The role of financial groups in Russia's banking crisis

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THE ROLE OF FINANCIAL GROUPS IN RUSSIA'S BANKING CRISIS

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Introduction

This article reviews the role of financial groups in financial crises, and then applies the lessons learnt to Russia though a detailed analysis of the ruble collapse, the GKO default and the banking crisis.

FIGs in an international perspective

Conglomerates connected with banks have often taken a leading role in industrial growth in many countries. Their role was perceived to be the channeling of bank savings by risk averse investors into large scale industrial investment and infrastructure, absorbing risks normally born by shareholders on their own balance sheets. This approach allowed individuals to leverage their own equity into controlling blocks to ensure governance of large firms and projects. Japan, Korea, West Germany, Italy and France have relied heavily on business groups since the 1950s. Groups have long existed in Latin America. They have also played a major role in many emerging South East Asian countries and are now forming in the former Soviet countries and in parts of Central Europe including Poland, the Czech Republic, and the Slovak Republic.

In the West, the opinion has markedly changed in the last twenty years: the performance of diversified Western groups is now judged to be substandard. In the United States, there was a remarkable wave of mergers in the sixties, now largely undone. Analysis of the US experience has given clear results. Group firms are valued lower than independent firms and they also tend to grow more slowly. When conglomerates are broken up, share prices of individual firms rise sharply. On the basis of these results, a classic explanation for group existence, the idea that they occupy a niche position in sectors neglected by capital markets, has been losing ground, at least for developed economies. More recent evidence indicates that Western groups practice a “socialist” form of allocation of resources. They move funds from profitable firms to support investment elsewhere and tend to invest more in sectors with low growth prospects and less in sectors with high growth prospects.

The origin of groups is often connected with policy of strong bank credit support (Japan, Korea, Germany), rapid privatization (Chile, Russia, the Czech Republic), or strong government favors to well connected groups (several South East Asian countries). Such favors may not involve any direct or indirect financial support but take the form of special licensing rules, which create either strong trade advantages (import-export licenses), or legal monopoly positions.

The main advantages of groups are clear: they represent a solution for private control of large companies (corporate governance). Groups can also resolve contractual difficulties in transacting among firms (contractual governance). Finally, groups may also mediate access of firms to scarce resources via their internal capital and product markets. This is believed to be very useful in an underdeveloped financial system.

On the other hand, what is often neglected is the role of such group to contribute to the persistence of an underdeveloped financial system. Their access to credit and legal favors give groups monopolistic advantages. This reduces entry and innovation. Moreover, since profitable firms in a credit-constrained economy can snap up assets very cheaply, groups have a tendency to grow too fast, borrow too much and acquire too much. This concentration of economic and political power is self-reinforcing and leads to excesses. Groups maximize their control span, creating a concentration of financial risk. Privileged status enables them to secure large amounts of loans; also from abroad, as foreign lenders expect government support this often leads to excessive leverage, over-expansion, and speculative investment. The lack of transparency and extreme leverage leads to forms of excessive speculation, which is very vulnerable to sudden losses of confidence. In an unstable economic context, any economic shock is amplified by the group structure and can lead to currency crisis.

In countries where the state has maintained a certain autonomy and independence from the groups, groups have been encouraged to compete with each other (Japan, Korea and West Germany). Unquestionably, these economies performed much better in the medium term than in countries where they were allowed to monopolize individual sectors (South East Asian, Southern European and Latin American countries). However, even countries with successful groups have seen their limits. In particular, there has been much criticism on the scale and allocation of their capital investment.

While investment rates by group firms have been high until the financial crisis, the current opinion is that groups tend to be too rigid in their investment strategies, with a tendency to over-investment. In fact, what has been praised in the past as a sign of strong commitment, is over time increasingly seen as a less innovative approach. This may be caused by financial subsidization, and may lead to reduced profitability and discouragement of new entry. Finally, the lack of transparency associated with group investment is perceived as a serious weakness at the moment of a loss of confidence among investors.

South Korea

An interesting example is the experience with South Korea’s large hierarchical conglomerates (chaebol). Chaebols control many enterprises via equity pyramids and high debt. They were favored by cheap credit, import barriers, tax breaks and other advantages. This helped them to grow large and diversified (the turnover of the top 30 chaebol recently reached 80% of Korean GNP). Chaebol groups tend to practice cross-subsidization, with large inter-firm loans and loan guarantees. They consume a big proportion of available credit while starving smaller firms of credit. They have a tendency to over-expansion, excessive diversification and over-leveraging. On the other hand, Chaebols competed fiercely with each other, which favored efficiency. By 1996 the average top 30 chaebol's debt to equity ratio stood at 400%. Their strategy to transfer cash flow from profitable operations to sustain rapid expansion in other sectors at some point came unstuck. Once profits in the leading sectors fell, cash-consuming investment could not be supported any longer and the financial crisis started in earnest. Ultimately, the chaebol structure, with its lack of transparency and complicated inter-firm financial relations, aggravated the overall crisis in Korea. Private investors were amazed to discover that private foreign debt in Korea was twice as high as previously believed.

The Czech Republic

Another recent example is the Czech Republic, an economy generally considered well administered and quite productive. In general, its initial conditions were relative good (high savings rate, better administrative controls, and low monetary overhang). This allowed hiding financial problems in the banking system for quite some time, thus not addressing the necessary restructuring needs. In the end, the mass privatization program jump-started the stock market but also choked it by assigning too much of a role to banks and not strengthening investors' rights. The country arguably went too far on raising the role of banks in corporate governance of the firms whose shares they held via their investment funds. In part, as a result of this heavy involvement of banks with firms, for too long, the government fudged the issue of industrial restructuring. For instance, it delayed and muddled the introduction of the bankruptcy code; the government also supported the banks' extreme reluctance to disclose bad loans, hoping growth would ultimately solve all problems. As a result, the Czech Republic has suffered in the last two years a serious loss of investors' confidence and has endured a painful if not major currency crisis.

Argentina and Chile

Banking crises in Latin America often have occurred following a period of intense transformation, such as rapid privatization and/or financial liberalization. In a situation of relaxed controls, a banking system with strong involvement with enterprises tends to grow too fast acquiring too many assets (equity or loans) for its equity base. Groups often form in this phase of rapid credit growth. Powerful groups can raise funds easily from foreigners because their debt is thought to be protected by state support; a combination of cheap loans and domestic assets (equity or high-yield debt) leads them to build massive speculative positions.

The Latin American response to banking crises associated with currency crisis can be best illustrated by comparing two contemporaneous banking crises during 1982-1986: Argentina and Chile. Both countries had in the early 1980s a very high level of foreign debt (twice as high in Chile). In both countries, large groups with bank participation dominated the corporate sector. They were hard hit by the jump in dollar interest rates. As a result, a currency crisis developed in both countries. The resulting recession added to create a massive bad loan problem. Banks, with very large exposure to dollar debt, were de facto bankrupt.

The parallel with Russia is particularly close with Chile, which also underwent an extremely rapid privatization program in which asset ownership ended up very concentrated. In Chile, the Pinochet government privatized very quickly in the late 1970s. First the banks were sold to powerful families, often allowing them to purchase the equity with a state loan. This allowed them to use the banks' balance sheet to acquire equity in the large industrial firms on sale. Prices of assets were quite cheap and the banks borrowed heavily in dollars to expand rapidly. This led to the formation of a few very large "grupos". Thus, the new owners had little own money at risk, and had extreme incentives to speculate to take advantage of the general confidence in the banks.

Under the weight of a large private dollar debt, the exchange rate collapsed in 1982 when US interest rates suddenly rose. The banks and their “grupos” went bankrupt. Both Chile and Argentina re-capitalized their banking systems by refinancing bad loans in exchange for bonds (to stop rolling over of bad debt) and obligating banks to repurchase the loans in the medium-term future.

The main lesson comes from the handling of the crisis in the two countries. Bank shareholders and depositors were treated quite differently. Chile closed down or nationalized several banks, albeit not the largest ones. They also renationalized all corporate equity owned by the insolvent banks. Ultimately, these assets were either sold more progressively (with foreign participation) or were re-privatized by granting the shares to the population pension funds. Since the Chilean government had been running a budget surplus, it was able to provided real resources to fund the repayment of deposits.
By contrast, Argentina used the printing press to fund the bailout. As a consequence, Argentinean banks were able to repay the refinancing loans at deflated value, while both the central bank and depositors lost heavily.
Thus a main difference of Chile versus Argentina was that Chile’s Central Bank purchased bad loans from troubled banks under an obligation to repurchase them in a few years, and made sure that the real value of these loans kept most of its real value. Argentina mostly inflated the losses away.
The main consequence was clear in a few years. Chile’s deposit base was restored to over 50% of GNP by 1990. Argentina’s banking system sunk to 8% of GNP.

PART II
THE RUSSIAN FINANCIAL CRISIS

The primary reasons for the collapse of the ruble in mid-August and the subsequent financial turmoil included the unsustainably large federal budget deficit, the unsustainable build-up of short-term ruble-denominated debt, the weak and under-capitalized banking system. All these trends were of course inter-related: it is the general lack of payment discipline which has lead to extensive use of barter and monetary surrogates, while at the same time allowed a steady increase in all kinds of arrears, including tax arrears. Thus neither the public deficit nor the increase in ruble debt can be seen as purely macroeconomic factors, just as the problems in the bank and insufficient payment discipline, they are due to institutional deficiencies of Russia's legal enforcement system. In the end, in the absence of better tax collection the rapidly growing government bond market became a Ponzi scheme, with borrowers being paid by new inflows with no realistic chance of ultimate solvency in sight.

Related to the problems in the banking sector is their role in the emergence of the so-called financial-industrial groups (FIGs). These groups involve close relationships between financial institutions and industrial enterprises to a degree not observed in mature market economies, where firm access capital primarily via am-length contracting with institutions and capital markets. Russian FIGs have for the most part been built around one of the big and politically influential Moscow banks, which thanks to powerful political connections managed to acquire cheaply large, controlling stakes in enterprises through the privatization process. Clearly, the banks were planning to tap into the cash flows generated mostly in the oil and other raw materials-based industries, as well as some retail sectors such as the food industry. The FIGs are thus in part a result of the deficiencies in today's Russian economy. Links within the FIGs allowed both banks and enterprises to move resources around bypassing the inefficient capital markets and avoid the non-payment problem.

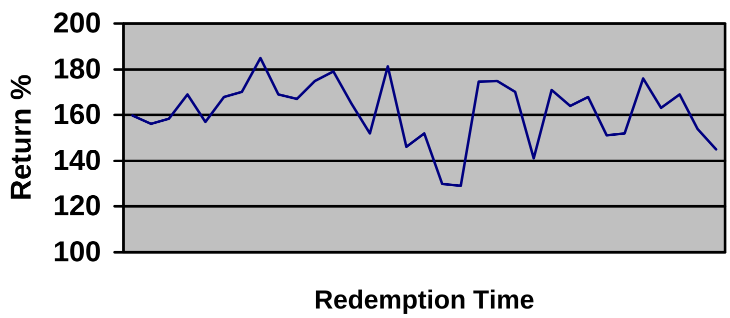
It appears also that the political power held by FIGs has played an important role in the process that caused the crisis. The FIGs have offered a convenient route for tax evasion and capital flight (via under-envoicing for export and over-envoicing for import), perhaps their most treasured advantage. Their control over media and finance has also reinforced their political power and thus their ability to influence or even blackmail the government, in a pattern typical of corporate groups in many developing countries. The recklessness of many banks' practices and the credibility which for a time foreign investors granted to them can be only understood in terms of a strong access to political and financial favors.

Russia's banks and their connected industrial groups have played a major role in the events leading up to the crisis. The banks were primary buyers of government securities. They also made major speculative investments in the stock market and acquired large controlling stakes in Russia's natural resource-based industries, thereby building up a massive exposure to fluctuations in commodity and financial prices. They borrowed abroad, exposing themselves to exchange rate risk. Being politically influent players, they counted on that the authorities would bail them out if things turned out wrong. In the event, the loss of investors confidence in Asia, the fall in oil prices, but most of all Russia's home-made tax problems made financial markets increasingly jittery about the ruble.

The immediate cause of Russia's financial collapse was the joint decision by the Government and the Central Bank of Russia (CBR) on August 17 to devalue the ruble and effectively default on existing ruble-denominated short-term debt, or GKOs to use the Russian acronym The nominal value of GKO/OFZ in circulation was RUR 387 billion. The common opinion was that the authorities were able continue to service their debt and control the exchange rate. As it was explained later by Anatoly Chubais the government decided to default in order to finance the budget at the investors' expense. Trading of GKOs was suspended through the remainder of 1998. It was announced that they were to be restructured into new securities with longer maturities and less onerous terms. Negotiation on this conversion are still ongoing between the authorities and Russia's creditors, foreign as well as domestic, and a final solution is still to be found. In addition, the authorities announced a moratorium on principal payments of Russian banks to their foreign creditors. This moratorium also applied to forward exchange contracts issued by the banks to allow foreign GKO holders to hedge against exchange rate changes.

The common opinion before the decision was that the authorities were able continue to service their debt. Casual evidence suggests that while a devaluation was expected, an outright default on the internal debt was not. This is confirmed by the consideration of the GKO yield curve. Usually in default, the bonds of different maturities are restructured in securities with approximately identical maturity dates. If the default is expected, the yield curve would have pronounced negative slope. That was not the case in Russia before the August measures. While a devaluation had been on

pic.
Yield Curve 14.08.98



everybody's mind throughout this year, few observers believed there would be an outright default, an extra-ordinary measure which sets Russia aside internationally.

Banks Become Insolvent

The August measures had two highly unfavorable consequences for the banking sector. First, banks were deprived of the sizable part of their liquid assets. According to central bank data, at end-June, banks held RUB 170 billion worth of government fixed income securities in their portfolios, or 22% of total assets. Loans accounted for 38% of the total assets. The average loan maturity interval was 181-350 days. Thus, as a result of the default on government debt, the banking sector was left with huge holes in its balance sheet.

Second, because of the devaluation, banks' foreign liabilities increased considerably in ruble terms. Borrowing at the low interest rates abroad and investing the proceeds in ruble-denominated assets was an important component of the financial strategy of Russian banks. Losses, related to on-balance sheet items such as syndicated loans and eurobond issues, were further augmented by losses on off-balance sheet items contingent liabilities such as dollar forward contracts. At the time of devaluation, many Russian banks had extraordinarily large open forward positions, often opened to hedge foreign investors' holding of GKOs. Extraordinarily lax central bank supervision and possibly weak internal controls allowed traders to take practically unlimited positions on the futures markets. Quite possibly, bank owners and top management were exhibiting a classical example of moral hazard behavior, gambling heavily as they counted on a the bail-out by the CBR in the case of devaluation. The perceived political support granted to the large Moscow banks involved in the FIG group lent them credibility vis-à-vis foreign investors and allowed them to build the exposure.
The banks also borrowed significant amounts using repurchase agreements to finance investment in Russian equity and government debt. The sharp decline in the stock market and the Government's default on GKOs made the banks unable to honor margin calls on REPO deals. According to the Central Bank data net foreign assets of the Russian banks were (-32.8) billion rubles or U$ (-5.3) billion. Therefore a devaluation of 150% cost the banking sector around U$ 5 billion. However, since the quality of dollar-denominated assets also fell considerably, the losses were much higher.

Because of both the default and the devaluation, most Russian banks became technically insolvent. However, much of the further loss of value since then has had little to do with financial price movements: a massive wave of asset stripping has left most of them as little more than empty liability shells.

The Banking Liquidity Crisis

Following the August measures, liquidity in the banking sector deteriorated dramatically, something the authorities sought to remedy through the moratorium on repayments of Russian debts to their foreign creditors announced together with the ruble devaluation. The moratorium allowed banks to maneuver their remaining assets to their advantage. As liquidity deteriorated severely, the payment system ground to a complete halt. Corporate payments to the budget and suppliers were frozen and in many cases entirely lost. Moreover, banks immediately froze most deposit withdrawals. This blow to the residual amount of cash payment in the system has probably set the tone for a complete barterization of the Russian economy for the foreseeable future.

The default on the internal debt deprived the banking system of a second source of liquidity, the interbank market. The banks could not estimate the losses that their counterparts suffered from the default on GKOs. This led to the collapse of the inter-bank credit market. The Moscow Inter-Bank Offered Rate (MIBOR) changed from 126% on August 17 to 224% on August 18. The inter-bank credit market has not recovered yet. Interest rates fell somewhat in September but the spreads between the offer and the bid rates are extreme and probably available to only the very best banks. Unsurprisingly, the trade volumes are extremely low.

The CBR regulates the liquidity of the banking system through two types of arrangements. Lombard loans of maturity up to 30 days are secured by holdings of GKOs. Overnight loans do not require any security but were available only to authorized GKO dealers. At the same time as the ruble was devalued, the Central Bank announced that GKOs with a maturity date before end-December 1999 were to be restructured into new securities.

That decision deprived many banks of the opportunity to draw the funds on the Lombard auctions. Still, on August 20, the CBR still lent banks through its Lombard facility but most of the September Lombard auctions were subsequently canceled by the Central Bank. The overnight central bank loan rate went up to 250% from 150%. In September, the overnight central bank loan rate was lowered to 80% and then to 50%. In the beginning of October, the overnight rate was down to 40%. The traders said the CBR was using the overnight loans to inject liquidity into favored banks and that the overnight loans were being extended indefinitely.

According to official data, the Central Bank spent USD 9 billion in July and August to maintain the fixed exchange rate for the ruble. A sizable portion of that was spent during the week immediately before the devaluation. The enormous demand for dollars by financial institutions probably contributed much to the decision of August 17 to let the ruble float. Only the lack of ruble liquidity did not allow the banks to aggressively continue to buying dollars, admittedly the only natural choice taken into the account the collapse of all other investment opportunities. On August 26, the Central Bank halted trading on the Moscow Inter-bank Currency Exchange (MICEX). In the course of the following two weeks, the exchange rate depreciated by 230-250%, from RUB 8 to RUB 20-22 per USD. Later, the rate recovered on extremely thin liquidity and stabilized around RUB 17 to the dollar.

Several developments contributed to the temporary stabilization of the exchange rate. The Central Bank continued a limited intervention policy, although only with some banks. The initial devaluation of 150% probably exceeded most estimates, and it was not justified in terms of the contemporaneous increase in the monetary base. Therefore, the depreciation

of the exchange rate and hike in prices were mostly due to a change in expectations and a related change in money velocity.
However, changes in money velocity are obviously limited when virtually all deposit withdrawals are frozen. As the initial price hikes met very scarce cash ruble liquidity in the second half of September, inflation expectations subsided briefly. Moreover, the exchange rate recovery was probably manipulated on a thin market by banks in order to ensure lower closing losses on large amounts of dollar forward contracts expiring in the period.
New rules for currency trading were introduced by the CBR in the beginning of October. Two trading sessions were to be held daily. On the first one, the required part of currency revenue of exporters would be sold to the importers. In the second trading session, the banks and all other participants would trade. The exporters were obliged to sell 50% of the currency revenues on the first session. The commercial banks were not allowed to leave open currency positions by the end of the day. These new rules, recently sharpened, have led to a multiplicity of the exchange rates and enhanced the ability of the CBR to manipulate the exchange rate.

The Central Bank acted initially to support the banks position. At the end of August, the CBR lowered the reserve requirement ratio from 11% to 10%, a massive injection of monetary basis. The RUB 4.1 billion thus released from the Central Bank were immediately directed to the foreign exchange market. Also, on September 18, the CBR organized a huge debt reconciliation scheme. The purpose of the action was to revive the payment system, which was paralyzed by the crisis. A major emphasis was put on the payments to the budget. The operation injected RUB 4.2 billion into the banking system. RUB 3.3 billion were drawn from the compulsory reserve funds and the rest was borrowed against the frozen short-term government debt. The banks were expected to repay the loans and to raise their reserve funds to the previous level by December 1.

In a second operation on September 25, the Moscow banks reduced their reserves by RUB 2.0 billion. Overall, the correspondent accounts in the

Central Bank rose by RUB 1 billion. In the following week, commercial banks' correspondent accounts with the CBR increased by RUR 2.4 billion. The Central Bank intervened heavily on the foreign exchange market but the ruble appreciation was quite insignificant. This suggests that part of the resources directed at the offset was immediately used to acquire foreign currency.

A third operation was conducted on October 2. There was no change in the correspondent accounts but the reserves fell by some insignificant amount. As the result of the offsets, the overdue payments decreased by RUB 30 billion, or 75% of the total. In September and the first week of October, commercial bank reserves in the Central Bank were reduced by approximately RUB 8.5 billion. Another RUB 15 billion was injected through the Lombard auctions and overnight loans.

Access to any credit at a time of extreme illiquidity and for banks in a state of insolvency clearly amounts to a massive subsidies. The allocation of these credit extensions was done in a rather obscure way, possibly favoring a few selected banks, among which presumably the group banks.

Following the cancellation of the short-term government debt market, the Central Bank attempted to introduce new financial instrument: central bank bonds. The banks were expected to use these bonds as liquid earning asset and as the security for the loans provided by the Central Bank. At first, the market required yields unacceptable for the Central Bank. Then, given the lack of short-term investment opportunities and the relative stabilization of the exchange rate, trading in CBR bonds picked up.

Bank Solvency towards creditors

Due to the moratorium on the principal repayments, Russian banks technically defaulted on their liabilities due after August 17. Some western creditors filed lawsuits, and the accounts of three Russian banks were frozen in London. Many banks also refused to honour their ruble debts. In the beginning of September, large Moscow banks stopped redemption of their veksels. At the same time, companies' accounts in the banks were frozen. It is unofficially reported that oil company Surgutneftegaz lost USD 1.2 billion in one of the banks. Corporate account holders in Menatep, Mostbank and Onexim were forced to swap their current accounts for veksels in Rosbank (to which we refer below) with one to seven year maturities. After a while, some organized trading of bank debt appeared. Some depositors were able to recover their money at 25%-75% discounts; however, trading was very limited.

The inter-bank credibility crisis was followed by a depositor run. All banks introduced limits on the amounts that could be withdrawn in a single day. Only Sberbank was able to satisfy the demands of its depositors continuously. All other large banks later stopped any payments to personal bank accounts. On September 9, CBR froze all the deposit operations in six Russian banks, four of which were ranked among the top ten. These commercial banks were offered to transfer their household deposit accounts to Sberbank. In return, Sberbank was to receive the money in the banks' reserve accounts with the Central Bank. The dollar accounts to be transferred would be converted into rubles at the exchange rate of RUB 9 per USD while the prevailing market rate was RUB 21 per USD. At the end of the month, the commercial banks strongly recommended their depositors to make the transfer. The restructuring packages offered by banks for its personal depositors were clearly less attractive than the offer of transfer.

It will be very hard for bank creditors to retrieve their money from selling bank assets. Frustratingly, although the banks themselves are now in many cases bankrupt, their industrial assets are still there and mostly out of reach for those that hold claims on the banks. FIG companies were usually controlled via foreign-registered holding companies. Other assets have been transferred to new entities via obscure transactions which the Central Bank has been unwilling or unable to stop. Admittedly, the lack of a bankruptcy law for financial institutions has hindered also legally its ability to intervene.

THE ROLE OF FIGs IN THE RUSSIAN CRISIS

The weaknesses of the regulatory framework contributed significantly to the crisis. Lack of transparency was long evident in the fact that the accounting information provided by banks in their annual statements is aggregated to a ridiculously high degree, so that it is impossible for outsiders to analyse their risks using such data. The prudential requirements were both inadequate and enforced selectively when at all. Moreover, contingent liabilities such as the exposure to the dollar forward market were enormous and basically unreported.

There were in fact few incentives for risk control for the banks. Provisions for some types of bad and doubtful debt are not tax deductible, not even expected losses on debts guaranteed by regional and federal authorities.

The worse institutional feature of the system is clearly the explicit lack of a bankruptcy code for banks. In many countries there is no need for such an explicit code: the law on the central bank leaves ample discretion of intervention to the monetary authorities. In Russia, banks were exempted by the general code and assigned to be subject to a subsequent law which was never prepared. This legal solution is the worse possible, as it ensures that no statute actually applies to the banks.

The powerful banking lobby (or better, the lobbyists of the individual banks) in the Duma were quite successful in allowing bankers to operate in a world of no possible penalty for default. To this date, no legislation has been enacted in this field, much as it lies at the foundation of the new concept for an Agency for Bank Restructuring (ARCO).

The problem would be mitigated if there had been other means to control risk-taking by banks. However, during the privatization process the major Russian banks became owners of large industrial assets. Banks tended to concentrate their holdings in a particular industry; undue risk concentration followed as a result. A majority of the top ten banks invested heavily in the resource-based industries; the fall in the raw materials prices in 1997-1998 thus led to a considerably deterioration of these investments.

Concerning risk-taking in lending, there are some legal restrictions on the loans to connected parties but their circumvention was quite widespread in FIGs. It is reported informally that Oneksim bank had not extended *any* loans to companies outside the circle of its controlled Interross group in 1998.
In effect, the banks were used as sources of equity, which made their position extremely risky.

Russian banks were been allowed to assume massive contingent liabilities in the form of forward contracts on the dollar with foreign investors in GKOs. These contracts allowed the banks to earn the huge interest differential between ruble and dollar asset with practically no investment until the collapse (Table 1). Thus, prior to the collapse, Russian banks accumulated dollar forward contract commitments many times their assets. Ratios of contingent liabilities of *20 times total assets* are simply extraordinary. While these are gross figures, in a system as weakly capitalized as Russia's, hedging exposure with minor banks does not really offer any protection, and are meaningless in a systemic crisis. Thus the difference between gross and net exposure is, so to say, only academic.

Yet another example of the soft constraints enjoyed by large groups is the emergence of massive tax arrears among large FIGs in Russia. It was quite profitable to run such arrears while at the same time investing the spared liquidity in GKO, which paradoxically paid a very high interest rate precisely because of the high default risk due to the tax nonpayment.
It appears that the political strength of these large groups overwhelmed any capacity by tax and bank regulatory authorities to contain their financial behavior.
In a normal country, shareholders and managers of the bankrupted banks would end up under investigation and the bank asset frozen. Yet it is clear that the large group banks did not run such a risk. In an extraordinary move, following the crisis the Central Bank allowed three of the major banks to merge. What is even more extraordinary, a new banking license was issued

in simply two days, quite extraordinary by any standards and certainly so by Russian criteria. The new Rosbank was formed in St Petersburg, receiving most of the best customer accounts from the old (bankrupt) banks. In most countries, this would be regarded as theft.

Another example is the failed attempt to close down SBS Agro, the second largest bank in terms of retail network. The Central Bank made a feeble attempt at seizing the bank. Within a few days of chaos, the inspectors left and the bank was left to its owners. For this bank as well as for other five favored institutions all deposit accounts were transferred to Sberbank.
A country where bankers are permitted to perform such machinations cannot seriously expect any more external funding. It seems also unlikely that Russians would deposit their funds in these new banks. Credibility in the banking system seems completely lost.

CONCLUSIONS

Against the background of the Russian crisis, it is useful to summarize the three principles drawn by international observers immersed in the Latin American experience on how banking crises ought to be addressed.
First, those who benefited from risk-taking should bear a large portion of restructuring costs (possibly over time). In the Russian context, this would imply that bank shareholders must be made to suffer the losses.
Second, troubled institutions should be quickly stopped from extending credit to high risk borrowers as well as taking speculative positions. This means that bankers should not be allowed to shift assets to newly created banks following default (whether as a result of the moratorium or not).
While it may even be too late, it is imperative for the second and third point that a bankruptcy law for financial institutions be passed as soon as possible, so that the new agency for bank restructuring may be empowered to a tough policy of bank closures (or in the best of circumstances, to sales to foreigners). Since Russian banks have lent little to the real economy and have few deposits, it is presumably less damaging to close down many of

them. In fact, closing down banks (or demand an equity re-capitalization by owners) is the sole possibility to encourage safer behavior in the future and restore value to the remaining solvent banks. While depositors should be at least partially protected, it is essential that managers and owners must be made to bear the pain.

Third, one must avoid the easy inflationary solution of inflating the losses away. There has to be a credible program of repayment for depositors funded with assets seized from insolvent banks.

Unfortunately, this seems a very challenging program for the much weakened Russian state.