

**Financing and Risk Management in Russia**

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## **1. Overview of Russian financial situations**

### **1) Establishment of private commercial banks and transition to two-tier banking system**

The establishment of private commercial banks began in the closing days of the former Soviet Union and they sprang up like so many mushrooms after a rain when the country shifted to a market economy. As a result, these commercial banks and the Central Bank of Russia form a two-tier banking system in Russia. At first, many of the commercial banks were nothing more than “pocket money banks,” servicing specific groups. They functioned only as groups’ safe keeper and currency speculators during the period of confusion. But some of them have brought leading enterprises under their umbrella and have grown up as the core of financial industry groups. Thus, the Russian indirect financing market was established. The banks that flourished on the strength of fat loan spreads and exchange profits under hyperinflation, however, were liquidated or forced out in line with exchange/financial stabilization after the outbreak of the financial crisis in August 1995. Due partly to loopholes in the Bankruptcy Law, there still exists a considerable number of banks. But they, in effect, have gone bankrupt due to the financial crisis. Table 1 shows changes in the number of commercial banks and banking licenses revoked. The Central Bank of Russia worked out a plan to promote the liquidation and consolidation of commercial banks by classifying them into four categories: (1) banks that should be rehabilitated with public-sector assistance, (2) banks with relatively sound financial conditions that should form the base of the local banking system, (3) banks whose liquidation or consolidation may have adverse effects on the national economy, and (4) banks that should be liquidated. The federal government is now implementing the plan by establishing the Agency for Restructuring Credit Organizations.

<p>The basic principle of commercial banking is “public responsibility,” “safety” and “profitability.” However, in view of the situations described above, it cannot be said that Russia has solidly established a commercial banking system trusted by individuals and enterprises to perform financial intermediary functions for the development of the national economy. Moreover, in view of the integration of the international economies, it will inevitably become necessary for Russia to pay more attention to its reputation risk both at home and abroad.</p>
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<Table -1 >

**Changes in the number of Russian commercial banks**

1991	1992	1993	1994	1995	1996	1997	1998
1,306	1,713	2,019	2,294	2,578	2,603	1,697	1,468

**Changes in the number of banking licenses revoked**

1996	1997	1998	1999	2000
266	332	221	127	36

**2) Other financing**

Besides the banking sector, there are securities/insurance markets in some way or other in the Russian financial markets. Following the switchover to a market economy, the establishment of joint-stock companies is approved and as a result of the issuance of privatization vouchers by state enterprises, establishment of joint-stock companies, and the issuance of government bonds by the federal government, a securities market came into being. When the securities market peaked in the autumn of 1997, the market capitalization of stocks was estimated to have reached about \$100. Thereafter, the market has been swayed by speculative activity, with the market capitalization plunging to one-tenth that of the peak period. The stocks of some blue-chip enterprises and banks are being traded on the international markets in the form of American depositary receipts (ADRs) and global depositary receipts (GDRs). But the main instruments on the domestic securities market are still government bonds and we cannot say that the market is playing its direct financing role as the place for corporate fund raising. Although various financing instruments, such as lease, factoring, mortgage loans, public and corporate bond issues, the market is playing only its limited roles at present due to inadequate legal and taxation systems.

**3) Position of the banking sector**

Although the center of the Russian financial market is indirect financing by the banking sector, its total assets account for only 20~30% of GDP, far lower than those in other emerging market countries. Most of corporate financing is still conducted under credit sales/purchase settlement, barter transactions, and cash settlement that are removed from market forces. Private individuals also prefer settlements in cash. As such, it is believed that a considerable portion of economic transactions is accounted for by the underground economy that is difficult to cover by official statistics. There is illegal capital flight through various channels in the corporate sector and it is estimated that \$30~50 billion worth of foreign bank bills are being piled up as closet deposits in the personal sector. If these amounts are taken into account, it can be said

that the role played by the Russian banking sector in the national economy is extremely small.

Situations around the time of 1998 financial crisis		
Estimates on 100 top Russian banks' asset composition (As of July 1, 1998)	Bank lending composition by sector (As of Nov. 1, 1998)	Individuals' financial asset composition (As of Dec. 1, 1998)
Lending: 40%	Corporation: 78.2%	Bank deposits: 139.9 billion rubles(45.8%)
Government bond investment: 27%	Banks: 16.2%	Cash: 116.8 billion rubles(38.3%)
Stock investment: Less than 5~6%	Individuals: 5.6%	Securities: 48.5 billion rubles(15.9%)
	<b>Total: 370.7 billion rubles</b>	<b>Total: 305.2 billion rubles</b>

Recent situations		
Russian bank sector (As of the end of 2000)		
	(In 1 billion rubles)	(Change from previous year)
Loan balance	: 956.3	+38.5%
Inter-bank (Share)	: 104.7	+16.7%
To corporations; medium- and long-term	: 11%	15% (previous year)
		+31.4%

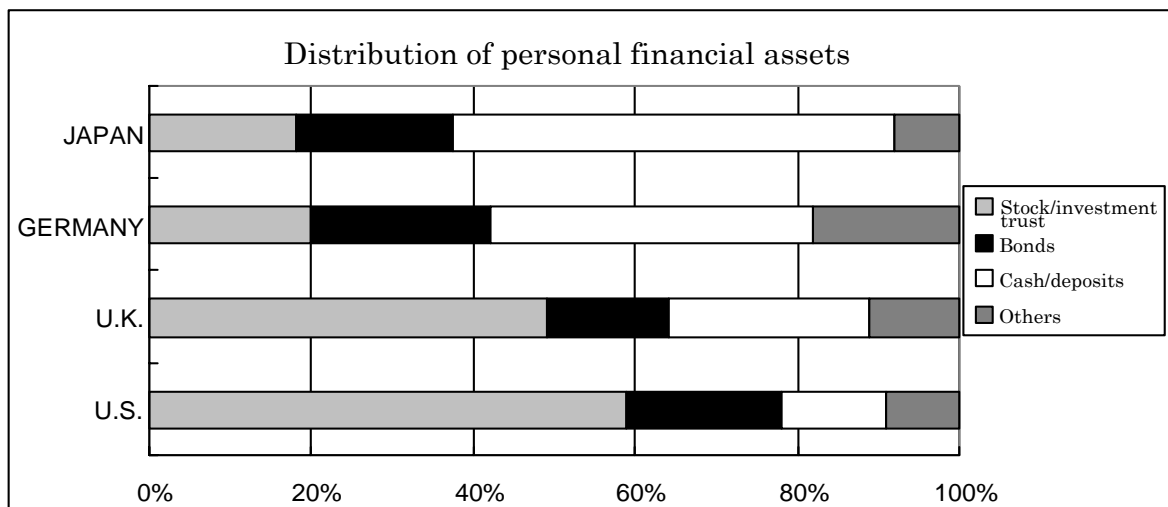
(Source: State Committee for Statistics)

Position of the bank sectors in old Soviet Union/East European countries			
	Bank loans/GDP (%)	State banks' share in bank assets (%)	Availability of deposit insurance system
Hungary	21	9	Available
Czech Republic	44	23	Available
Poland	19	25	Available
Slovenia	36	42	Available
Estonia	26	6	Available
Russia	12	42	Not available
Ukraine	9	12	Not available
Belarus	19	60	Available
Moldova	12	0	Not available

<b>Personal financial assets (excluding foreign currency deposits/cash)</b>	
	(Unit: 1 billion rubles)
	462.6(Feb.1, 2000)
Total	:731.1(Jan.1, 2001)
Bank deposits	:304.2
Cash	:289.3
Securities	:137.6
	704.0(Feb.1, 2001)

<b>Personal deposits (Ruble and foreign currency-denominated)</b>	
318.9 (Jan. 2000)	397.3 (Jul. 2000)
453.9 (Dec. 2000)	462.5 (Jan. 1, 2000)
(Share of Sberbank: 75.1%, Year earlier: 73%)	
Expenditure ratio of foreign currency purchases: 8% (Jan. 2000) 7% (Jan. 2001)	
(Personal revenue: 285.7)	
(Personal expenditure: 322.2)	

Source: State Committee for Statistics (IF d/d 5 Ma. 2001)



(Note) Cumulative total calculated by Goldman Sachs from the central bank, pension fund, insurance and investment trust data, as of the end of 1999

Commercial banks have an important role to play as the blood of the market economy. But Russian banks have only about 20 years of experience. Among the problems facing the Russian commercial bank sectors are (1) non-performing loans, (2) under-capitalization, (3) excessive involvement in speculative transactions, (4) a high weight of transactions with related companies, (5) inexperienced management and staff, and (6) too much reliance on politics and finances.

Due partly to reflection on the speculative activities during the financial crisis, commercial banks are called to increase investment and loans to the real economy. However, there are lots of problems that must be solved, such as the “accounting system,” “corporate governance,” and “transparency,” in addition to the problems mentioned above.

## **2. Re-entry into international financial markets**

Russians had been effectively closed out of the overseas fund-raising market even before the demise of the Soviet Union, when the external debt problem of the former Soviet Union began to draw the attention of the international financial market. However, from around 1995, when a basic agreement on debt rescheduling was concluded, the Russian government, local governments, commercial banks and blue chip companies made re-entry into international markets one after another. Although the payments of new and old debts had become difficult due to the financial crisis of 1998, the following sections deal mainly with the debt disposal situations thereafter.

In carrying out debt rescheduling, it is important to give equal treatment to the creditors having various interests. In the case of Russia, some forcible measures were taken to defer debt payments, leaving the impression that they are neither transparent nor fair in terms of (1) domestic debts and external debts, (2) ruble debts and foreign currency debts, (3) domestic creditors and non-resident creditors, and (4) treatment of various non-resident creditors (such as banks, enterprises and investment funds).

### **1) Outbreak of debt problems**

Around the time when the former Soviet Union collapsed in 1992, the problem of huge external debts came to the surface. Debt rescheduling negotiations were held with creditors and the Paris Club agreed on rescheduling in 1996 and the London Club in late 1997. The claims held by the former Soviet Union were, in effect, only sovereign debts, such as those to the former Soviet Foreign Economy Bank and Foreign Trade Corporation. But, after the shift to market economy, local governments, private enterprises and banks came to the surface as debtors to foreigners. The outbreak of financial crisis in August 1998 rekindled the Russian debt problem.

### **2) Composition of Russian state debts**

- (1) To international financial institutions**
- (2) Euro bonds**
- (3) Former Soviet Union Paris Club**

An agreement was reached on tentative rescheduling of the principals and interests that come due in 1999~2000.

**(4) Former Soviet Union London Club**

At least one-fourth of the claims was held by investment funds, as they were securitized into financial instruments called PRIN (Principal Note) and IAN (Interest Arrears Note). In February 2000, a basic agreement was reached on rescheduling, including debt reduction, under the following terms.

Claims covered	Amount(In \$1 billion)	Reduction rate	Newly issued Euro bonds
PRIN	22.2	Terms 37.5%	30 yrs/7 yrs grace
IAN	6.8	33.0%	30 yrs/7 yrs grace
Accrued interest	2.8	0%	10 yrs/6 yrs grace
<b>Total</b>	<b>31.8</b>	<b>Average 36.5%</b>	

**(5) Domestic foreign-currency bonds**

About \$11 billion. According to one estimate, about half of them were held by non-residents.

**(6) Domestic ruble-denominated bonds**

Forcible refinancing was declared in August 1998. According to one estimate, non-residents held about \$17 billion, or nearly one-third of the total, at the peak time.

**3) Debts of local governments**

The foreign debts held by Moscow City, the largest borrower, amounted to about \$1 billion. The city issued a total of about \$2 billion worth of Euro bonds.

**4) Debts of private enterprises and banks**

At the peak before the financial crisis of 1998, the outstanding debts held by private banks were estimated at \$19.2 billion and those by enterprises at \$6~8 billion.

**Russian state's foreign-currency obligations**

(Unit: In \$1 billion)

	Jan.1, 2000	Jan.1, 2001	Jan.1, 2002
1. Public credit	66.5	66.0	65.3
Paris Club countries	48.6	* 48.4	48.3
Non-Paris Club countries	3.3	** 3.1	2.9
Former COMECON countries	14.6	14.4	14.1
2. Private credit	39.4	39.1	39.1
London Club	30.1	29.8	29.8
Commercial credit	9.3	9.3	9.3
3. International financial institutions	19.4	18.3	19.7
4. Foreign-currency bonds	26.7	26.7	25.7
Eurobonds	15.6	15.6	14.6
Min Fin Bonds	11.1	11.1	11.1
5. Central Bank of Russia	6.4	6.2	6.2
Total	158.4	156.3	156.0

(Source: Materials attached to the fiscal 2001 budget submitted to the lower house of the parliament in August 2000)

**Ruble-denominated debts**

(Unit: In 1 billion rubles)

	1 Jan. 2001	1 Jan. 2002
Total	578.544	575.73
OFZ-PD (variable yield)	24.297	24.297
OFZ-FD (fixed yield)	376.014	319.463
OGNZ (savings type)	3.247	30.0
OFZ-FK (fixed coupon)	131.565	131.565

\*Country-by-country Paris Club obligations

Germany:	21.1
Italy:	5.9
Japan:	5.6
U.S.:	4.0
France:	3.0
Australia:	2.5
Canada:	1.6
U.K.:	1.5

\*\*Country-by-country Non-Paris Club obligations  
(Unit: In \$1 billion)

South Korea:	1.1
Kuwait:	1.0
U.A.E.:	0.4

### **3. Russia's banking sector**

#### **1) Developments up to date**

First, I would like to look back on the movement of the Russian commercial banks after the demise of the Soviet Union. In addition to pure commercial banks that were established during 1991~1992, many other banks were established, as branches of former state-owned specialty banks became independent and turned into commercial banks. But they were commercial banks in name only. Their main business was taking in super-low interest loans from the central bank in those hyperinflation days to funnel the funds into group companies and engaging in speculative exchange transactions of the ever-depreciating ruble. However, the situation changed completely as the country experienced the "Black Tuesday" of August 1995 that threw the exchange market into confusion and caused malfunctioning of the inter-bank market, following the central bank's suspension of direct lending for covering fiscal deficits and the central directive lending on April 26, 1995. After the "Black Tuesday," it was hoped that commercial banks would finance the real economy to make up for the dwindling inflow of capital from the central bank and the central government. However, it was difficult for the commercial banks to provide financing to the real economy, as the financial basic infrastructure had yet to be fully established and as disclosure of the financial conditions of enterprises was insufficient and their corporate governance inadequate. Instead, the commercial banks shifted their business to buying the relatively safe and high-return short-term government bonds that were issued to make up for the fiscal deficits. Their move resulted in crowding out private fund demands. In the end, the commercial banks relied excessively on external borrowings and suffered a destructive blow from the financial crisis of 1998. They are now striving to shift to investment and loans to the real economy, or their primary business, by settling their debts themselves and restructuring the banking system. The following table lists banking sector's main coefficients seen from various angles.

&lt; Table - 2 &gt;

## Russia's banking sector

	Jan.1998	Jun.1998	Sep.1998	Jan.1999	Jun.1999
1. Authorized capital (In 1 billion rubles)	33.2	42.6	45.5	52.5	74.8
2. Total net worth (excludes savings banks)	95.9	96.2	94.9	51.5	48.2
3. Investment account items (excludes savings banks)					
(a) Government bonds	55.1	49.4	33.6	25.5	22.8
(a') share in total assets	9.5	8.3	6.0	3.3	2.3
(b) Stocks	6.6	9.3	9.4	7.6	8.3
(c) Promissory notes	40.7	49.3	48.3	61.6	74.2
4. Lending total	291.5	293.1	292.9	441.7	490.0
(a) To real economy (denominated in ruble)	128.6	115.2	112.1	97.4	140.5
(b) To real economy (denominated in foreign currency)	84.7	100.4	102.6	239.8	217.3
(c) To individuals (denominated in ruble)	12.6	12.4	12.1	10.5	11.4
5. Delinquent loans	12.1	14.1	14.8	39.8	40.2
6. Interest arrearage	11.9	11.9	11.6	5.9	9.1
7. Corporate deposits	175.5	148.2	142.5	283.2	382.6
8. Individual deposits (denominated in ruble and foreign currency)	170.2	193.7	181.2	199.8	234.8
8'. Individual deposits (includes savings banks)		137.3	127.7	148.2	178.3
9. Inter-bank borrowings	106.0	103.3	104.9	195.7	204.2
9'. Inter-bank borrowings (those from non-resident banks)	74.7	78.5	79.5	133.6	128.9

## 2) Composition of banks' balance sheet

The following are Russian commercial banks' major balance-sheet items and the factors that affect individual items. It shows that they are exposed to various risks to be described later.

**Composition of Russian banks' balance sheet**

Assets				Liabilities			
Shift to foreign currency	←	Ruble; Foreign currency	Cash	Borrowings from central bank	O/D; Repo.	→	Tightening
Russian commercial banks; Foreign banks		Central bank reserve deposits	Deposits	Deposits	Individuals/corporation; banks	Ruble; Foreign currency	Closet deposits; Increase exchange risk
Deterioration of loans	←	Group firms; Local governments	Short-term loans	Promissory notes/bills of exchange			
				Short-term borrowings	Russian commercial banks (ruble, foreign currency), Foreign banks (foreign currency);		Fund-raising difficulty
Sharp price decline; Liquidity decline	←	GKO (ruble): Min Fin/foreign bond (foreign currency):	Short-term government bonds Medium- and long-term government bonds				
Deterioration	←	Group firms:	Medium- and long-term loans	Medium- and long-term borrowings	→		Fund-raising difficulty
Sharp price decline; Liquidity decline	←	Group firms:	Stocks Furniture/ fixtures	Net worth	Capital; Reserves	→	Forcible conversion of the foreign currency portion to ruble
Asset fixing	←	Newly built head office building:	Land/ building		Reserves	→	Increase

Now, let's take a look at the banks' situation at the time of the financial crisis of 1998. From the asset side, the following characteristics can be pointed out.

- Cash/deposits: Preference of foreign currency and foreign banks was strong due to exchange risks and the lack of trust in domestic banks. A large amount of U.S. dollar bank notes were imported every year. Even in 1998, when the crisis broke out, about

\$15 billion worth of bank notes were imported.

- Loans: Most of them were to group companies and in short term. In the case of big banks, main borrowers were natural resources export-related companies, the linchpin of the Russian economy. But, their cash flow and balance sheets were deteriorating due to a decline in international commodity prices.
- Securities: Investment in short-term government bonds was active. But, a sharp decline in prices produced a huge amount of latent losses, lowering the liquidity that would otherwise have been high. However, local banks suffered relatively minor damage in general, as they were not benefiting from investment in short-term government bonds. The stocks held for investment purposes plunged, while funds were inefficiently fixed as a result of holding stocks for group formation.
- Immovable assets/real estate: A huge amount of assets were fixed as a result of the construction of new head office buildings as well as purchases of villages and luxury automobiles. More than a few banks faced a crisis or went bankrupt shortly after the completion of their head office buildings.

Next, let's take a look at characteristics from the liability side.

- Deposits: With people's trust in general commercial banks low, more than 70% of total individual deposits were accounted for by the state savings bank (Sberbank). But, individual deposits had yet to develop into a stable source of funds and their maturity was short amid inflation concerns. Corporate deposits were on a downward trend due to intensified tax collection starting at the beginning of 1998. The weight of foreign currency deposits was relatively heavy. (But, they decreased from \$9.1 billion in October 1997 to \$6.5 billion in August 1998 and to \$1.8 billion in October of the same year.)
- Borrowings: Banks increasingly shifted from domestic procurement of funds through inter-bank transactions and bill issuance to the procurement of foreign currency on the international financial market. Some banks raised medium-term funds through the issuance of bonds on the international financial market. But most of the banks raised short-term funds. They had difficulties in refinancing and new borrowing after the outbreak of the Asian currency crisis.
- Net worth: Although big banks' capital adequacy ratios appeared to meet the international requirements on the surface, their capital was mixed with low liquidity capital, such as investment in kind and bills. Some voiced concerns that any arbitrary write-off of non-performing loans and reserve shortage may reduce the real net worth of the banks.

To sum up, the balance sheets of the Russian commercial banks is characterized by the unstable investment/fund procurement base, concentration of investment, excessive fixing of funds, and the exchange risk-embedded structure. It can be said they are extremely vulnerable to external shocks. Given the Russian financial infrastructure, it would be an unreasonable request for us to call on the commercial banks to implement liquidity and exchange risk measures and ALM fully. Moreover, the sudden increase of liabilities in off-balance sheet items, such as margin calls and forward exchange contracts, was worth noting in the crisis.

Tables 3 and 4 show the relationship between the main balance sheet items of the 100 largest Russian banks as of the end of 1999 and their relevant external economic units.

Whether it is a bank or a company, any economic unit acts under its own, but effectively interconnected, balance sheet items. This is the vary reason why “rules of the game” and “business ethics” are called for in market behavior. It is necessary to punish violators of the rules and ask them to leave the market.
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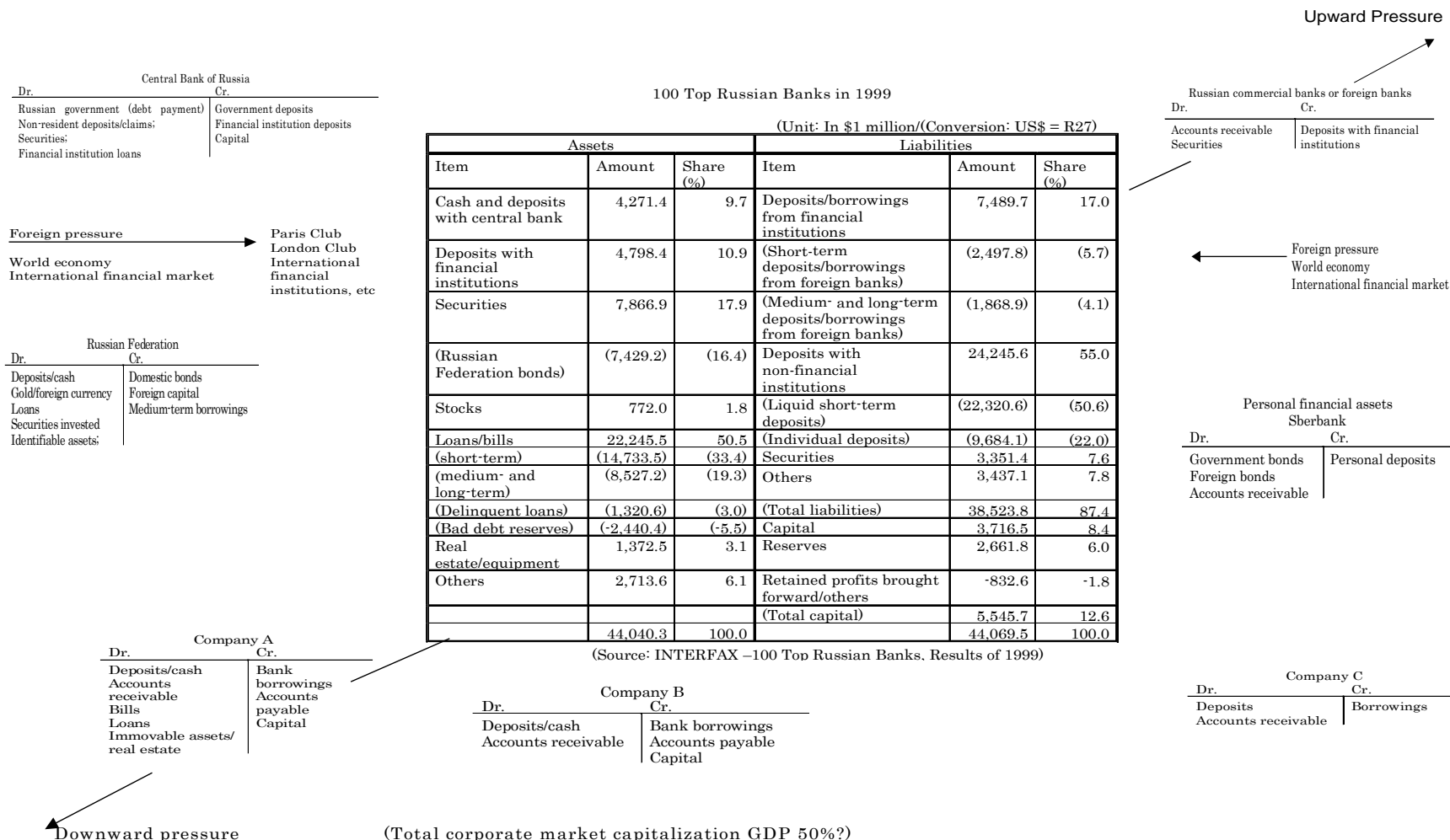
< Table - 3 > INTERFAX: 100 Top Russian Banks

(Unit: In \$1 million)

		Total assets	Cash and deposits with the central bank	Deposits with financial institutions	Securities	Loans	Loans (short-term)	(Overdue) (medium- and long-term)	Total liabilities	Net worth	Cash and deposits with financial institutions	Same as left (foreign banks)	Deposits with non-financial institutions	
All Banks	Amounts							( 1,320.6)						
		31.12.1999	44,069.5	4,271.4	4,798.4	7,866.9	22,245.5	14,733.5	8,527.2	38,523.8	5,545.7	7,489.7	4,306.7	24,245.6
		30.6.2000	52,536.6	7,103.8	6,113.3	8,721.3	24,909.6	16,970.9	9,469.5	46,780.8	5,755.8	8,038.5	3,990.8	30,484.8
	Proportion								( 3.0)					
		31.12.1999	100.0	9.7	10.9	17.9	50.5	33.4	19.3	87.4	12.6	17.0	9.8	55.0
		30.6.2000	100.0	13.5	11.6	16.6	47.4	32.3	18.0	89.0	11.0	15.3	7.6	58.0
Banks except Sberbank	Amounts							( 1,061.9)						
		31.12.1999	30,041.9	2,854.2	4,642.0	2,344.8	16,653.7	10,374.6	7,078.1	25,729.2	4,312.7	7,207.7	4,285.5	12,991.0
		30.6.2000	35,619.1	3,478.9	6,019.6	2,822.0	19,036.7	12,,776.6	7,481.5	31,146.6	4,472.6	7,801.8	3,970.3	16,814.8
	Proportion								( 3.5)					
		31.12.1999	100.0	9.5	15.5	7.8	55.4	34.5	23.6	85.6	14.4	24.0	14.3	43.2
		30.6.2000	100.0	9.8	16.9	7.9	53.4	35.9	21.0	87.4	12.6	21.9	11.2	47.2
Banks in Moscow	Amounts							( 996.8)						
		31.12.1999	25,225.3	1,929.2	3,497.2	2,147.7	14,518.8	8,812.2	6,461.0	21,417.0	3,808.3	6,501.8	3,749.2	10,120.1
		30.6.2000	28,753.9	2,229.8	4,404.8	2,361.3	16,068.7	10,429.1	6,776.1	24,828.2	3,925.7	7,167.9	3,505.4	12,252.6
	Proportion								( 4.0)					
		31.12.1999	100.0	7.6	13.9	8.5	57.6	34.9	25.6	84.9	15.1	25.8	14.9	40.1
		30.6.2000	100.0	7.8	15.3	8.2	55.9	36.3	23.6	86.3	13.7	24.9	12.2	42.6

Banks except those in Moscow and St. Petersburg	Amounts							( 16.3)							
		31.12.1999	2,785.6	666.5	927.2	92.3	847.2	578.6	299.8	2,439.5	346.1	154.5	117.5	1,809.2	
										( 14.6)					
		30.6.2000	4,481.5	941.2	1,448.9	232.9	1,500.9	1,215.5	329.3	4,097.9	383.5	150.5	88.1	3,316.9	
	Proportion								( 0.6)						
		31.12.1999	100.0	23.9	33.3	3.3	30.4	20.8	10.8	87.6	12.4	5.5	4.2	64.9	
										( 0.3)					
		30.6.2000	100.0	21.0	32.3	5.2	33.5	27.1	7.3	91.4	8.6	3.4	1.9	74.0	

<Table-4>



### 3) Foreign-affiliated banks

Although there were various restrictions to protect fragile domestic banks, a considerable number of foreign banks have entered the Russian market in the past 10 years. They not only worked as an inflow channel of a large amount of foreign-currency funds but also introduced various financial technologies and management know-how into Russia. In their initial stage of operations, the foreign banks were mainly engaged in trade-related financing and exchange/fund transactions with Russian commercial banks. But, as of the end of June, 1998, about 32% of the total assets of the 12 major foreign banks were accounted for by investment in Russian government bonds. Some of the banks had invested more than 50% of their total assets in government bonds.

Bank name	Assets (Unit: In \$1 million)	
	Dec.1997	Jun.1998
Chase Manhattan Bank Int.	446.6	1,130.7
Citibank T/O	917.0	1,030.7
AMN AMRO Bank	382.8	755.5
Credit Suisse	829.7	752.3
Credit Lyonnais (Russia)	662.2	705.4
Westdeutsche LBVostok	241.9	466.6
Rep; Nat'l Bank of New York	343.4	373.1
BNP Dresdner Bank	367.0	368.0
Societe Generale Vostok	315.5	360.8
Raiffeisenbank Austria	162.2	212.9
Bank of Austria	200.7	181.5
ING Bank Eurasia	659.6	969.7
Total	5,528.6	7,307.2

The latest asset situations of the foreign banks are as follows:

< Table - 5 > Major foreign banks in Russia

30.6.1998

31.12.1999

30.6.2000

(Unit: In \$1 million)

	Total assets	Cash and deposits with central bank	Deposits with financial institutions	Securities	Loans	Loans (short-term)	(Overdue) (medium- and long-term)	Total liabilities	Net worth	Cash and deposits with financial institutions	Same as left (foreign banks)	Deposits with non-financial institutions
ABN-AMRO	304.0	11.2	1.8	71.0	211.4	211.6	0.7	284.7	22.0	181.5		69.9
	335.0	30.6	34.6	11.4	238.4	166.4	76.3	299.7	35.2	162.3		117.0
	351.5	25.2	132.3	10.9	168.7	93.3	79.5	314.0	37.5	102.2	82.0	171.7
(30.9.98) BNP-Dresdner	351.2	14.8	1.4	11.0	316.3	166.4	142.5	325.2	26.0	251.8		60.9
	437.8	31.4	29.0	4.9	365.2	291.2	60.8	429.6	8.1	243.9		165.8
	444.5	31.6	3.1	9.2	394.6	336.9	51.4	442.8	1.8	247.0	240.6	178.9
Citibank	1,073.1	51.1	34.2	445.6	508.5	485.4	21.5	932.4	140.7	569.7		269.0
	737.5	54.1	27.6	100.2	479.0	366.4	114.5	681.7	55.8	324.9		282.7
	785.6	46.0	14.0	124.7	490.4	405.1	102.1	711.9	73.6	323.1	300.2	279.6
Ingbang	969.7	20.5	19.0	358.7	553.1	229.9	325.4	925.1	44.6	828.2		76.3
	331.4	28.4	12.5	57.8	207.3	12.7	187.4	294.6	36.9	152.2		89.3
	307.4	16.6	30.9	35.3	201.5	42.8	159.0	256.0	51.4	138.1	125.0	85.9
(30.9.98) RZB	216.3	6.3	4.1	43.1	115.1	79.1	36.5	227.9	▲ 24.4	192.9		30.3
	302.0	31.1	38.8	20.3	201.4	136.0	70.2	279.1	22.9	102.5		161.6
	409.4	42.9	16.5	21.9	295.6	209.0	100.6	386.3	23.1	105.4	64.5	237.2
Total of above	2,914.3	103.9	60.5	929.4	1,704.4	1,172.4	526.6	2,695.3	208.9	2,024.1		506.4
	2,143.7	175.6	142.5	194.6	1,491.3	972.7	509.2	1,984.7	158.9	985.8		816.4
	2,298.4	162.3	196.8	202.0	1,550.8	1,087.1	492.6	2,111.0	187.4	915.8	812.3	953.3
Total (value)	3,124.7	198.7	477.4	262.2	1,907.1	1,386.7	(overdue 53.3) 563.9	2,656.4	468.3	1,178.3	857.0	1,120.4
Total (proportion)	100.0	6.4	15.3	8.4	61.1	44.4	18.0	85.0	15.0	37.7	(foreign banks) 27.4	35.9

Situations of foreign capital-affiliated banks (Source: Central Bank of Russia, as of Jan. 1, 2001)

174 subsidiaries + 1 branch (Armenia)

Of them, 129 subsidiaries + 1 non-bank organization hold general license.

Geographical distribution (dispersed in 28 regions)

Moscow City/Province 88 banks

St. Petersburg 8 banks

Tumen Province 7 banks

Orenburgskaya 2 banks

Primorski Krai 2 banks

Udmurtia Republic 2 banks

100 % foreign-owned banks: 23 banks, Capital: 9.4 billion rubles

20~100% foreign owned banks: 33 banks, Capital 5.8 billion rubles

Total stocks held by non-residents: 15.5 billion rubles (up 30.9% from previous year)

Total net worth: 207.9 billion rubles (up 86.6% from previous year)

#### 4) State bank problems in Russia

With regard to the revision of the Central Bank of Russia Law, there are problems concerning the sale/privatization of the following banks in which the central bank has equity stakes.

- Overseas banks: Sale within one year
- Foreign Trade Bank: Sale within 3~4 years
- Russian Savings Bank (Sberbank Rossii): Within 5 years (on condition of the establishment of a deposit insurance system)

In addition to the above banks that have been in place since the old Soviet era, the following banks were newly established.

- Russia Development Bank
- Russian Agricultural Bank (Rosselkhozbank)
- Russian Export-Import Bank
- External Economy Relations Activity Bank (Vneshekonombank)

It is necessary to study such problems as financing small and medium-sized enterprises to which private financial institutions are unable to provide loans and investment due to high risks, extending loans to high risk countries to promote exports, and establishing special-purpose state banks to implement long-term plant and equipment investment as national policies, separately from the problems of eliminating pressures on private financial institution businesses by state banks and introducing competitive forces to state banks.

## **5) Regulations of commercial banks' activities by the Central Bank of Russia**

Commercial banks are required to provide financial intermediary functions that are indispensable for the market economy and ensure public responsibility and safety. Therefore, there are various regulations and controls on their activities. Major regulatory guidelines that are in place now are as follows (See 6. Banks' risk management).

Capital adequacy ratio: At least 8%

Liquidity: Minimum 20% (cash), Maximum 70% (current account), Maximum 120% (long-term), Minimum 120% (overall)

Per-company (group) credit ceiling: Maximum 25%

Regulation on large-lot loans: Maximum 800%

Limit on per-company liabilities (deposits): Maximum 25%

Limit on per-shareholder lending: Maximum 20%

Total credit line to shareholders: Maximum 50%

Credit line to affiliated companies: Maximum 2%

Same as above (including guarantee): Maximum 3%

To non-resident financial institutions: Maximum 400%

Limit on holding shares of third parties: Maximum 25%

Limit on holding per-company shares: Maximum 5%

Limit on bill issuance: Maximum 5%

Liquidity ratio for precious metal transactions: Minimum 10%

In addition to the above, there are regulations on the ceiling on personal deposits and on exchange positions. Incidentally, the total of exchange open position limits of the commercial banks is estimated at 11~15 billion rubles.

## **6) Moves toward banking system reform**

In February 2001, the Central Bank of Russia sent to the lower house of the parliament a new "concept" document aimed at revitalizing investment and loan to the real economy. The main points of the document are as follows:

- Inflation, lowering interest rates, refinancing, and introduction of a mechanism to stabilize ruble's exchange rate
- Raising awareness about the financing instruments that are available for various position adjustments by banks (for example, syndicate loans, risk sharing, and debt insurance)
- Medium- and long-term fund procurement: Increased absorption of personal

deposits, establishment of a deposit insurance system

- Lowering the income tax rates on financial institutions to the level of those on industrial enterprises

- Raising the limit on foreign bank's capital (from 12% of total capital at present to 25%)

- Increasing trust in foreign banks: Disclosure of information on unsettled NDF balance (At present, the legal ground of NDF is not clear. Revision of the Civil Law is planned as need arises.)

#### **4. Securities market of Russia**

##### **1) Overview of the market**

The Russian securities market was formed in line with the appearance of tradable securities, such as the privatization vouchers of state-run enterprises, short-term government bonds, and stocks issued by privatized enterprises. An estimated \$3~4 billion worth of portfolio investments flew into the country in 1994~1995, creating a mini bubble. The inflow was the cause of the "Black Tuesday" of August 1995. Shortly before the financial crisis of August 1998, overseas trading in stocks of Russian enterprises became possible in the form of GDR and ADR and the market capitalization of Russian stocks exceeded \$100 billion at one point.

However, the Russian securities market still depends to a large extent on speculative Western capital. Moreover, Russian commercial banks play an active role as market participants and as investors in the market, taking advantage of lax regulations on their securities businesses. Fostering domestic institutional investors and individual investors as stable investors is the task that has to be tackled in the future. To this end, it is necessary not only to promote the accumulation of domestic funds but also to reform basic matters, such as the peculiarity of the stock ownership structure that holds in it a large number of insider management and employees created in the process of the privatization of state enterprises, the protection of minority shareholders, the financial disclosure system, and the taxation system that tend to tempt investors to shift to off-shore transactions. We must look squarely at the fact that, while Russian investors prefer U.S. dollars, real estate and overseas assets, an estimated 60~90% of the fund supply to the Russian stock market is accounted for by foreign investors, despite the speculative nature of the market. However, it will be necessary in the future to improve the legal and tax systems in order to give vitality to the stock market through the promotion of the issuance of corporate bonds backed by

domestic real estate. Fortunately, the Russian stock market, which was almost devastated by the financial crisis in 1998, began to attract foreign bargain hunters in 1999, reflecting surplus funds in the world. The RTS Index, the benchmark stock index, which plunged to 46 points in September 1998 after hitting the record high of 571 points in October 1997, again picked up and rose to 150 points at the end of 1999. At the beginning of 2000, the index recovered the 200-point level for the first time since June 1998, on expectations of political stability following the lower house elections in December 1999 and the resignation of President Boris Yeltsin. Anyway, in the past five years, the market capitalization of Russian stocks, though fluctuated violently, stayed at about \$50 billion.

<b>Stock markets of former Soviet Union and East European countries</b>			
(Analysis by EBRD as of December 1999)			
	Number of listed companies	Ratio of market capitalization to GDP (%)	Ratio of trading volume to market capitalization (%)
Bulgaria	828	5.8	7.6
Croatia	59	12.8	2.9
Czech Republic	164	21.8	34.9
Estonia	25	35.2	15.9
Hungary	68	33.4	88.2
Latvia	70	8.2	11.6
Lithuania	54	10.7	25.5
Poland	221	19.6	37.7
Romania	5,825	2.6	36.3
Russia	207	39.7	3.9
Slovak Republic	845	3.8	65.5
Slovenia	28	11.1	39.8
Ukraine	125	3.6	11.1

## **2) Problems of Russian enterprises' ADR issuance**

The following decisions have been made with regard to stockholders' voting right that had been unclear and uncertain.

The Federal Securities Commission has decided to prohibit the management of ADR-issuing companies from voting at shareholders' meeting on the basis of the power of attorney allotted by the custodian banks. The issuing companies are required to submit to the Commission the documents confirming that the information concerning the shareholders having the right to vote at shareholders' meeting is included in the contract concluded between the issuing companies and the custodian banks. It is also required that the custodian contracts include provisions prohibiting the custodian

banks from issuing letters of attorney on voting. The Federal Securities Commission may suspend the issuance of ADRs by the Russian companies whose total stocks issued abroad exceed the total stocks issued on the Russian domestic market.

According to an estimate made by CSFB, the trading volume of ADRs of Russian enterprises amounts to about 40% of the securities trading on the domestic market. Incidentally, the comparable ratio is 40~50% in Poland and Hungary and 10~15% in Turkey, with a monthly trading volume amounting to \$2.5~3.5 billion and \$25~35 billion, respectively. Russian enterprises began to list their stocks on the ADR market in January 1996, mainly for the purpose of enhancing their corporate image. This has much to do with the fact that the enterprises had a negative image of the domestic market. Incentives for quantitative expansion of the Russian securities market, if any, would be a shift to a savings-type pension system, the development of more intensive mutual funds and the solution to such political issues as the abolition of restrictions on capital movements.

The number of industry-by-industry Russian enterprises issuing ADRs is as follows:

Oil/gas: 6

Electricity: 7

Communications: 12

Others: 3

On the basis of the decision by the Federal Securities Commission, the Central Bank of Russia issued an official directive concerning the separate management of securities brokers' and customers' accounts (effective March 1, 2001).

## **5. Outbreak of Russian financial bubbles**

### **1) Financial crisis of August 1998 and declaration of moratorium**

On Aug. 17, 1998, the Russian government and the central bank surprised the international financial community by abruptly announcing a joint statement concerning a package of emergency financial measures. The key points of the package are (1) effective devaluation of the ruble, (2) a 90-day moratorium on repayments of some external debts owed by the private sector, (3) suspension of the redemption of short-term government bonds denominated in ruble, and (4) restrictions of capital transactions in case of emergency. At the same time, the Russian central bank announced the transactions covered by the 90-day moratorium starting on Aug. 17, 1998 as follows:

- Repayments of the principals of external debts maturing in 180 days or beyond

- Payments of margin calls concerning securities-backed loans, including transactions under repurchase agreements

- Execution of forward exchange transactions

The state's current transactions concerning repayments of external debts and external economic activities are not covered by the moratorium.

The debts covered by the moratorium are estimated at about \$400 million in foreign borrowings, about \$2.5 billion in margin calls, and about \$10 billion in forward exchange contracts. When we say moratorium on external debts, we normally mean borrowings. But in this particular case, the amounts of margin calls and forward exchange contracts are large, suggesting the existence of the Russian version of mini-hedge funds. This is believed to be one of the causes that plunged Russia into the crisis, despite the \$22.6 billion emergency financial package provided by the IMF on July 13, 1997, including \$1.5 billion in untied loans from the Japanese government. Besides the financial package, the private sector agreed to refinance a total of \$6.4 billion worth of newly issued or ruble-denominated government bonds with medium- and long-term eurobonds.

Support by IMF, etc. (In \$100 million) (Agreed on July 13, 1998)			
	1998	1999	Total
IMF	125	26	151
World Bank	17	43	60
Japan Ex-Im Bank	6	9	15
	<u>148</u>	<u>78</u>	<u>226</u>

Here, I would like to survey the background that led to the financial crisis. The breakdown of the debts covered by the above moratorium clearly reveals the cause of the crisis.

(1) First, it is the increase of external debts. The procurement of foreign funds by Russian private banks and major enterprises, which started in around 1995, surged during the period from 1996 to the first half of 1997. However, the maturity of most of the loans with some exceptions was one year plus 6~12 month extension option at the most. Among the external debts owed by resident private banks, there was a considerable amount of loans provided by Western banks to their local subsidiaries in Russia.

(2) Ruble-denominated short-term government bonds, which began to be issued in 1995 to help finance fiscal deficits, were being smoothly absorbed by Russian commercial banks and non-resident investors. This was because the ruble was stable thanks to the introduction of an exchange band system and because the bonds were seen as

high-liquidity, high-yield, and safe instruments that move in tandem with the official discount rate.

At one time, non-residents held as much as about 30% of the bonds, amounting to more than \$20 billion.

Official discount rate								
1996.2.10	7.24	8.19	10.21	12.2	97.2.10	4.28	6.16	10.6
120% →	110% →	80% →	60% →	48% →	42% →	36% →	24% →	21%
1998.1.1	2.2	2.17	3.2	3.16	5.19	5.27	6.5	6.24
28% →	42% →	39% →	36% →	50% →	150% →	60% →	80% →	60%
Changes of ruble's exchange rate								
June 1996	Dec.	June 1997	Dec.	March 1998	June	Sept.	Dec.	
5.097 →	5.56 →	5.782 →	5.96 →	6.106 →	6.198 →	16.0645 →	20.65	

Note 1: Month-end central bank official rates of the ruble vis-à-vis the dollar

2: The figures before 1997 have been calculated on an after-denomination basis.

The short-term government bonds, which looked attractive to non-residents, began to remain unabsorbed in the second half of 1997 due to an outflow of non-resident funds, reflecting the distrust of emerging markets that was triggered by the Asian currency crisis. Meanwhile, the Russian fiscal deficits continued expanding and, in 1998, the government kept issuing the bonds by raising interest rates in rapid succession. But, the issuance of the bonds was approaching its limit in terms of demand.

(3) Then, there arose concerns over the country's balance of payments. Russia kept chalking up a huge trade surplus even after the demise of the Soviet Union on exports of primary products, mainly oil and natural gas. But, a decline of commodity prices on the international market raised concerns that the trade surplus would taper off and the prospect of the trade balance falling into the red became gradually realistic. This, in turn, amplified concerns that the ruble may be devalued, providing additional motive for suspending the inflow and accelerating the outflow of non-resident funds.

The psychological impact that political instability had on the market was large amid increasing concerns in the currency and financial fields. While rumors about President Yeltsin's health were continuously floating about, Prime Minister Viktor Chernomyrdin was dismissed and in his place Kirilenko, whose ability is unknown to the financial world, was installed.

The Russian financial system collapsed abruptly amid the above changes in financial environment in and outside of Russia. Keywords are increased issuance of short-term government bonds, increased reliance on foreign funds, and concerns about ruble devaluation. The following diagram summarizes the financial scheme that closely connects the three factors. I would like to call this the Russian version of a “pyramid scheme and explain the process of its construction and collapse. Please note the existence of various risks and understand the importance of their management.

## 2) Russia's financial pyramid scheme

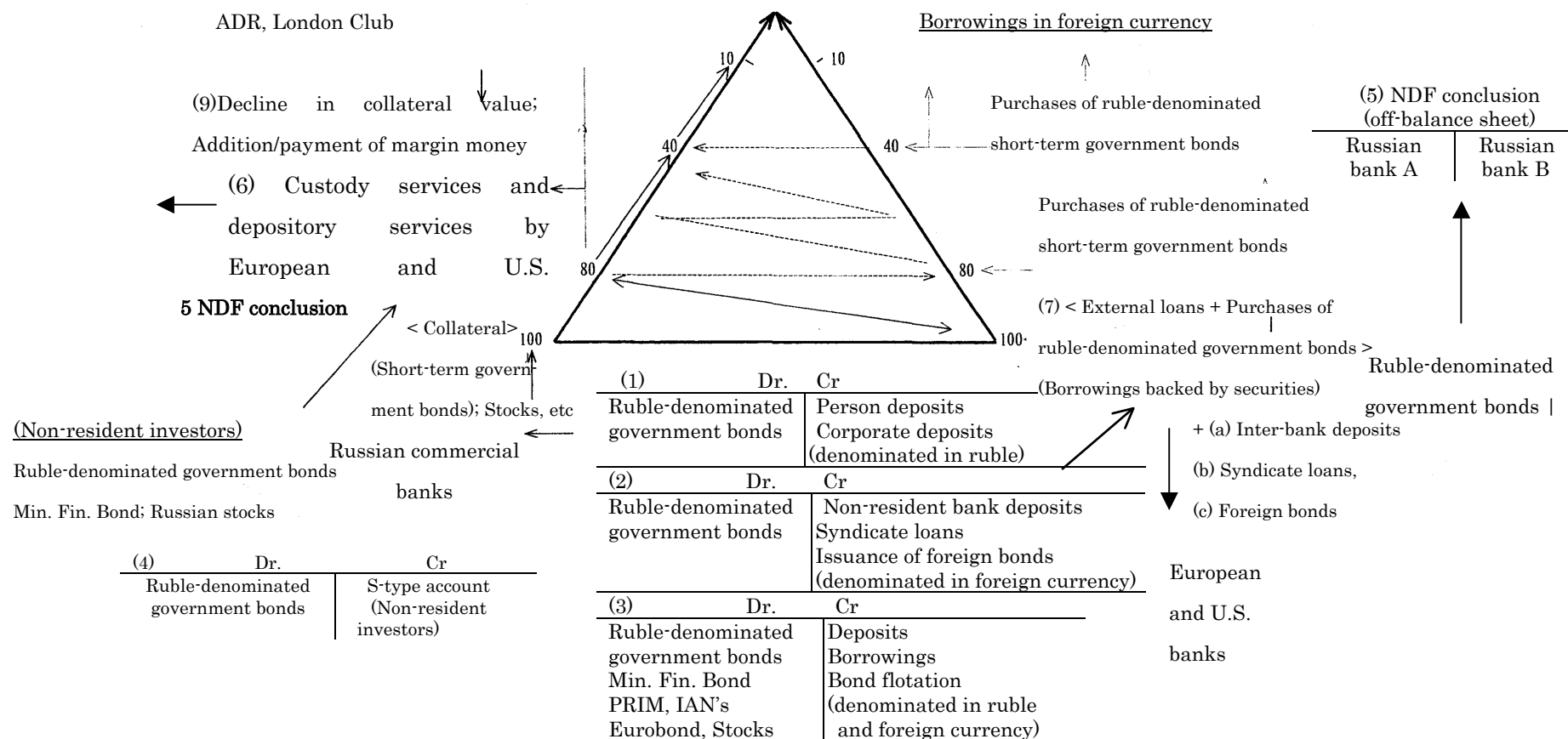
(8) Ruble/foreign currency collateral

Ruble-denominated: GKO, OFZ, stocks;

Foreign currency-denominated: Min. Fin,

ADR, London Club

### Pyramid scheme that utilizes ruble-denominated short-term government bonds



The diagram shows the financial pyramid scheme that had been constructed before the outbreak of the financial crisis in August 1998. I would like to explain its process in order of transactions.

(1) Russia began issuing short-term government bonds in 1996 to make up for fiscal deficits. The bonds were sold via primary dealers (banks and securities companies) or the market to investors. However, since domestic capital accumulation was not enough in those days, it was only some of the major enterprises and commercial banks that held investment funds in Russia. Normally, institutional investors, such as insurance companies, are the main buyers. But they were still underdeveloped. Therefore, the commercial banks purchase the government bonds with the funds deposited by individuals and corporations. In addition, they worked as intermediaries for some large corporations and individuals or non-resident investors to purchase government bonds. Up to this point, their behavior is utterly natural.

(2) Then, amid the increased issuance of government bonds and slow progress in corporate financing, one of the original businesses for a bank, due to various reasons, leading Russian commercial banks began to rely on the procurement of foreign currency from abroad (inter-bank deposits, syndicate loans, foreign bond issuance, etc.) for their investment in government bonds, apparently attracted by their relative superiority in terms of safety, reliability and high yields. Overseas investors, who increased their confidence in the stability of the Russian financial and exchange markets, began to take part in government bond investment. European and U.S. banks, which had been gradually increasing their presence in the Russian financial market, also played a big role. At this stage, Russian investors and non-resident investors began to shoulder potential exchange risks associated with the ruble's exchange rate fluctuations.

(3) In line with Russia's re-entry into the international financial market that had been suspended due to the external debt problems of the former Soviet Union, or in the process of integration of the Russian economy into the world economy, the link of the Russian financial market with those of other countries was strengthened both in terms of procurement and investment. Not only the above-mentioned ruble-denominated government bonds, but also other securities have begun to be traded actively both in Russia and in other countries. Among such bonds are the stocks of privatized Russian enterprises, American Depository Receipts (ADRs) issued against such stocks, domestic foreign currency-denominated bonds (Min Fin. Bond) issued against the foreign currency deposits frozen by the former Soviet Foreign Economy Bank, Russian Federation Eurobonds, and securitized debts to the London Club. As a result, the

investors have begun to be exposed to various risks, such as country risk, delivery risk, liquidity risk, price fluctuation risk, and credit risk.

(4) That a large amount of funds flow into Russia from abroad means Russia's creditworthiness abroad has increased on one hand, but on the other hand, it also means increased risks of an unexpected outflow of short-term, speculative funds from Russia. In view of the danger of short-term capital transactions, the Russian financial authorities at first required buyers of ruble-denominated short-term government bonds to conclude foreign exchange swap contracts (the foreign currency-based yield after the conclusion of a swap contract was kept at the same level as a Eurobond of the same maturity. But the requirement was gradually eased and eventually abolished) and to open a special account called an S-type account. Since the ruble fluctuates only within a certain range under the currency corridor system, the authorities feared that attractive interest rate differentials resulting from such system might invite an excessive inflow of speculative funds into Russia.

(5) The abolition of the swap requirement can be viewed as the liberalization of short-term capital transactions. But for non-resident investors, it means they are excessively exposed to exchange risk in view of the possible expansion of the fluctuation band under the currency corridor system, though it also offers them a greater chance to seek higher returns. Russian banks were also exposed to a similar risk, though their investment in ruble-denominated government bonds with borrowings from abroad were under the restrictions of exchange open positions set by the central bank. It was under such circumstances that Non-deliverable Forwards (NDF), a kind of derivative to hedge against exchange risk, was created. The NDF is mainly utilized in emerging markets, where it is difficult to conduct normal forward exchange contract transactions due to exchange control restrictions or due to the peculiarity of their financial markets. It may sound an argument after the result is known, there are still confusions as to the handling of NDF transactions. After the financial crisis, it became impossible to settle many NDF transactions. Some courts ruled that since such transactions are gamble transactions, they need not be settled. Foreign creditors, for their part, distrained some Russian bank accounts.

(6) Non-residents' investment in Russian stocks and bonds increased the need for the custody and management of actuals. However, there is only an extremely small number of Russian financial institutions to which one can entrust the custody and management of actuals and almost none that can handle the clerical work for such services accurately and promptly. The local subsidiaries of leading European and U.S. banks are the only financial institutions that can meet such requirements and they

have introduced modern custody and depository services into Russia, which proved to be extremely beneficial to Russian banks and enterprises as well. It is difficult for overseas investors to accurately understand the risks (country risk, credit risk, etc.) involved in Russia, a transition country. But, as a result of Russia's re-entry into the international financial market, European and U.S. rating agencies have come to respond to the needs of investors wishing to invest in Russia.

(7) As a result of the establishment of various financial instruments, technologies and infrastructure, it has become possible to raise funds by using the financial products mentioned above as collateral (for example, transactions under repurchase agreements). That is to say, it has become possible for commercial banks and enterprises to raise new funds efficiently by providing the government bonds, bonds, or stocks they held for investment purposes as collateral. This has resulted in exposing them to the price fluctuation risk involved in the financial products and operation risk.

(8) Now, suppose that a bank procured new funds by putting up collateral as mentioned above. There would be no problem if the bank's credit intermediation functioned normally, the legal and tax infrastructure to support the function was in place, and the funds raised were funneled into the real economy in such form as operating funds and trade financing. If not, the bank has to seek other investment instruments. Before the financial crisis, most of such funds were re-invested in government bonds. The price of a government bond is determined by market forces based on political/economic situations and interest rate movements. But, when interest rates are stabilized at a certain level, the value of the government bonds put up as collateral declines gradually but the bank can procure and invest funds repeatedly as the pyramid scheme shows. However, since bond prices, or the collateral value of bonds, change in accordance with market movements, it is normally required to put up guaranty money called margin money against the risk of a sudden decline in value.

(9) Now, what was happening before the financial crisis, when the pyramid above had already been in place? [1] Foreign investors became cautious about emerging markets due to the outbreak of the Asian financial crisis around the summer of 1997 and began gradually withdrawing funds. [2] The Russian fiscal deficits were on the increase. [3] The international prices of Russia's main export items began to decline, raising concerns that Russia may suffer trade and current account deficits. [4] The Russian political situation became more and more chaotic. In the circumstances, foreign investors, alarmed by increasing country risk, including concerns about a possible devaluation of the ruble, began to suspend fresh investment and sell or recover investments. The Russian government raised interest rates in rapid succession in order

to cope with the rapid outflow of foreign capital. As a result, the prices of government bonds, or commercial banks' invested assets, declined sharply and the value of collateral also fell, forcing them to either put up additional collateral or repay the debts. In other words, the left side of the pyramid fluctuated rapidly and drastically. Banks' balance sheets lost the equilibrium between government bond investment on the asset side and foreign borrowings on the liability side. The banks that are refused renewal of loans have to tap other sources of capital or sell the government bonds on the market to cover the deficits. But there lies market risks, such as price fluctuations and liquidity.

(10) In view of the developments described above, a collapse of one enterprise/bank has the risk of causing a crisis of the system as a whole, as it inevitably spreads to other enterprises/banks and triggers a chain-reaction bankruptcy due to their relations on the balance sheet. This is clearly proved by the devaluation of the ruble, the declaration of moratorium on private external debts, and the forcible rescheduling of ruble-denominated government bonds that were all implemented at the time of the financial crisis in 1998. The ensuing problems, such as the rescheduling of external debts, the settlement of NDF, and the rehabilitation of the banking sector, remain unsettled.

### **3) NDF problems (off-balance sheet transactions)**

NDF is the abbreviated name for Non-deliverable Forward, a kind of forward exchange contract that is concluded off-balance sheet. It was actively utilized as a means to hedge against the exchange risk of investment in ruble-denominated government bonds and was instrumental in constructing the financial pyramid that collapsed in 1998. Since defaults on a huge amount of contracts occurred after the crisis, many of the banks that went bankrupt or collapsed are involved. Total liabilities are estimated at about \$8 billion. But the whole picture has yet to be grasped. In 2001, the Russian central bank belatedly called on Russian commercial banks to report the balance of unsettled amount of NDF contracts concluded before Aug. 17, 1998. Some lower courts ruled the NDF transactions as a kind of gamble transaction and denied payment obligations. The Russian central bank is reportedly planning to bring the issue before the Supreme to assess the legality of the transactions. This constitutes a kind of legal risk. Incidentally, with regard to the problem of NDF settlements, France's Credit Agricole Indosuez and Russia's National Reserve Bank are engaged in international battle, including the seizure of assets, in court. Depending on the outcome of the battle, the National Reserve Bank may decide to collect its claims to the other Russian commercial banks that conducted similar transactions as counterparts.

Depending on the outcome of the court ruling, more than \$8 billion in debts will be added to the Russian financial market and this would trigger a new banking system crisis. In such a case, it is reported that about 10% of the Russian commercial banks would go bankrupt. However, for banks, such as the Russian Foreign Trade Bank, that recognize the necessity of external debts and are implementing payment of external debts in their entirety, it would become possible to collect claims to other Russian commercial banks, if the legality of the transactions within Russia is recognized.

At present, each bank's balance of unsettled NDF transactions is not clear. But, according to various reports, it is as follows:

Uneximbank (US\$1.7 billion), Chase Manhattan International (US\$633.8 million), CS First Boston (US\$284.2 million), Avtobank (US\$239.3 million), Alfa bank (US\$34.5 million), INKOMBANK (a considerable amount), MFK, Alba Alliance, VIZAVI.

#### **4) S-type account**

The S-type account was initially introduced for non-residents to purchase designated ruble-denominated securities. After the financial crisis of 1998, the balance of the accounts was frozen and various restrictions were introduced. Investment in prescribed Russian domestic projects was approved in 1999, the procedures for such investment were revealed in the Russian central bank directive issued on Oct. 3, 2000, and the procedures were put in order by another directive issued on Dec. 28 of the same year, as follows:

- Non-residents can open an account only with authorized financial institutions (34 banks at present)
- Non-residents can open an account even when they do not have a branch or representative office in Russia
- The following 3 types are available:
  - (a) Conversion type (for buying/selling foreign currency with the ruble)
  - (b) Investment type (for capital investment in securities or financial institutions)
  - (c) Project type (For investment in domestic projects listed on the government ordinance dated Nov. 20, 1999.: But requires approval of the Russian central bank)
- As for the first two accounts, non-residents can open one account with each authorized bank. As to the Project type, non-residents can open any number of accounts.

The balance of funds that have been frozen in S-type accounts since the end of the financial crisis of 1998 is estimated at about 10 billion rubles. So far, the following

deregulation measures have been taken:

- When trading in ruble-denominated government bonds on the secondary market was resumed in 1999, it was approved to purchase rubles acquired through the purchase/sale of special government bonds with foreign currency via foreign currency auctions and remit them abroad.
- Or can be transferred to the Project type account described above and remitted abroad after one year.
- In March 2001, the Russian central bank board eased restrictions on the procedure for using accounts balance. Specifically, it approved remitting abroad the interests on public and corporate bonds and the stock dividends that are deposited in the account. As a result, it is possible to remit about \$2 million abroad in 2001.

Since balance transfer between non-residents was approved, it has become possible to provide undervalued ruble funds to foreign investors interested in making fresh investment in Russian government bonds or corporations via portfolios. According to the Russian central bank, an estimated \$1 billion will be remitted abroad as a result of these measures.

In addition, it has opened the way to use up to 2 billion rubles of them as a source for direct investment in Russia. Specifically, it has become possible to use the loans to designated projects approved by the Economic Development and Trade Ministry or capital investment in Russian corporations and remit them abroad after three years. The limit may be revised upward in 2001 as need arises. As a result, a considerable number of investors in government bonds will transfer their holdings. But, the share of non-residents in this particular market is estimated to remain at around 20%.

The Russian Finance Ministry and Alfa bank estimate the size of S-type accounts as follows:

< Balance in the first half of 1999 >

Conversion A/C: 3,024 million rubles, Investment A/C: 8,083.7 million rubles, Frozen Transit A/C: 4,726.5 million rubles

Total market value as of November 2000: 70~80 billion rubles (about \$2.5~3 billion)

(Total market value of S a/c plus Russian government bonds)

Most of the risk government bonds mature at the end of 2001. In view of the 10 billion rubles that non-residents are expected to receive as interests on their holdings and a rise in the market prices of government bonds, the total market value of the government bonds held by non-residents is likely to further increase by 15~18 billion

rubles.

It looks as if the Russian liberalization of short-term capital transactions related to trading in short-term ruble-denominated government bonds implemented too early. It is necessary to weigh the merits against the demerits of liberalization and take liberalization measures based on the situations of the country. But, it is also important to have dialogue with the “market” that can be changed drastically by external factors.

## **6. Banks' risk management**

### **1) Views on risk**

#### **(1) Bank management environment**

Global activity and complicated financing techniques characterize the recent banking industry. Due to these factors, the complicated risk aspects of the banking industry have emerged. Deregulation movements have made it possible for banks to venture into new businesses. For example, there were restrictions that separated the banking industry from the securities industry both in Japan and the United States. However, the deregulation of the restrictions has prompted competition between the two industries. Macro-economic factors also affect the industry. When the economy is expanding rapidly, the risk is relatively minor. But, when it is not, the ability to assess complicated risks becomes necessary in order to promote businesses. In short, globalization, deregulation, changing economic environment, and ever-progressing financial technology have increased various risks in the banking environment. In other words, the banking industry of today has changed from the intermediary of funds to the intermediary of risks.

#### **(2) Failure of risk management**

As recent examples of shocking failures, the case of Baring Brothers and Daiwa Bank can be cited.

Barings suffered a loss of 9 million pounds as a result of fictitious stock index futures trading by one trader. In the case of Daiwa Bank, one bond trader caused the bank to lose \$1 billion. The two examples show that one employee can easily trigger a corporate failure. However, bond trading and futures contracts are perfectly legitimate. In fact, in order to generate profits, it is necessary to take risks. Therefore, what is important is not how to avoid risks, but rather how to manage risks.

#### **(3) Accounting and rules**

The supervising stance of banks has been shifting from the protection of the banking industry to more market-oriented policies. Self-responsibility is being stressed

and strengthening internal risk management processes is being called for. The processes, rather than the risks, are the subjects of banking inspection. In addition, shareholders, rating agencies and investors are calling for more transparency. Market-to-market accounting of trade businesses has become common.

#### **(4) Risk category**

[1] Market risk: The risk that arises from a change in the value of portfolios, or financial instruments and ranges from financial products to foreign exchange contracts.

[2] Credit risk: The risk that arises from default on contract by debtors. This is the risk intrinsic to commercial banks.

[3] Liquidity risk: The risk of debts becoming insolvent before they come due.

[4] Settlement risk: The risk result from a trading partner becoming unable to fulfill his/her payment obligation

[5] Operation risk: The risk of suffering a loss due to a fraudulent act by personnel or inadequate internal management, such as a defective system

[6] Legal risk: The risk of suffering a loss due to insufficient legal documents or a suit filed by a third party

## **2) Major risk management methods**

### **(1) Market risk**

The basic point to minimize the risk to establish an internal management system, such as [1] risk pick-up policy, [2] organization, [3] trading authority/position limit, [4] reports, and [5] personnel management.

Senior managers of a bank must clearly determine the balance between risk and return and introduce an appropriate check system between the front office and the back office. The authority and position limits should be specified in writing. As a loss becomes large in a short period of time due to the nature of the business, reports should be made as frequently as possible. It is extremely important to develop officers with risk-management capabilities.

### **(2) Credit risk**

This is the risk most intrinsic to the commercial banking business. First, credit policy should be made clear and the business promotion division and the screening division should be separated. It is also important to make clear who has the approval authority. A credit assessment system is an ideal criterion for managing credit risks. Of late, a portfolio management to establish a better lending-asset structure by assessing an expected loss from loans as a whole is drawing attention. Naturally, it is

essential for a commercial bank to judge a debtor's ability to repay debts consistently and strictly.

### **(3) Liquidity risk**

There are two kinds of liquidity risks: "Funding Risk" of fund raising from the market becoming difficult, and "Market Liquidity Risk" of having to make additional cost payments due to the low market liquidity of positions. The latter is manageable by limiting positions, but the former is difficult to manage.

### **(4) Settlement risk**

This is defined as default by trading partners. Settlement risk is basically credit risk but is similar to liquidity risk or system risk. This is because, when the market liquidity is limited, settlement risk arises regardless of the trading partners' credibility. In order to avoid this risk, such systems as the Real Time Gross Settlement System and the International Netting System, are established.

### **(5) Operation risk**

Experience tells us that most of the catastrophic losses were caused by a fraudulent act of an employee. The organization, authority and office flow must be clearly defined in order to understand what is happening within the bank and to prevent such an incident. In addition, it is necessary to reinforce internal auditing and inspection functions.

### **(6) Legal risk**

There are various aspects, such as the following: [1] Petition: daily problems, complaints by shareholders, [2] Law observance: check the legality of activities in each country, [3] Document preparation: check the validity of legal documents, [4] Strategic field: new businesses, patents, etc.

## **3) Credit risk management**

This refers to the risk of financial institutions' credits falling into default due to a deterioration in the earnings of the debtors. This risk is intrinsic to financial institutions. Various methods for managing the risk have long been experimented and studied. In view of the diversification, sophistication and internationalization of banking businesses, a further sophisticated management method is being called for. There are two kinds of management methods as follows:

(1) Risk management concerning individual credit: This deals with credits one by one and takes safeguarding measures such as the inspection and management of each credit and the requirements of collateral.

(2) Risk management as portfolio: This is designed to avoid a concentration of credits

and disperse risks by managing credit portfolios as a whole after quantitatively measuring the risks and returns involved.

**(1) Credit risk management concerning individual credit**

Normally, system support by computer is necessary, in addition to the following 5 processes.

**[1] Credit policy**

**[2] Credit approval**

**[3] Credit monitoring**

**[4] Credit examination**

**[5] Problem credit administration**

[1] Credit policy refers to bank's basic stance on the management of credit, including lending. Specifically, it refers to (a) credit judgement criteria, (b) approval authority and credit administration criteria, and (c) credit rating system, etc.

[2] refers to grasping the actual situation of clients, judging the validity of each credit, and analyzing cash flows.

The points of [3] are (a) a periodic review of clients' business conditions, (b) a follow-up study on the use of loans, and (c) overall management of the corporate group to which clients belong. Specifically, it means conducting balance-sheet analysis every business term and checks on changes in the balance sheet and bank-wide observance of large-lot lending regulations.

The point of [4] is inspection of the status of credit risk management by a third party by establishing a division independent of the regular business/screening division.

What is important in [5] is focused management of credits extended to the clients whose businesses have deteriorated. For example, bringing the credits to such clients under the centralized control of the head office so that, in case of emergency, it can be dealt with under the guidance of management/collection experts at the head office.

The points of credit approval are as follows:

A. Client screening: (a) quantitative analysis, (b) qualitative analysis

B. Credit analysis: (a) confirmation of the use of credit, (b) confirmation of the resource of payment funds

C. Cash flow analysis

**(2) Credit risk management as portfolio**

As risk has become diversified and complicated, it is necessary to use a more sophisticated method for managing credit risk as portfolio. Specifically, the following two methods are being employed: (a) a credit rating system and (b) a quantification of credit risk. Under the credit rating system, the credit risk of debtors and the credit are

assessed by using a unified standard and the credibility is expressed with a symbol. It is designed to sophisticate the management and administration of credits by quantifying the risks involved. The basic idea of rating debtors is to assess the magnitude of debt burden and the size and stability of the sources to repay the debt. As to debt-payment source, a client's supplementary ability to repay debts is measured from the asset value and external liquidity by assessing the future size and stability of the source produced by operating cash flow.

The assessment items in rating general business corporations are as follows:

**[1] Assessment of operating cash flow**

A. Quantitative factors (management index)

(a) Ability to repay debts: debt maturity, interest coverage ratio, etc.

(b) Financial conditions: safety (net worth ratio, etc.), profitability (return on sales, return on assets, etc.), growth (growth rate of recurring profits, etc.), corporate size (net worth, etc.)

B. Qualitative factors (actual conditions of management)

(a) Management environment: demand trend, competition

(b) Corporate characteristics: business history, management, shareholders, business foundation, competitiveness, etc.

C. Assessment of future cash flow

**[2] Assessment of supplementary sources to pay debts**

A. Asset value: value of disposable assets

B. External liquidity: support from parent company, support from main bank, etc.

**[3] Assessment of the actual conditions of debts**

Grasping the actual conditions of debts by evaluating the non-performing assets of subsidiaries and affiliated companies and legal risk, etc.

It is necessary to make a final judgement after objectively verifying the above evaluation by referring to ratings and corporate assessment, etc. made by outsiders. The rating of each deal must be determined after assessing collateral/guarantee, credit period, preservative attachment problems, and transfer risk, in addition to the rating of the debtor.

The rating thus determined should be reviewed periodically at least once a year (in principle within 6 months after the end of every business term) and every time there is a change in the credibility of the debtor.

**4) Asset and Liability Management (ALM)**

Simply put, ALM means managing assets and liabilities in an optimum composition and content (1) by forecasting the economy and financial environment, (2) by maintaining necessary liquidity, and (3) by avoiding credit or market risk, etc. (4) in order to achieve stability or maximize final profits. To this end, the following environment/conditions are essential: [1] liberalization of interest rates, [2] stable medium- and long-term interest rate system, [3] establishment of secondary market for funds/securities, and [4] corporate managers who take a change in interest rates as a good chance to secure profits.

As is well known, the banking business is accompanied by various risks. With regard to credit risk, for example, it is important to avoid a concentrated extension of credits and establish an auditing/inspection system, in addition to studying the profitability from the viewpoint of offsetting risks. With regard to market risk, it is necessary to manage off-balance transactions, such as forward exchange contracts, interest-rate swaps, and auctions, by paying attention to changes in market movements. Market risk means risks involved in the transactions of foreign currency, assets, bonds, and stocks. Specifically, it is the risk involved in fund procurement, interest rate fluctuations, and exchange rate fluctuations. Incidentally, interest rate changes for the following reasons: economic growth, inflation rate, customer's fund needs, exchange rate, and monetary policy of the central bank.

The following is an example of the risks involved in lending and deposits, the simple and basic banking business.

**(Case 1)**

Assets	Liabilities				
1. Loan	100	Deposits 100	Average cost 3% p.a.		
1-year time deposit interest rate: 5% p.a.		2-1 Current 20 0% p.a.	2-2 3-month 30 3% p.a.	2-3 6-month 30 4% p.a.	2-4 1-year 30 4.5% p.a.

Net margin 2% p.a.

(a) Credit risk: The possibility of the loan 100 of the 1 falling into default on the settlement date

(b) Fund procurement risk: The possibility of the balance of the 2-1 current deposits being withdrawn;

The possibility of the 2-2~3 time deposits not being renewed on their maturity dates

(c) Interest-rate fluctuation risk: The possibility of the interest rates on the 2~3 time deposits differing from those set at the beginning

Since there is a difference in structure between assets and liabilities (difference between investment period and fund-procurement period), banks are exposed to both fund-procurement risk (bankruptcy due to failure in fund procurement) and interest-rate fluctuation risk (bankruptcy due to having incurred losses or deficits).