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Speech by Bank of Russia Governor Elvira Nabiullina at the XV International Banking Forum on 14 September 2017 | Bank of Russia

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Good afternoon.

I am pleased to welcome all participants here today at the forum. These autumn meetings in Sochi have truly become an established date on the calendar. And this year, the Association is undergoing important developments, as Mr Aksakov has said.

Yesterday, the Association held an extraordinary meeting where it was decided that it would expand its scope of activities - both regional and major federal banks will be represented. This is a very important step not only for the Association itself but also in terms of banking sector development.

As we see it, it is also crucial that bona fide market participants, who envisage the long-term successful development of their business within competitive conditions - choose the Association as a platform for dialogue between big and small banks that will help to find the balance of interests between different players and be an effective platform for interaction between banks and the regulator. This should lend strong impetus to further development of competition in the banking sector.

In my speech today, I would like to focus on three points. The first is the Bank of Russia’s evaluation of the current state of the banking sector and the conclusions that we can all draw from the events occurring in recent months in the banking market. The second is the development of competition in the banking sector. And thirdly, on the back of your decision to develop the Association of Regional Banks (Russia Association), I would like to raise the issue of a potentially increased role for banking associations to play.

I will start with the current trends in the banking sector.

The main banking performance indicators are on the rise. In the first eight months of this year, banking sector assets increased by 4.5%; loans to the economy - by 3.5%; and loans to non-financial organisations - by 2.3%.

Personal loans increased by 7.0%. In principle, we can confidently talk about retail lending recovery and how its quality is stabilising due to banks switching to more conservative scoring models. The Bank of Russia will continue to pay particular attention to this segment.

It should be highlighted that the quality of the loan portfolio was successfully stabilised. However, the share of overdue corporate loans slightly increased (by a maximum of 0.1%), while overdue retail loans took a slight downturn. These changes are minimal and thus it is fair to say overdue loans have stabilised.
Household deposits continue to grow; over the last eight months they increased by 5.0% to almost 25 trillion rubles. The increase in deposits and funds in organisations’ accounts was more modest at 0.9%. That the share of household deposits in bank liabilities exceeded the share of corporate funding is typical for the banking sector. However, this trend ran contrary to this for a long time.

Profit continued to grow. The profit over the last eight months of 997 billion rubles has already surpassed the 2016 financial result. Profit is the source of capital growth. We believe that this is its primary use.

I will now broach the hottest topic - the events of this year. Mid-2017 saw us initially decide to appoint an interim administration at Yugra Bank and subsequently revoke its license.

This is one of the most unpleasant instances in a series of revocations due to irresponsible behaviour on the part of the bank owners. This corporate strategy involved the establishment of a ‘crony’ bank primarily intended to finance the bank owners’ own projects. Yugra’s management sidestepped restrictions imposed by the regulator and attracted funds from depositors. The quality of its loan portfolio was poor and the majority of collateral showed signs of having been overvalued.

The bailout plan proposed by the owners did not meet legislative requirements. Moreover, it presupposed long-term (ten-year) state subsidisation of what were essentially business projects run by a group of individuals across various sectors. The actions of the bank’s owners and management led to the inevitable licence revocation.

I sincerely hope that the banks present here today understand that they must take rigorous efforts to reduce business risks undertaken by owners and the management and refrain from deceiving the regulator by way of elaborate ownership schemes and informal arrangements.

Banking should be banking and nothing else, not investment. If bank owners want to go into another business, it must not be financed from funds in their own banks. Otherwise we end up with asymmetric distribution of those at the top and bottom: if the business is successful, the owners reap financial gains, while if the business fails, the Deposit Insurance Agency has to pay insurance indemnities to depositors. It goes without saying that we find this absolutely unacceptable.

I would now like to address the biggest event of the summer – the resolution of Otkritie Group.

A lot of people ask why Yugra had its licence revoked while Otkritie was put into resolution.

First, Yugra, unlike Otkritie, is not a systemically important bank. Otkritie is one of the largest banks in the country. Yugra was in fact unintegrated into the financial system and had weak links to other financial institutions, whereas the Otkritie episode had an impact on a number of banks and also on pension funds and insurance organisations.

Second, Yugra did not have a business model that, as I already mentioned, could have become viable even with capitalisation support. Theirs was a model designed to attract funds from the general public and finance business projects linked to the owner. Despite all its flaws and the risks involved in its business model, Otkritie can be ‘cured’, ‘repaired’ and put a path of further development.

Nevertheless, Otkritie business oversights led it to being unable to independently maintain its financial stability. Thus, the Bank of Russia was forced to intervene.

At the end of August, we decided to take action to recover Otkritie’s financial stability. The new financial recovery mechanism was used for the first time: capital from the Banking Sector Consolidation Fund was injected directly to Otkritie.

This mechanism makes it possible to solve problems even in big banks without incurring financial stability risks. We can now state that Otkritie’s reorganisation had a minimal negative impact on the financial
system: there is no deposit outflow from other banks, and there is a slight increase in bond yield by 100-150 basis points. However, it does not have systemic risks, and the stock market hardly reacted at all.

Therefore, the bank’s issues did not escalate into a systemic problem. However, we need to draw conclusions from this and amend policy so as to minimise the probability of such cases recurring in the future.

What provoked the bank’s problems? I would like to reiterate the underlying cause – it is vital that we all learn lessons together. The bank’s strategy involved exceedingly risky, constant expansion and its business model was based on large-scale, risky operations. Furthermore, the bank did not pay enough attention to risk management. I would like to point out that three years ago, before the bank became the turnaround manager of TRUST Bank; it held a position similar to a number of other big banks. TRUST’s reorganisation was a serious, complex project but if it had been the only complex and risky project the bank faced, it probably would have been able to get through it.

However, the further expansion and a lot of other risky deals made the bank vulnerable to risks. Ultimately, these strategic projects caused problems so serious the Bank of Russia had to intervene.

I would highlight the purchase of Rosgosstrakh as one of those risky projects. It was practically forced upon them because the bank was a major creditor of the insurer. The bank often operated with focus on short-term benefits without grasping the long-term consequences.

We observed this behaviour in the widely-discussed purchase of Russia-30 Eurobonds in order to engage in currency repo transactions with the Bank of Russia. In general, the operation did not worsen Otkritie’s financial performance and, after seeing that the securities were all on the balance sheet held by one participant, we reduced the limits and raised the rates in 2015. However, the worrying thing that should be a lesson for the entire banking sector: Otkritie’s balance sheet had these securities recorded at an overvalued price, allowing them to exaggerate the bank’s financial standing. The market price was manipulated.

Certainly, we understand that our bond market is not deep enough and certain market players still have such opportunities – carrying out multiple transactions on the stock exchange while making it appear to be a market transaction. But for us as a regulator it is crucial that they do not lead to the undervaluation of capital. Therefore, as part of the work to increase risk control, which I will now go into in more detail, we can demand that additional reserves are created in cases where a bank’s balance sheet is almost entirely concentrated on a particular security – as this creates additional risks. I request that banks take this into account in their operations.

The bank carried out a lot of its operations solely for opportunistic reasons without conducting a full risk analysis, which was the clear driving force behind this regrettable outcome.

Otkritie’s recovery process, as we have said, will take several months. Once this process is complete, the bank will have capitalisation support, and the Otkritie financial group will coordinate with the Bank of Russia its strategy for stable growth.

The Chairman of the Board will only be appointed to complete the work of the interim administration of the Banking Sector Consolidation Fund’s management company. Nonetheless, I would like to announce today that Mikhail Zadornov, present here today, has agreed to take up this position in the bank at our invitation. I believe that this announcement will add certainty for both the clients and counterparties of the bank.

There is a question that we are often asked: does the new reorganisation model pose the risk of nationalising the banking sector? No, it does not. It is our plan to swiftly straighten out financial institutions that receive funds from the Banking Sector Consolidation Fund and, if necessary, restructure them. This involves merging them and introducing them to the market, not necessarily by searching for a
strategic investor but by selling them in parts, piecemeal, or holding an IPO. We do not seek to increase the state’s share in the banking sector. On the contrary, our goal is to have healthy and successful private banks with viable and profitable business models operating in the Russian market.

Moving on from Otkritie and its assumed risks, which ultimately resulted in reorganisation, let us turn to the issue of risk management in banks as a whole. This is an issue that we plan to address systematically.

By 1 November this year, all banks with assets above 500 billion rubles must submit special reporting on risk management systems and capital adequacy evaluation procedures to the Bank of Russia. By the end of the year, the Bank of Russia will fully assess the quality of risk management systems and evaluate the capital adequacy of the largest credit institutions.

The Bank of Russia will assess the quality of credit institutions' procedures, their risk management strategies and capital planning methods, the amount of capital that banks need to cover all acquired and potential risks, the extent of which should be determined by stress testing.

If we discover that the amount of a bank’s available capital is insufficient to cover assumed risks or the degree and quality of risk management procedures is insufficient, possibly causing the bank to face a shortage of capital in the long term, then this organisation will be subject to specific, tighter capital requirements.

This is a fundamentally new approach to supervision. In other words, the Bank of Russia will analyse both individual transactions and decisions taken by banks’ management and will comprehensively evaluate the quality of banks’ risk management and internal controls. Supervisory requirements will not be applied ex post facto (after violations have been detected, for example, reserve requirements), but as a preventive measure – if the Bank of Russia ascertains that a credit institution has low-quality risk management.

The Bank of Russia may also apply other serious supervisory response measures, for example, restricting and prohibiting certain transactions when credit institutions violate their tighter, specifically established, standards.

As I already stated, this year we are embarking on this kind of supervisory work with the major banks i.e. those with assets of more than 500 billion rubles. All other credit institutions will be assessed next year (2018).

What I just said is part of our ongoing efforts to improve supervision and regulation. However, there is another side to the problem: supervision should not and will not replace management or bank owners; it should not involve decision-making regarding specific operations, nor will it be responsible for them.

In this respect, we believe there is merit in setting financial incentives in order to reduce the level of risk taken on by bank managers. Namely, the regulator may decide to postpone payment of bonuses and dividends to those banks undergoing problems until these are rectified. Ultimately, if the way bank managers run their business precipitates the bank leaving the market or being reorganised using state money, this bank management can hardly be deemed effective and worthy of bonuses.

Incidentally, specifically pertaining to Otkritie, we are planning to challenge the payment of 2017 H1 executive bonuses in court. The decision to pay increased bonuses and dividends a month and a half before license revocation or reorganisation may be regarded as asset withdrawal. Therefore, we believe that it is justified to restrict payment of bonuses and dividends in banks facing problems and we consider it necessary to raise this issue.

I will now broach the second topic – in our view, one of the key topics – on developing competition in the financial market. A competitive environment is a necessary condition for the effective operation and development of the financial market. Therefore, the Bank of Russia’s strategic objectives include competition in the financial market. It goes without saying that we will continue to closely cooperate with
the Federal Antimonopoly Service as we do now on this objective. I believe that the Association can contribute to this field, especially given that the Association has been a long-standing, vocal proponent of developing competition.

We aim to create a stable and transparent competitive environment. This means fair price-setting, markets with high allocative efficiency, consumer protection and satisfied customers and investors in financial institutions.

I would like to share some of the findings from an empirical study of banking sector competition that we have conducted.

We note a pronounced trend in the geographical concentration of credit institutions' head offices: they are found exclusively in Moscow, not even in large cities (with populations over a million). Over 50% of Russian banks have their head offices in Moscow. There is no comparable financial centre in Russia; even St. Petersburg’s share is below 5%.

Despite the fact that quantitative competition indicators are at an acceptable level in the Moscow region, the quality of competition is not as high as you would think. While there are a large number of banks operating in the Moscow region, only two players have real market power. This is testament to the fact that even the Moscow market needs attention and efforts to improve the competitive environment. Competition is not only measured by the number of players in a given market.

However, there are a number of regions that are ‘economic deserts’, that is, mainly depressed regions with very few banks and bank offices.

There are certainly a few regions with an advanced competitive environment. For example, we are in one such region right now – the Krasnodar Territory. It has a relatively large number of banks, both federal and regional, and its market players are competitive in terms of market power. This means consumers have access to a wide range of financial instruments. In this way, such better conditions should, in turn, ensure the development of small and medium-sized businesses, which is one of the priorities behind the banking sector’s development.

We can draw another conclusion from the empirical data of the study: the policy of cleaning up the banking sector does decrease competition. Ridding the market of weak and unscrupulous players increases the number of market participants with market power. It also eliminates business models that law-abiding business cannot compete with, thus creating the prerequisites for attracting quality capital to the banking sector.

What measures are we taking and consider necessary to develop competition in the banking sector?

The first and most obvious measure is completing the process of cleaning up the banking system and improving the efficacy of supervision. This involves developing behavioural supervision. Behavioural supervision is, on the whole, an innovation in the Bank of Russia’s activities. It is aimed at establishing conditions that oblige financial market participants to provide the consumer with comprehensive information. Such conditions when they are truly forced to provide comprehensive information about the product and offer consumers the products they truly need, to refrain from imposing products on consumers that may pose them risks. The aim of behavioural supervision is to both increase consumer satisfaction in the financial sector and help consumers make the right competitive choice and select the best offer.

The second measure is proportional regulation of the banking system, a niche for players with different business models and different size businesses. The experiences of individual regions speak volumes about the fact that various players of varying sizes find their market niches in an effective competitive environment and, ultimately, the regional economy achieves a greater volume of financial resources.
Proportional regulation is one of the key factors in encouraging and lending to small and medium-sized businesses. We expect that this type of customer will gain greater access to financial resources, and banking products will further adapt to the needs of enterprises, especially small and medium-sized businesses.

I would like to say a few words about to what extent banks are prepared to transfer to a new type of licence. We believe that the transition to proportional regulation should and will be sufficiently smooth, which is our guiding principle. As of 1 September, 222 credit institutions had less than 1 billion rubles in capital.

Furthermore, for almost all of these banks, the total volume of transactions considered extra-legal for banks with a basic licence is within 10% of their assets. There are only eight banks where this type of operation accounts for over 30% of their assets. In other words, the transition to proportional regulation will not bring about disruption in banks' business models.

According to our estimates, the capital held by the majority of banks, categorised as banks with a basic licence, stands at somewhere between 300 and 500 million rubles (of the banks with capital of less than 1 billion rubles, 60% fall within this figure). 13.5% of banks with capital of less than 1 billion rubles have in excess of 700 million rubles. This means that these banks can select a capital growth strategy and achieve the level needed for a universal licence.

The third factor affecting competition is digital technology. This includes increasing financial accessibility, reducing the cost of data processing and sales channels, increasing consumer satisfaction and entering new markets. We now clearly understand that digitalisation is a significant trend and one that will only continue to expand, making the Russian financial market increasingly extraterritorial and, subsequently, competitive. The banks with advanced technology platforms and business models focusing on the use of artificial intelligence, with highly automated business processes and remote customer service with rapid response times will have a competitive advantage. And vice versa. Banks that come late to the digital revolution risk losing their clients and, consequently, their income. I will not go into fintech or new technologies right now. In October we will meet here in Sochi again at the Finopolis forum to hold in-depth discussion about new technologies in the financial sector, their advantages and the risk management involved.

The fourth measure for developing competition is standardising products and introducing so-called cooling periods so that the client or consumer has a chance to think things through, developing financial advisory instruments (based on up-to-date platforms), and ensuring that financial products are clear and comprehensible to consumers so they can compare products and choose the right one.

A further, specific but important question that has been raised at almost all of our meetings is competition between banks for funds from state companies and state corporations. Given that we are soon going to see a fully established rating industry, it will soon be necessary to switch to the practice of using credit ratings as criteria for liquidity access, giving up on bank size as a criterion. We are currently discussing the timeframe for such a transition with the Ministry of Finance. Our position is unchanged: the bank’s size is not a criterion for its reliability, so we must transfer to the use of criteria that really indicate its reliability.

And the third and final topic I would like to briefly address is the role of banking associations in the development of the financial industry. This issue is closely linked to developing competition in the financial market because should the market fail to promote fair competition and forgo involvement in the efforts to eradicate unscrupulous practices, the quality of competition will just never improve.

We are truly optimistic when we look at the steps the Association is taking to bring about its own institutional development. Unlike other sectors of the financial market, the banking sector has no practice of self-regulation. We have to discuss its prospective development and introduction in due course. Nevertheless, we can already see that the Association is ready to take on more functions.
In this vein, we can see a lot of potential for developing relations between the Bank of Russia and banking associations. Let me elaborate.

1. We can see that associations have the capacity to combine the forces of various participants, participants of different sizes, in order to share costs when working towards certain goals, or when executing projects that may be costly for a sole participant. This involves the creation of information databases, staff training, marketing, ‘know your customer’ compliance procedures, and cloud computing and reporting. It is clear that this is the field where associations could make an impact.

2. Assessing the regulatory impact of the Bank of Russia’s initiatives in financial regulation. We are keenly interested in this effort. We maintain constant contact, publishing all our draft regulations on our website. We receive comments and hold discussions but, certainly, we would welcome a more formal assessment of the regulatory impact of our initiatives. Just like at the initiative introduction stage, we are also interested in hearing the banking community’s objective evaluation of the potential impact of such regulatory initiatives. We believe this is important for developing both the competitive environment and, in general, furthering the efficacy of banking regulation and our interaction.

3. The third point is, certainly, consolidating and sharing banks’ best practices and recommendations, among association members, on how they are implemented.

We expect that the Association will commit to formulating banking sector standards as self-regulating organisations do. We are pleased to see the beginning of these efforts and hope they will continue.

To conclude, I would like to once again congratulate the Association on selecting their new leadership and outlining their new development model. I have no doubt that this step will further the development of healthy, stable and transparent banking. I wish you every success in business and productive interaction at the forum.

Thank you.