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SIZE OF PUBLIC SECTOR IN THE RUSSIAN BANKING INDUSTRY

This paper addresses state participation in the financial sector. We take the example of the Russian banking industry to suggest criteria for a more accurate definition of public sector boundaries and an assessment of the actual scale of state presence in the national banking market.

Introduction

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

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

What is a state-owned bank? (Literature review and the suggested new approach)

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

La Porta, López-de-Silanes and Shleifer (2002) define a *state owned bank* as a bank with state share (both direct and indirect – with state-owned enterprises acting as a stockholder) of above 50%, or 20% if the state is the largest known shareholder. The criterion of at least 50% of federal, regional and/or municipal ownership is followed by absolute majority of authors, e.g. [Barth, Caprio, Levine, 2002; EBRD, 2006]. Iannotta, Nocera and Sironi (2007) consider a bank as government-owned if either national or local government is its ultimate owner, i.e. a holder of more than 24,9% of the bank's equity capital with no other single shareholder owning a larger

share.

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

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

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

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

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

We believe that constructing a more relevant definition of public sector is vital for accuracy of subsequent empirical research. The actual scale of state presence in a national banking system may differ substantially from the combined market shares of largest «official» state-owned banks. Ownership-based estimates might have a downward bias, i.e. they miss chunks of the industry that are not formally owned by the state. Thus we argue that, to draw a more realistic boundary of state presence in a country's banking, one must go beyond the analysis of banks' ownership type. Cor-

rect identification and classification also requires an analysis of other possible channels of control over banks that the state and its representatives can exercise through governance and otherwise. This is particularly relevant in the Russian context and in view of the institutional environment. This, unlike ownership type, remains the least examined aspect.

The estimated scale of the «bank-state network» in Russia

Estimates of the scale of state presence in the Russian banking industry vary broadly. Following Russian official statistical sources, Raiffeisen (2006) and Moody's (2007) argue that the state accounts for just about 35–40% of total assets. RosBusinessConsulting (2007) put the share of top state-owned banks at 43% of total banking assets. Vernikov (2007) estimated the scope of presence of the «broad state» in the banking industry to total some 45% as of the year-end 2005.

We based our enhanced empirical evaluation of state presence in the Russian banking industry on the analysis of various aspects of a bank-state interaction. Our sample included about 150 top Russian banks ranked by assets as of 01.01.2009. The analysis has revealed three potential channels of state participation: *ownership, governance and other forms of control*.

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

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

«indirectly state-governed banks».

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

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

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

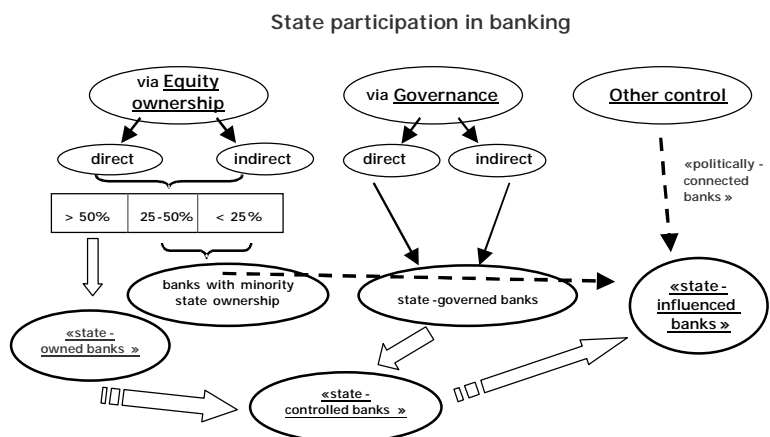


Fig. 1. Classification of state-related banks

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

majority stake in a bank is owned by state-owned enterprises. The second category that we defined as «state-controlled banks» includes, in addition to «state-owned banks», also banks with minority state share in equity but with identified state participation in governance, either direct or indirect. Finally, «state-owned banks» and «state-controlled banks» as well as all other banks that are neither majority-owned nor governed by the state but for which any of the above-mentioned criteria of being «politically-connected» applies form the broadest group of «state-influenced banks».

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

The ultimate market share of each group of banks measured as proportion in total banking assets in Russia is displayed in Fig. 2.

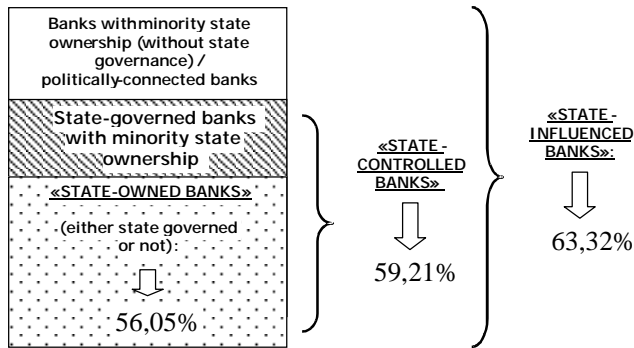


Fig. 2. Shares of banks with state participation* as a percentage of total assets by 01.01.2009

* Adjustment for the value of assets of VEB provides additional 2% to each overall asset share.

Source: authors' calculations and estimates.

As of 01.01.2009 we estimate that 63,3% of all banking assets were under decisive influence of the state. 10 largest state-controlled banks accounted for some

54,1% of total banking assets.

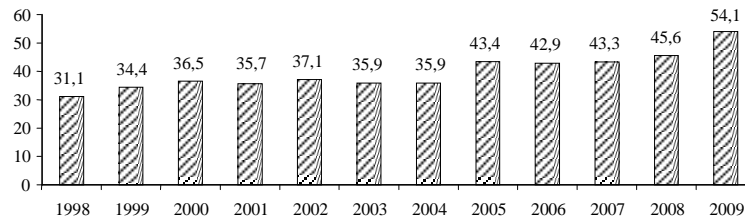


Fig. 3. Overall asset-share of 10 largest state-controlled banks*
(beginning of the year), %

* Sberbank, Gazprombank, VTB, Bank Moskvyy, Rosselkhozbank, Bank VTB 24, Bank VTB Severo-Zapad, Ak Bars, Transkreditbank, and Khanty-Mansiyskiy bank.

Source: [RosBusinessConsulting, 2007]; authors' calculations for year-2009.

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

- Bank Moskvyy, with direct equity share of Moscow government having decreased from 62,7% in 2004 to 46,5% at the beginning of 2009;
- VTB, with its announced sale of additional share issue in Russian Commercial Bank (Cyprus-located VTB subsidiary) to an entity controlled by the bank's top-management.

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

Conclusions and directions for further research

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

First, according to our own estimations based on the book value of banks in the sample, the actual scale of state presence is much higher than publicly declared 40% and falls within the range between 56% and 63% depending on the definition.

This proves the hypothesis about the presence of downward bias in official estimates.

Second, this paper provides evidence that the channels of state influence over banks are not limited to equity ownership. Governance and other methods of control and influence are employed as well. Hence an analysis of ownership structure alone would be incomplete. In the case of Russia the phenomenon of state banking requires a more extensive investigation due to high extent and institutional specificity of government intervention in the financial system.

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

We envisage two broad directions for future research. At macro level the impact of the extent of state presence on the depth of financial intermediation and stability of the banking sector will be analyzed. At micro level we intend to investigate behavior patterns as well as the operating efficiency and other performance indicators of Russian banks depending on their ownership structure.

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