank, and Roseximbank) were transferred from direct federal ownership to Vneshekonombank. After 2008 the government assigned the task of taking over failed private banks to “state corporations” (ASV and Vneshekonombank) and state-owned enterprises, and funded the rescue operations.⁹ The stake of the Moscow city government in Bank Moskvyy, Russia’s fifth largest financial institution, was replaced by indirect ownership of federal authorities via entities of the VTB group.

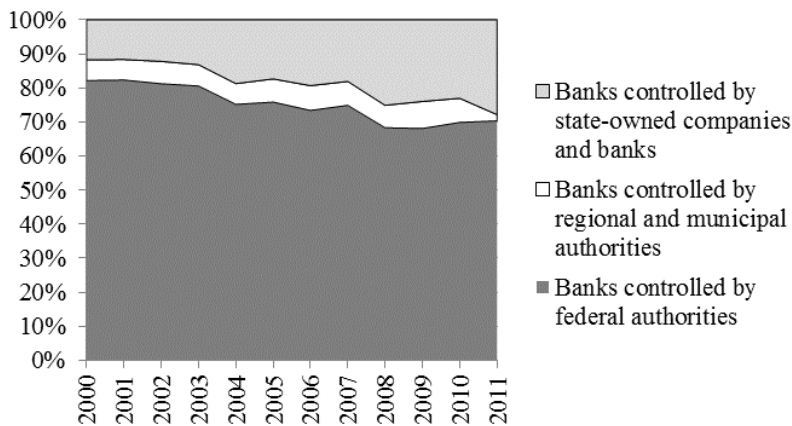


Fig. 2. Restructuring within the public sector (percent of assets of state-controlled banks at year end).

Sources: Author’s calculations based on bank data and RBK (2012).

⁹Unlike Fidrmuc and Süß (2011), who regard bank takeovers by ASV and Vneshekonombank as direct government bailouts, I view those cases as fitting the pattern of indirect state control because neither ASV nor Vneshekonombank are official government entities and both have significant autonomy in handling their subsidiaries.

Indirect state ownership of banks tends to be in the form of proprietary structures having several intermediate layers of corporate control and a large state-owned enterprise or bank at the top (i.e., via corporate pyramids). There may be several reasons why the government as the owner of a bank would find a pyramid to be an attractive option. Such a choice may stem from the inability to efficiently manage and control a large number of banks by traditional bureaucratic methods of state governance. Other motivations, relatively benign one, reflect the desire to overcome financing and property rights constraints as well as to increase efficiency via more flexible decentralized decision making. Indirect public ownership provides a higher degree of immunity from government interference and preferential access to public funds (Fan et al., 2005; Okhmatovskiy, 2009). Indirectly owned banks can better pursue profit-oriented policies; in 2001–2003 the average return on assets at banks with ties to state-owned enterprises was higher than that for banks directly controlled by the government (Okhmatovskiy, 2009)

A pyramidal structure, however, separates ownership from control, and each additional tier weakens public scrutiny over the use of funds. Indirect state ownership is preferred by bank insiders because it reduces their accountability and makes it possible to manage those banks like quasi-private property, which often leads to dilution of majority stakes, tacit appropriation of bank equity, related lending, self-trading, and other forms of opportunism. Moscow's city government fully controlled Bank Moskvyy at its inception in 1995, but the government's direct control gradually was reduced after a sequence of outwardly innocent corporate actions, leaving the city holding only 48 percent of its equity. In 2011 it became known that the previous management team of Bank Moskvyy had loaned over 200 billion rubles to related companies without properly disclosing the matter (*Kommersant*, July 5, 2011).

2.3. State-controlled banks compared with other market participants

State-controlled banks in the sample tend to be much larger than other Russian banks. The mean assets held by the 6 core state-controlled banks at the end of 2011 (3.2 trillion rubles) and 25 other state-controlled banks (154 billion rubles) dwarfed those of all other Russian banks (34 billion rubles, as shown in **Table 2**). The share of loans in total assets is slightly below the average, indicating the significance of non-lending activities. State-controlled banks tend to rely less on household deposits to fund their operations than other Russian banks.

Table 2. Basic financial indicators of the top-500 Russian banks, December 31, 2011

Statistic	Core state-controlled banks, $N = 6^a$		Other state-controlled banks, $N = 25$		All other Russian banks, $N = 469$	
	Average	S.D.	Average	S.D.	Average	S.D.
Assets (bill. rubles)	3228	3,898	154	480	34	91
Loans (bill. rubles)	1651	2,446	72	209	17	47
Loans/assets (percent)	46	13.4	41.6	15.3	48.7	...
Household deposits/liabilities (percent)	21.6	22.9	27.2	15.9	23.4	...
Household deposits/loans	43.9	43.4	51.0	34.7	48.5	...

^aSberbank, VTB group (VTB, VTB24, Bank Moskvyy, and Transkreditbank), and Rosselkhozbank.

Source: Author's calculations based on RBK, 2012.

Although argument have been made that the form of ownership is irrelevant for performance and that the truly important factors are the quality of corporate governance, management, and the legal system, empirical studies in which the form of ownership is an explanatory variable have found that the market behavior and financial performance of state-controlled banks do differ from those of private and foreign-controlled banks. Whereas lending and pricing decisions of state-owned banks can deviate from rational economic practice, lending on behalf of the government need not imply inferior revenue performance of public banks in comparison with their private peers. In Russia, domestic public banks are no less efficient than the private (Karas et al., 2010). Although that finding was met with some skepticism, it was later verified by the financial details disclosed in banking statistics. By 2010 the profitability of state-controlled banks (using the CBR's definition) was higher than that of all other groups of domestic banks, as shown in **Table 3**, based on CBR (2011, pp. 22–23).

Table 3. Return on assets and equity of Russian banks, 2009–2010 (percent)

Category of bank	Return on assets		Return on equity	
	2009	2010	2009	2010
State-controlled ^a	0.7	2.4	4.3	14.8
Foreign-controlled	1.1	2.1	8.3	14.5
Large private domestic	0.4	1.1	3.2	8.4
Small and medium-sized in Moscow	1.2	1.4	5.2	6.7
Small and medium-sized elsewhere ^b	1.1	1.5	6.2	9.8
All banks	0.7	1.9	4.9	12.5

^aCBR definition. The source does not specify which banks are included in the category of "state-controlled." Probably indirectly state-controlled banks are covered only in part. ^bIn other regions of Russia except Moscow.

Source: Central Bank of Russia.

State-controlled banks also tend to perform better on at least one measure of efficiency. I calculated a ratio of costs to operational profits for Russia's top 30 banks in 2011, using data from the Central Bank's website (<http://www.cbr.ru>) and respective banks' data. The result for state-controlled banks was better than for foreign-controlled banks and for domestic private institutions (46.5, 62.8, and 73.8 percent, respectively).

Evidence of higher profitability and efficiency of state-controlled banks in Russia runs counter to the conventional wisdom, which maintains that it should be the lowest among all participants (e.g., La Porta et al., 2002). It also contradicts the findings of the prevailing empirical literature on European economies in transition (Bonin et al., 2005; Fries et al., 2006). The interpretation of this phenomenon is, to say the least, a challenging task. It might be assumed that a substantial share of profits earned by state-controlled banks may in essence represent rent extracted from an oligopoly position, such advantages as the handling of public procurement, the general backing of the state, and from administratively imposed preferences. Pricing policies of state-controlled banks might reflect specific lending practices and procedures, which particularly might facilitate an understanding of the phenomenon.

A different explanation for the higher profitability of public-sector banks points to the fact that the financial data that they report are less reliable than those disclosed by private and foreign-owned banks. For example, until 2011 Bank Moskvyy's financial statements did not reveal the magnitude of lending to related companies, thus enabling the bank to report substantial "profits" and conceal an immense gap on its balance sheet. Oddly, this was not detected (or in any event was overlooked) by external auditors, casting serious doubt on the quality of financial reporting by other large state-owned banks.

In any event, profitability is a poor indicator of relative performance in an economy with a blurred boundary between commercial banking and development banking and absence of a level playing field for all financial entities. If players with the largest market shares are basically non-market entities that by definition cannot go bankrupt (thanks to soft budget constraints), standard models of industrial organization may not be particularly relevant in explaining the behavior of Russian banks.

3. Industry structure: Convergence with CEE or with China?

3.1. Tiers and macro-level design

The Russian banking system formally consists of two tiers (the Central Bank and all commercial banks), but in fact it has evolved into a three-tier system. The intermediate layer is represented by the core state-controlled banks—i.e., Sberbank, the VTB-group banks (VTB, VTB24, VTB-Severo-Zapad, and since 2011 also Bank Moskvyy and Transkreditbank), and Rosselkhozbank. Gazprombank could also be added, although government control over it is indirect and less transparent. Core state-controlled banks are the first ones to receive state assistance during periods of stress. They act as agents of the monetary authorities in supplying credit, channeling liquidity into the system, bailing out weaker institutions, setting a politically desirable price level for loans and deposits, and supporting the money exchange and even the stock market.

The structure of the Russian banking industry is presented in detail in **Table 4**. The leading position of the three federal-level “national champions” (Sberbank, VTB, and Rosselkhozbank) has become increasingly consolidated over time through organic growth as well as mergers and acquisitions, especially by VTB, which recently took over Bank Moskvyy and Transkreditbank. Figure 3 shows the corresponding erosion of market share and crowding out of the domestic private sector.

Table 4. Structure of the Russian banking system, 2011

Bank type	Share of state authorities in equity, percent	N	Market share (percent)			
			Total assets	Loans to non-financial companies and households	Household deposits	Household loans
State-controlled commercial banks, of which:	> 50	16	40.2	49.3 ^d	57.4 ^d	46.4 ^d
Banks controlled by federal executive authorities or the Central Bank of Russia	> 50 ^a	4	39.2
Banks controlled by regional and local authorities	> 50 ^b	12	1.0
Indirectly state controlled commercial banks	> 50 ^c	22	15.5	33.2 ^d	31.1 ^d	27.9 ^d
Other commercial banks	< 50	827	26.2			
Foreign-controlled banks	-	113	18	17.5 ^d	11.5 ^d	25.7 ^d
Total	-	978	100	100	100	100

^aCentral authorities. ^bRegional and local authorities. ^cBanks controlled by “state corporations” (ASV - Deposit Insurance Agency and Vneshekonombank), by state-controlled banks, and state-owned non-financial companies. ^dData are for the end of 2010.

Source: Author’s calculation based on CBR, 2011, 2012, and other bank data.

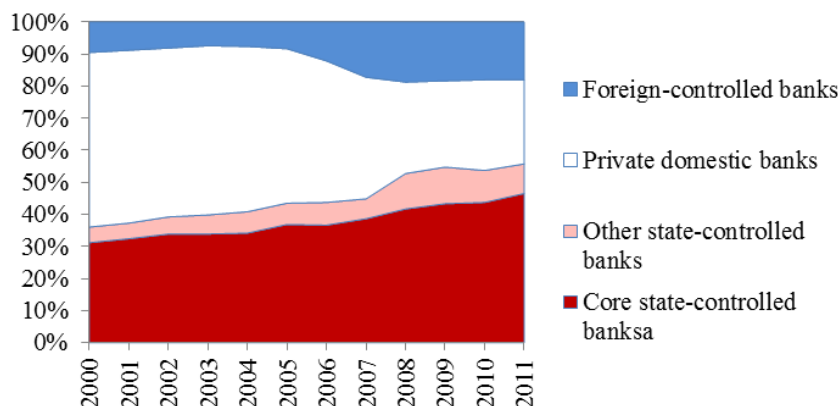


Fig. 3. Structure of the banking system (commercial banks only; shares of total bank assets at year's end). Core state-controlled banks include Rosselkhozbank, Sberbank, and VTB Group banks (VTB, VTB24, VTB-Severo-Zapad, and since 2011 also Bank Moskvya and Transkreditbank).

Sources: Author's calculations based on bank data reported in CBR (2011, 2012), and RBK (2012).

The government is the source of two-thirds of all investment in industry and infrastructure, and most of that investment is channeled through state-controlled banks. Russia also has a development bank but, unlike China, does not have officially recognized “policy banks.”¹⁰ Social demand for policy lending is partly met by large state-controlled banks that are engaged in supplying long-term financing to “systemically important” enterprises and “strategic projects,” including sports and convention facilities, or in providing emergency relief funds to companies and regions impacted by natural or technological disasters. As a result, the public banks have built a portfolio of policy-based assets (loans, equities, and industrial assets) that are unusual for commercial banks. VTB and Sberbank now are spearheading Russia's outward economic expansion into Europe and Asia, which pursues mainly geopolitical goals and for which there is often little business justification (such as acquisition of a German auto-maker or a failing Austrian bank).

The growing numerical indicators of financial depth and bank outreach in CEE (IMF, 2010; World Bank, 2010; Raiffeisenbank, 2011, pp. 14–18, 60–61) may suggest to some observers that Russian banking system is gradually converging with the rest of emerging Europe. However, institutionally and structurally the gap remains wide. Most of post-communist countries in Europe have curtailed the government's presence in the banking industry to below 20 percent and opened it up to international competition, whereas these trends are moving in the opposite direction in Russia (**Fig. 4**).

¹⁰Russia's Vneshekonombank, the development bank, has a sizeable portfolio of corporate loans that might equal 2 percent of the total loans granted by commercial banks (Vneshekonombank, 2011). In China, apart from the China Development Bank, there are also two “policy banks”—the Export-Import Bank of China and the Agricultural Development Bank of China (CBRC, 2011, p. 150).

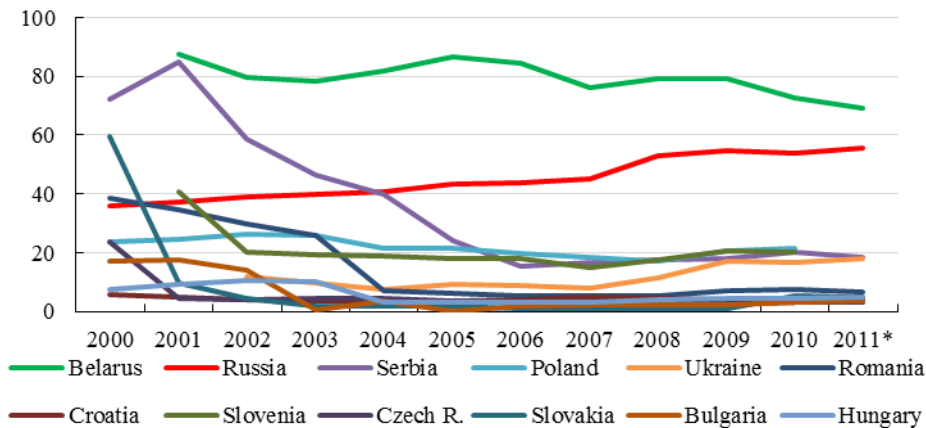


Fig. 4. Market share of state-controlled banks (percent of total assets at year's end). Asterisk (*) for 2011 indicates for all countries except Russia; data reported for 2011 are for the first half of 2011. *Sources:* For Russia, author's calculation based on bank data and his definition of state-controlled banks; for other countries, Raiffeisenbank (2006, 2011).

On most counts, a growing similarity is evident between the banking models of Russia and China, rather than between Russia and the CEE countries. The sheer size of the public sector in banking puts Russia in the same league with India (around 75 percent) and China (over 90 percent). Industrial policy consists of growing “national champions” in the public sector, modernizing them to the extent possible, and supporting their expansion in both domestic and international markets. While the public sector is the driving force, domestic private capital plays a complementary role, even though it is gradually being marginalized despite its impressive growth (policy lending and directed lending guided by the government are growing at faster rates than regular commercial lending). Foreign direct investment (FDI) into Russian banks remains limited (ca. 18 percent of total assets) and cannot reshape the industry the way it has done in CEE.

To date the similarities between China and Russia have not been recognized due to political sensitivities in Russia. Russian analysts perceive the Chinese banking system to be functional and successful,¹¹ whereas the Russian one is not. Consideration of selected technical parameters and political rhetoric has tempted some authors to conclude that Russian banking is evolving in a different direction from China (Speranskaya, 2009). Divergent measures of financial depth in China and Russia, however, can originate from broader structural and institutional characteristics such as China's high savings rate, which fuels local banks with cheap liquidity. Causality can go in either direction though, and it is the

¹¹For succinct reviews of the regulatory framework and reforms in China's banking sector, see Liu and Wu (2008) and He and Fu (2008). Broader and more recent perspectives on China's related economic policies can *inter alia* be found in Keidel (2011), Kroeber (2011), and Naughton (2011).

stability and trustworthiness of core state-owned banks that enhances the propensity to save in China. Conversely, low savings rates, a high share of cash in broad money aggregate, financial shallowness, and mistrust of banks in general might be a product of two-and-one-half decades of ill-conceived reforms of the banking/saving system in Russia.

3.2. Market structure

If measured in a traditional way, concentration in the Russian banking industry is not particularly high by European emerging market standards (Raiffeisenbank, 2011, p.10). The CBR (2011, p. 14) reported that by the end of 2010 average values of the HHI (Herfindahl-Hirschman Index)¹² stood just under 0.1 for total assets and total equity, 0.125 for loans to non-financial companies, and 0.236 for household deposits—i.e., at relatively low levels.

Table 5. Market share of top-ranking banks in Russia, 2011^a

Rank	Name	Ownership	Market share, percent of			
			Total assets	Corporate loans	Household deposits	Profits
1	Sberbank	State-controlled	25.9	35.1	46.5	37.9
2	VTB group ^b	State-controlled	17.1	16.3	9.0	6.4
	<i>VTB</i>	State-controlled	9.8	11.2	0.1	2.5
	<i>Bank Moskv</i>	State-controlled	3.2	2.9	1.3	0.7
	<i>VTB24</i>	State-controlled	2.9	0.8	6.9	1.9
	<i>Transkreditbank</i>	State-controlled	1.2	1.4	0.7	1.4
3	Gazprombank	State-controlled	5.8	6.7	2.1	4.6
4	Rosselkhozbank	State-controlled	3.5	4.4	1.3	0.2
5	Alfa-Bank	domestic private	2.3	3.7	2.0	1.3
6	UniCredit Bank	Foreign-controlled	2.1	2.1	0.4	2
7	Rosbank	Foreign-controlled	1.5	1.3	1.1	1
8	Raiffeisenbank	Foreign-controlled	1.4	1.5	1.7	1.8
9	Promsvyazbank	Domestic private	1.4	2	1.0	0.6
10	Nomos	Domestic private	1.1	1.6	0.5	0.5
	Total		62.2	75	65.6	56.6

^aAs of year-end. ^bVTB Group includes here only the four banks indicated in italic type. Had the four been ranked individually, VTB would have retained its No. 2 position, Bank Moskv would have been in fifth place, VTB24 in sixth, and Transkreditbank twelfth.

Source: Author's calculations based on data in CBR, 2012 and RBK, 2012.

One must keep in mind, however, by the size of assets 6 of the top 10 banks are state-controlled institutions (Sberbank, VTB, Gazprombank, Rosselkhozbank, Bank Moskv and VTB24), 3 are foreign

¹²The Herfindahl-Hirschman Index (HHI) is calculated as the sum of squared unit market shares. HHI shows the degree of market concentration and varies from 0 (no concentration) to 1 (total concentration).

controlled (UniCredit Bank, Rosbank, and Raiffeisenbank), and only 1 (Alfa Bank) is owned by domestic private capital, as shown in **Table 5** above.

Banks controlled by the state might be viewed as ultimately related parties if we add up the market shares of the main state-controlled banks (Sberbank, VTB Group, and Rosselkhozbank) to check the effect it would produce on concentration. If we measure concentration as the market share of the top five banking institutions on a stand-alone (unconsolidated) basis and then on a consolidated basis,¹³ we obtain a difference of a few percentage points. This difference, albeit small, is enough to push the combined market share of state-controlled banks over the controlling level of 50 percent (**Figure 5**).

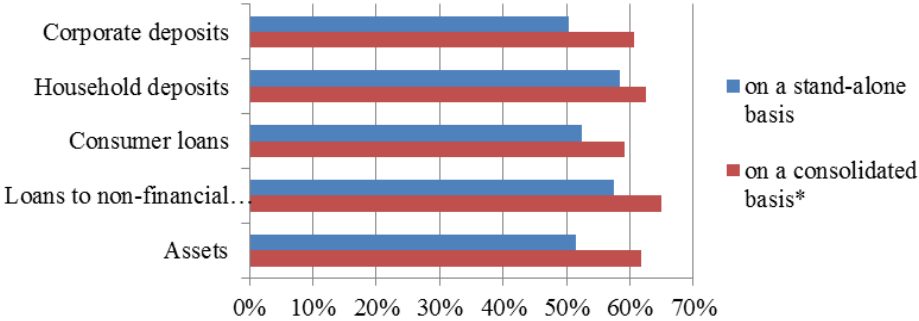


Fig. 5. Concentration in the Russian banking sector (combined market shares of the top five banks) on a stand-alone and consolidated basis, December 2011.

Sources: Author’s calculations based on RBK (2012) and CBR (2012).

Let us now turn to an analysis of market concentration by calculating the HHI for various segments of the banking market for the two most recent years, namely 2010 and 2011.¹⁴ On an unconsolidated basis, all market segments except household deposits appear dispersed (HHI values below 0.15). When we consolidate the market shares of the main state-controlled banks, the markets begin to appear moderately concentrated, and the household deposit market and the corporate loans segment both cross the threshold of high concentration (HHI = 0.25), as shown in **Figure 6**. The level of concentration would even be higher after we add the market shares of other public banks (Gazprombank, Ak Bars, Svyaz-Bank, Globex, etc.). The recent growth in concentration might be one of the effects of the global financial crisis and the post-crisis consolidation that reduced competition by strengthening mainly the large state-controlled banks (see IMF, 2011, p. 5).

¹³Consolidation means that the market shares of the core state-controlled banks (Sberbank, VTB Group, and Rosselkhozbank) are summed.

¹⁴The sample is representative, as it covers 94.3 percent of all bank assets in Russia, 78.1 percent of loans to non-financial companies, 95.2 percent of loans to physical persons, and 96.5 percent of all household deposits.

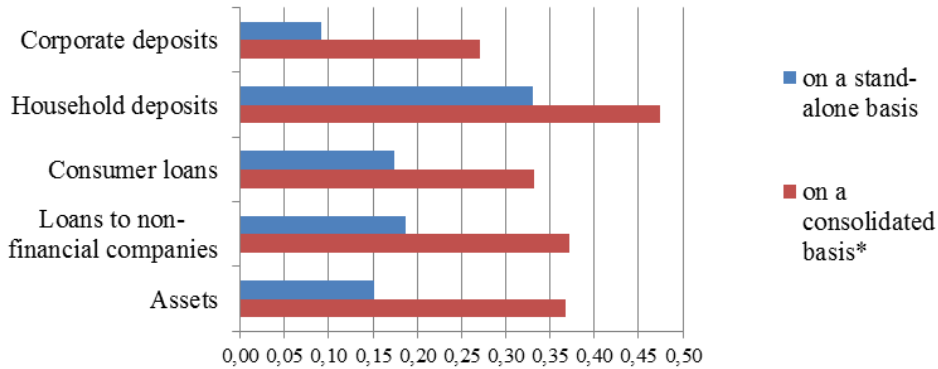


Fig. 6. Concentration in the Russian banking sector (values of Herfindahl-Hirschman index by end of 2011).
Sources: Author's calculations based on RBK (2012) and CBR (2012).

State-controlled banks in Russia are now active in nearly all of the country's market segments with few exceptions. According to the CBR, by the beginning of 2011 state-owned banks held 57.4 percent of all household deposits, 40.1 percent of corporate deposits, 49.3 percent of all loans, 46.4 percent of household loans, and 50.6 percent of the banks' securities portfolios (CBR, 2011, pp. 17–21)¹⁵. This dominant position allows state-controlled banks to become price-setters in the different segments of the broad market. Anzoátegui et al. (2012) have studied competition in the Russian banking sector using non-structural methods (unrelated to indicators of market concentration and structure) and found that Russia's top 20 banks, and state-owned banks more generally, seem to be able to exert greater market power than the smaller banks and privately owned institutions. The study suggests that they could thus charge prices well in excess of their marginal costs.

4. Policy implications

Since 1988 state involvement in Russia's banking industry has followed a cycle of disengagement and re-engagement. After many decades of a state monopoly in banking, massive and spontaneous state withdrawal occurred. There was no organized privatization of banks in Russia, unlike in CEE countries, so top managers and other insiders were able to quietly appropriate the assets and physical infrastructure of hundreds of local divisions and branches of *spetsbanki* (specialized state-owned banks covering each broad field of activity). A gradual but continuous re-engagement of government with the banking industry began only after the 1998 financial crisis, and received additional impetus during the next crisis in 2008–2009. By 2010 the number of banks under state control exceeded the number that the

¹⁵ We think that this estimate is on the low side.

government could run efficiently, and their fields of activity and operations of branch networks began to overlap. Consequently a new phase of disengagement ensued, with the government withdrawing from some of the second- and third-tier banks it had come to control directly or indirectly. State divestment was handled in the usual opaque way, allowing insiders and operators with political connections to benefit from the process.¹⁶

In March 2012, the pressure on the state to divest led Russia's then-president Dmitriy Medvedev to instruct financial authorities to prepare for a reduction of the government's share in core banks to a level below 50 percent (*Vedomosti*, March 23, 2012). This significant initiative may reflect one of two possible scenarios. First, the authorities are sincere in their intentions (Scenario A). In this case, Sberbank, VTB, Rosselkhozbank, and Gazprombank will have to rediscover themselves as privately held, market-based institutions. Conversely, (under Scenario B), the authorities do not intend to relinquish control over the core national lenders, and the president's instruction was merely a public gesture by an outgoing politician.¹⁷ The announced withdrawal is disingenuous and the government will continue steering the decisions of core banks through corporate governance instruments and by allowing formally unaffiliated business groups to become new shareholders of record.

Scenario A is unlikely because it implies self-destruction of the pillars of the country's national financial system that served Russia well during the last financial crisis¹⁸ and have implemented the government's industrial and social policies. A genuine state withdrawal from the largest banks would worsen their financial standing due to the inevitable loss of quasi-sovereign ratings at an investment-grade level; these ratings now enable banks to raise funding relatively inexpensively. Whether banks will become more efficient after government withdrawal is an open question. During the previous round

¹⁶A fairly typical example of a rigged "privatization" scheme is the management buy-out of Russian Commercial Bank, a VTB subsidiary in Cyprus, for a price below the intermediate dividend for the second half of 2009, which new shareholders received shortly after the transaction (*Vedomosti*, November 13, 2009). Another case is Sobinbank, whose rescue was financed by public funds and executed by Gazenergoprombank, a member of the Gazprom group. In 2010 both banks were "privatized" for an undisclosed amount, having been turned over to a politically well connected operator, Bank Rossiya of St. Petersburg (*Kommersant*, December 3, 2009; June 18, 2010). A similar case is that of Bank Petrovsky, which after an expensive bailout by the deposit insurance agency (ASV) was sold at an unknown price to a private financial group, FK Otkrytie (<http://www.asv.org.ru/pr/intelligence/arc/show/?id=165618>). Another case involves the government of the Khanty-Mansiysk region, which sold its controlling share of Bank Khanty-Mansiyskiy to the private Nomos-Bank, and with that its control of a subsidiary called Novosibirskiy Munitsipal'nyy Bank. The terms were not disclosed (*Vedomosti*, December 17, 2010).

¹⁷The media have been skeptical in their accounts of the government initiative to withdraw from core banks (e.g., Iskyan, 2012).

¹⁸During the last financial crisis and the subsequent credit crunch, the country's state-controlled banks reduced the supply of credit to a lesser extent than did other financial players, thus supporting the view that an objective function of state-controlled banks is to support the economy during economic downturns (Fungáčová et al., 2011).

of state disengagement, the pilfering of the *spetsbanki* by insiders did not produce gains in efficiency (Schoors, 2003), and most of the offspring of the *spetsbanki* are now defunct due to mismanagement, incompetence, fraud, and asset stripping.

Under Scenario B the same risks exist, but to a lesser extent. From the viewpoint of the public interest, it will be a lose-lose situation: the authorities will continue to bear all of the liabilities without being able to enjoy the advantages ensuing from direct control over lenders. That contributes to diminished transparency and greater scope of the agency problem and managerial opportunism.

Not every type of ownership change in a state-controlled bank can be considered “privatization.” Market placement of a minority stake in Sberbank or VTB, for example, does not affect control. The identities of the substantial minority shareholders also matter, because there is a tendency to bring in related parties or other public-sector institutions, including foreign ones, such as sovereign funds from China or the Gulf states of the Middle East (*Gazeta.ru*, June 24, 2011).

More or less in line with Chinese experience, Russia could try to accommodate an IPO of a large state-owned bank within the existing institutional and political arrangement by adopting and mastering the mechanisms of corporate governance (boards of directors, non-executive directors, committees, external audits, etc.). A reduction of equity participation below 50 percent would not automatically lift the government’s grip on bank management and the main financial flows. La Porta et al. (2002), for example, considered a bank to be “government-owned” if the state holds at least 20 percent of equity but acts as the single largest shareholder. OECD (2005) has suggested that significant state control starts at the level of 10 percent of voting rights in the company.

If the Russian banking system is converging with that of China and not with the CEE countries, then policies should aim to eliminate inconsistencies in the model. Russia needs to rediscover how to reap potential benefits of a centralized system, such as high saving rates, high relevance of banks for the real sector of the economy, strong resilience to exogenous shocks, low volatility of bank earnings, and direct effective control over managers. Otherwise it may only bear the costs of such a system, namely overcapacity, inefficiency, over-lending to state-owned enterprises and local authorities, low quality of assets, poor controls, lack of transparency, rampant fraud and managerial opportunism, and regular costly bailouts of public banks.¹⁹ In particular, Russian authorities should reconsider their tolerance for multi-layered corporate pyramids in the banking sector and consolidate their equity stakes into a

¹⁹In 2011, the bailout of Bank Moskvyy involved a cost of 100 billion rubles in the form of new capital from VTB and 295 billion rubles in the form of a loan from ASV ultimately financed by the CBR (IMF, 2011, p. 11).

government bank holding. Corporate pyramids also exist in China, but they have fewer layers between the government and the entity at the end of the chain; in Russia there may be up to five intermediate layers that dilute control. Some consolidation within the public sector already is evident, as the two “national champions” (Sberbank and VBT) take over smaller banks. The government might start profiling the activity of its banks more strictly, thus making another step toward the Chinese system, which resembles the system of *spetsbanki* in the former Soviet Union.

5. Conclusions

The purpose of this paper was to provide additional insights into the political economy of banking in Russia, with a focus on state control. It has offered an alternative estimate of the size of the public sector by encompassing banks directly controlled by public organizations as well as those that are controlled indirectly by other entities. The method outlined here makes it possible to increase the number of public-sector banks in the sample from 16 to 38, with their combined market share rising to almost 56 percent of the total assets in the banking system by the start of 2011. The fact that these institutions now dominate a number of segments of the banking market has important implications for an assessment of empirical calculations of bank efficiency and competitiveness.

A recent development is the gradual replacement of direct public ownership by indirect ownership (and control) through the mechanism of state-owned companies and state corporations. At present roughly 25 percent of public-sector banking is situated beyond direct state control. Such indirectly controlled banks are in the advantageous position of being able to access public funds without (for the most part) the responsibility for performing socially important functions on behalf of the government. Although this confers certain advantages in terms of flexibility and efficiency, indirect public ownership exacerbates the agency problem in the public sector. Furthermore, the emergence of corporate pyramids in the public sector may be a sign that insiders have entrenched themselves vis-à-vis both external investors and the state *per se*. Banks within these structures are thus at risk due to the opportunism of top managers as well as other “insiders.”

Contrary to predictions in some theoretical literature on economic transition and to the findings of empirical studies of banking in CEE, Russian state-controlled banks display higher, not lower, profitability and efficiency than other participants. The key to this phenomenon may lie in the competitive position of these banks and in the nature of operations they carry out on behalf of the government (policy-lending, acquisition of industrial assets and their subsequent disposal, etc.). Some of

the earnings of these banks represent, in essence, rent rather than market-earned profit. Thus, reported numbers for profit and all derivatives thereof (ROA, ROE, Z-score, etc.) may constitute improper measures to use for modeling bank behavior in an economy with a blurred boundary between commercial and development banking and the lack of a level playing field for the various financial agents.

My paper also suggests an alternative way of looking at market concentration in Russia by consolidating market shares of core state-controlled banks instead of considering them on a stand-alone basis. This modification produces a picture of a more concentrated banking market than has been officially claimed, particularly for household deposits and loans to physical persons.

Finally, I argue that with respect to its banking system Russia is more comparable to China than to the countries of Central and Eastern Europe, because typologically and institutionally the Russian and the Chinese systems tend to be similar. The direction of the Russian system's further evolution, therefore, might not involve convergence with Europe. To put it succinctly, the dominance of state-controlled banks in Russia may persist for quite a long time. Public banks are indispensable as long as the economy remains under control of a state bureaucracy whose leaders have children interested in securing prestigious, well-paid jobs. Even the popular news magazine *The Economist* now recognizes that government banking in emerging markets might have some advantages, rather than solely drawbacks (Mutually, 2010, pp. 10–12). In this context, the recent initiatives of the Russian authorities to withdraw from core banks seem misplaced, for such measures would benefit the insiders of those banks and their competitors, but otherwise serve to inflict damage. It would instead make sense for the government to consolidate its direct and indirect stakes in banks into a transparently organized and better-managed bank holding.

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