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THE EXPERIENCE OF THE RESOLUTION REGIME DURING THE CRISIS IN RUSSIA

1. INTRODUCTION

Russia is one of the countries that have made a full use of fast and effective resolution regime during the crisis. Until the peak of the recent crisis, we had tried to preserve a purely market approach towards insolvency issues in banking sector. The authority of the Deposit Insurance Agency to resolve financially troubled banks appeared in the law as late as October 2008. Before the changes in the Law, difficulties of six banks were resolved on case-by-case basis. Then, it became obvious that systemic stability in banking sector needs to be supported by a resolution function of special institution. The initial decision to carry out resolution function until 2011 is being currently reconsidered and the Law will be preserved on a permanent basis.

In November and December 2008, effective and fast implementation of the Law in 18 cases helped to preserve trust not only to these specific institutions. Fast resolution of bad banks is of a higher importance for the trust of creditors in the rest of the banks, especially in respect to smaller institutions. At the same time we felt that resolution regime may not be the basic and only way to overcome difficulties in financial sector during the crisis. The amount of public funds used for resolution

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was about 20 percent of the total amount of assistance to banks by different means. But as a supporting measure its significance is hard to overestimate.

2. REMARKS ON THE MAIN REASON FOR FINANCIAL DIFFICULTIES OF BANKS IN RUSSIA

In Russia, financial rehabilitation is considered to be an anti-crisis tool. At the same time its practical implementation discovered, that the reasons for financial difficulties of the resolved banks in most of the cases have very few links to the macroeconomics of the crisis. We had only one serious influence of shock at stock exchange at financial standing of a bank. For the rest of the resolved banks, the financial difficulties were the result of mismanagement or fraud. In most cases mismanagement was caused by underestimation of concentration of credit risks, particularly for the business of owners of banks. Heavy investments in real estate are a typical example. Before the crisis, real estate was an attractive asset with dynamic price increase.

Unfortunately for some of the banks, financial fraud was the main reason of difficulties. In the recent case – Bank of Moscow – former managers withdrew at least \$5 bn. These funds can be returned to the bank only by means of criminal prosecutions or other legal actions.

Comparing different ways of financial rehabilitation, it is necessary to stress the importance of the private sector. We tried to make full use of finding new private owners to resolved banks. Long deposits from the Deposit Insurance Agency served for them as enough stimulus to motivate them to financial rehabilitation.

In most cases we used this method instead of investments in capital of the bank. We feel more comfortable when managerial duties in a bank during its financial rehabilitation are not carried out by government authorities. We considered direct investment in capital by the Deposit Insurance Agency as the last and undesirable possibility. After investing funds in the capital of 7 banks 3 of them had already been merged to others.

3. THE NEED TO PRESERVE MARKET DISCIPLINE IN THE PROCESS OF FINANCIAL REHABILITATION

Our experience shows the need to preserve market discipline in the process of financial rehabilitation. All financial obligations of private investors that attract government funds for resolution of banks should be, first, guaranteed by collateral and, second, made public. These are the means of making private investors accountable for the results of their business in banking resolution area.

In our case the participation of the private sector in the financial rehabilitation of banks does not receive any public resistance or criticism. It was an amazing fact for our country that a massive support of the banking sector did not result in a wave of embarrassed bankers. The recent case of the Bank of Moscow is an exemption. The reasons of \$5 bn loss are now being studied by different authorities.

Another important issue for market discipline in the resolution process are the relations of new investors and the Deposit Insurance Agency with former owners and managers of the resolved banks. Needless to say, in any case of financial fraud respective persons should be properly prosecuted. But the results of financial rehabilitation can be more effective if the former stakeholders cooperate with the new owners. Under these terms prosecution may not be needed. The current losses in the value of the assets may be overcome in the future if new investors get control over temporarily illiquid investments made by former managers.

4. GOVERNMENT FUNDS AND CENTRAL BANK LOANS FOR THE PURPOSE OF RESOLUTION PROCESS

The experience of our country shows the possibility of effective use of government funds or loans from the Central Bank for the purpose of resolution process in the banking sector. Its total amount was about 1.2 percent of GDP for 2008. In this respect we cannot ignore the discussion about the use of public funds for resolution purposes. Unfortunately, problems in banks appear to be large when they are disclosed. It is very difficult to make the industry accumulate enough funds to cover the problems of any of the banks that should be rehabilitated taking into account its systemic importance. In Russia, the abovementioned 1.2 percent of GDP was an equivalent of 14 percent of capital of all banks. Total funding at the expense of the private sector is hard to imagine without significant costs that would damage profitability and investment attractiveness of the rest of financially solvent banks. Thus, the role of government funding, in our opinion, is difficult to replace without more undesirable consequences for systemic stability. Moreover, the use of loans of Central Bank for the purpose of resolution of banks appears to be fast and effective. We also did not find any influence of these operations on inflation.

Market discipline during resolution regime should be preserved by other means than prohibition of using public funds. The resolution authority may have an obligation to contribute a full disclosure of the reasons for financial difficulties and provide a clear way of returning public funds used for resolution. At the same time the role of the private sector should have an obvious priority over government participation in the management of resolved banks.

5. ISSUES OF SYSTEMICALLY IMPORTANT BANKS

We think that the concept of systemically important banks should be developed on a national level. During the crisis and up to nowadays we have not yet made such announcements. But in practice, before each case of financial rehabilitation of an individual bank, we prepare the conclusion of systemic importance for ourselves and it is also obligatory.

In Russia, before making decision to disclose the list of systemically important banks, we would try to solve two difficulties. First, a list of banks should not give them any competitive advantage. That is why all banks that are recognized as systemically important should have clear duties and may have additional responsibilities. Second, a list of systemically important banks should not be a closed list for the possibility of resolution support, especially in crisis and should not be a mandate for resolution in any case.

We hope that our experience in the implementation of resolution tools achieved its aim to preserve trust in banks. We are looking forward to future developments in banking and hope that in spite of all considerations the resolution function will not be used as often as three years ago.