

# Credit Boom in Russia despite Global Woes – Driving Forces and Risks

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After the crisis slump of 2008–2009, real year-on-year credit growth in Russia turned into a boom in 2011, with double-digit growth climaxing at +24% in mid-2012, before slowing down again. The ratio of domestic credit to GDP is, however, not high compared to peer countries. Retail lending, while still modest, developed most dynamically. Yet domestic deposits rose even more swiftly than domestic loans, and the loan-to-deposit ratio slightly declined. The driving forces of the Russian credit boom are (a) on the demand side: the oil price recovery (from early 2009 to early 2012) and relatively brisk domestic demand growth, partly driven by generous public salary and pension adjustments, and financial deepening in the highly profitable retail sector; (b) on the supply side: the “deposit boom,” increasing profits of resource enterprises, and official liquidity assistance. Risks related to the credit boom include surging unsecured consumer loans (+44% in real terms in 2012, thus accounting for 60% of household credit), widespread connected lending, elevated levels of nonperforming loans (NPLs), and modest provisioning. The Central Bank of the Russian Federation (CBR) reacted to the (consumer) credit boom by moral suasion and some prudential measures. The deceleration of lending growth since mid-2012 was probably largely due to the general economic slowdown. Shock-absorbing factors are considerable, including growing deposits as well as satisfactory profitability and the banking sector’s net external creditor position, but some factors, such as capital adequacy and loan loss provisions, have been eroding recently. In the current economic situation, the most probable outlook for the Russian lending boom is a soft landing.

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This study examines the driving forces and risks of the current swift lending growth in Russia. In an environment of global uncertainties and economic stagnation or feeble growth in Europe, only few Central, Eastern and Southeastern European (CESEE) economies – for various reasons – witness strong credit expansion, e.g. Turkey, Moldova, Armenia, Azerbaijan, Mongolia and Russia. This study links up with an article by Barisitz and Lahnsteiner (2010) on the Russian banking sector. Following the introduction, section 1 provides a succinct overview of salient features of the Russian banking sector’s development since 2010 (the previous period

is covered by the publication just mentioned). Based on a review of topical literature and up-to-date information and statistics, section 2 presents probable driving forces of the credit boom. These driving forces may be structured in demand-side and supply-side factors. Section 3 identifies risks generated by or accompanying the credit boom. The policy reactions of the Central Bank of the Russian Federation (CBR, Bank of Russia) as well as reasons for the most recent slowdown of lending growth are dealt with in section 4. Section 5 assesses other shock-absorbing factors. Finally, an outlook sketches likely near-term developments and scenarios.

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## 1 Outline of the Banking Sector's Development and Credit Growth since Late 2010

After the crisis slump of 2008–2009, real credit<sup>2</sup> growth in Russia turned positive (year on year) in the fall of 2010, producing a modest expansion of 3.5% at end-2010. Crisis-related state support to banks was successively withdrawn: Improved liquidity enabled banks to repay uncollateralized CBR refinancing ahead of schedule (in 2009 and early 2010), relaxed loan classification rules were discontinued for new loans in mid-2010, and CBR guarantees on inter-bank lending were unwound by the end of that year (IMF, 2011, p. 8). As chart 1 illustrates, in 2011, lending growth

accelerated substantially (+21.0% at end-2011) and thus fueled economic growth. Credit growth reached its climax in mid-2012 (+24.0%), before receding to a still brisk 11.3% rate of increase at end-September 2013. The ratio of credit to GDP rose from about 40% in mid-2010 to 46% in mid-2013 (table 1).<sup>3</sup>

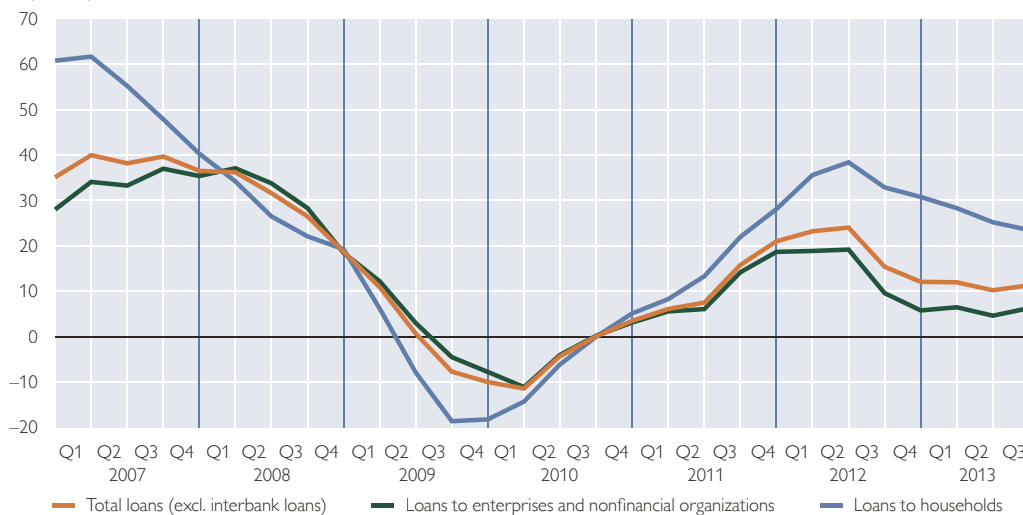
While in this study we do not define a “credit boom” in statistical terms, the strong credit growth Russia has witnessed in recent years can be regarded as unusual or extraordinary in a post-global financial crisis framework and therefore appears worth investigating in more detail.<sup>4</sup>

Loans to households, including mortgage loans, surged. At its apex in

Chart 1

### Russia: Real Credit Growth from the Pre-Crisis to the Post-Crisis Boom

%, year on year, CPI deflated



Source: Bank of Russia.

<sup>2</sup> In the following, credit is understood to comprise commercial bank loans including loans to government agencies and nonresidents, but excluding loans to other credit institutions. Credit growth is measured in real terms (deflated by the year-on-year CPI) because Russian inflation is relatively high and variable (between 4% and 10% in the observation period).

<sup>3</sup> This level remains relatively low in an international comparison, though.

<sup>4</sup> In contrast, if we look at longer-term developments in the Russian banking sector, namely as from the 1990s, very high growth rates (e.g. above 20% in real terms year on year) are by no means extraordinary (see also pre-2008 years in chart 1). Thus, as pointed out by Jafarov (2013, p. 28), between 2001 and 2008, average annual credit growth amounted to 28% in real terms in Russia.

mid-2012, retail credit expansion exceeded 38% (in real terms, year on year).<sup>5</sup> At end-September 2013, loans to households were still over 23% larger than they had been a year ago. Within retail loans, uncollateralized consumer credits<sup>6</sup> rose most dynamically (+54% in mid-2012, +38% at end-March 2013). Loans to enterprises also boomed, but less spectacularly (mid-2012: +19%), and they decelerated much more swiftly (end-June 2013: +4.6%), before slightly regaining momentum (end-September: +6.3%). Therefore, while the credit boom to households is far from over, real loan growth to enterprises currently does not much exceed overall economic growth. In absolute terms, though, enterprise loans contributed about 60% more than household loans to Russian credit expansion from 2010 to 2013. The share of retail loans in total loans in the last three years rose several percentage points to 29%; mortgage loans continue to make up about a quarter of household loans. Neither of the last two ratios is elevated in comparison to peer countries.<sup>7</sup> The share of foreign currency loans in total loans decreased from 23% in mid-2010 to 17% at end-September 2013. Foreign currency loans still make up over one-fifth of enterprise loans, but play an insignificant role in retail lending (about 3%).

From mid-2010 to end-September 2013, total deposits rose even a bit more swiftly than total loans, although

the expansion was somewhat smoother, with growth rates fluctuating a bit less. Deposit expansion peaked in 2011 (+20.3%), while household deposits had grown most in 2010 (+20.6%). The ratio of deposits to GDP increased from 33% to 40% (mid-2013). There is no doubt that credits as well as deposits have boomed in Russia in recent years. The deposit boom has been driven primarily by households, but also by enterprises, with both largely maintaining their shares in total deposits (about 60% versus 35%). Accordingly, the loan-to-deposit ratio somewhat *declined* from 122% in mid-2010 to 119% three years and three months later. Foreign currency-denominated deposits decreased from slightly below 30% of total deposits in early 2010 to around a quarter in 2011, then stayed at about this level. Margins between average retail deposit rates and enterprise lending rates slightly narrowed to about 4% over the observation period.

Nonperforming loans (NPLs) in their narrow as well as broad definition<sup>8</sup> gradually declined from 9.5% and 20.0% of total loans in mid-2010 to 6.6% and 15.1% at end-September 2013 (see also chart 3, which, however, identifies the NPL threshold only as the broad definition, which is explained further below). Despite this decline, loan loss provisions have not quite covered NPLs in their narrow definition in recent months. Banks' liabilities to the CBR substantially increased from about

<sup>5</sup> Thus the retail credit growth rate almost equaled pre-crisis highs (2007: +41.0%).

<sup>6</sup> For a more detailed description and discussion of uncollateralized or unsecured consumer credits, see subsection 3.1.

<sup>7</sup> See also the comparison of ratios of retail and mortgage loans to GDP for Russia and peer countries under subsection 2.1.3.

<sup>8</sup> The narrow definition of NPLs chosen here corresponds to the share of problem loans (quality category IV) and bad loans (category V) in total loans (in this case including interbank loans), while the broad definition of NPLs reflects the share of doubtful (category III), problem (category IV) and bad loans (category V) in total loans (including interbank loans), as stipulated in CBR regulation no. 254 (Central Bank of the Russian Federation, 2004).

1% of their total liabilities in late 2010 to around 4%–6% from mid-2012. This probably reflected stepped-up liquidity assistance to the sector in a situation when lending had started to boom and some liquidity bottlenecks had made themselves felt. At the same time, banks apparently drew down their claims on the CBR from about 5% to 3% of total assets. As can be expected during a credit boom, capital adequacy gradually declined from a relatively high level (18.9% in mid-2010) to 13.4% at end-September 2013 (table 1).<sup>9</sup> The substantial decline pushed this indicator to a level somewhat lower than that reached during the boom period preceding the crisis of 2008–2009. Profitability slowly recovered from the crisis, may have reached a climax in the second half of 2012 (end-September 2012: ROE: 18.3%), and has since then slightly declined (end-September 2013: ROE: 16.1%). Russian banks' profitability is distinctly lower than what had been attained before the crisis, but higher than in most other CESEE countries.

## 2 Driving Forces of the Russian Credit Boom

The forces that triggered the strong credit expansion in Russia may be broken down into several demand-side and supply-side factors.

### 2.1 Demand-Side Factors

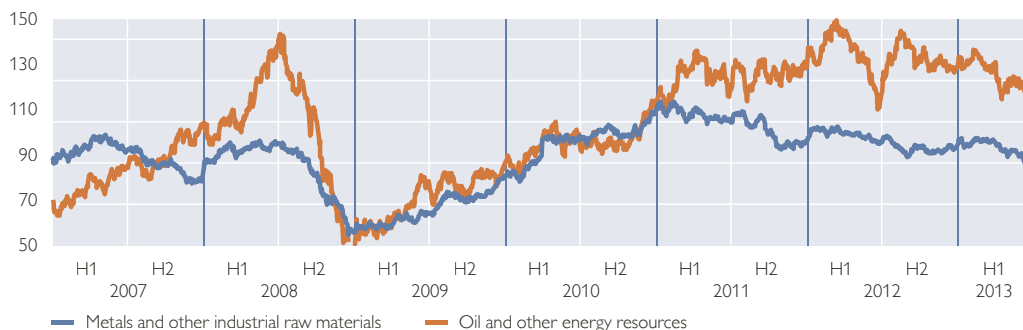
#### 2.1.1 Oil Price Recovery and Relatively Brisk Economic Growth (until Recently)

Prices of oil and gas as well as of metals and other raw materials, which are Russia's main export goods, augmented (again) in recent years (see chart 2), which in turn caused resource enterprise profits and profit expectations to rise and allowed for sustained increases in household incomes as well as for expectations of rising household incomes. In an environment of low unemployment,<sup>10</sup> these economic trickle-down effects contributed to relatively brisk consumption and an investment-fueled economic recovery, which helped reignite and stimulate credit growth in Russia.

Chart 2

### World Market Prices for Oil, Metals and Other Raw Materials

HWWI "Euroland" index, 2010=100, euro based



Source: HWWI.

<sup>9</sup> The CBR's mandatory capital adequacy minimum is 10%.

<sup>10</sup> In September 2013, the Russian jobless rate (ILO definition) was 5.3%.

### 2.1.2 Generous Public Sector Salary and Pension Adjustments

The authorities seem to have played a major role in driving income increases in recent years. Benefiting from the tide of rising energy prices, the government repeatedly raised public sector salaries as well as public pensions: Cases in point are strong pension increases in the last quarter of 2009, smaller public sector salary raises in the last quarter of 2010 followed by heftier ratcheting-up in the second half of 2011, and smaller upward adjustments of both public salaries and pensions in the first half of 2012 (Korhonen, forthcoming: table on wages (statistically recorded), pensions, prices). When taking into account the timing of the most recent elections (parliamentary: December 2011, presidential: March 2012), the political cycle could possibly be of explanatory relevance for the lending boom.

### 2.1.3 Financial Deepening, Structural Catching-Up and Attractiveness of Highly Profitable Retail Lending

Financial deepening also plays a role: Supported by a wave of Russian consumer purchases of durable goods, retail lending appears to be on a structural catching-up path vis-à-vis peer countries (with approximately the same level of per capita GDP). Whereas total loans to households in 2012 corresponded to 12.4% of GDP in Russia, in Romania, for instance, a comparable level of this ratio had already been reached in 2006, and in Bulgaria a year earlier. Mortgage loans expanded in Russia from almost zero a couple of

years ago, and, in 2012, made up slightly more than 3% of GDP, compared with no less than 20% that same year in Hungary, and 19% in Croatia. As retail lending has so far been very lucrative,<sup>11</sup> many credit institutions re-directed resources to this activity to raise their profitability. But lending to enterprises has also continued to benefit from potential for expansion. Accordingly, low levels of personal and corporate indebtedness have created room for credit demand in Russia.<sup>12</sup>

### 2.1.4 Partial Funding Switch of Corporate Sector

As to corporate lending, whose contribution to the credit boom in absolute terms clearly exceeded that of retail lending, the heightened risk aversion in international capital markets following the 2008–2009 downturn prompted the corporate sector to partially, and temporarily, switch from external to domestic bank funding (IMF, 2012, p. 6; Oura, 2012, p. 37).

## 2.2 Supply-Side Factors

### 2.2.1 “Deposit Boom,” Increasing Profits and Generous Official Liquidity Assistance

Russian banks’ balance sheets benefited from strong deposit growth due to repeated sizeable income hikes and, at least in the second half of 2011 and the first half of 2012, increases in nominal and/or real deposit rates. The four quarters reflecting the strongest lending growth (from mid-2011 to mid-2012) also account for the most dynamic deposit growth, which under-

<sup>11</sup> According to the CBR, banks above a minimum size and specializing in retail lending (credit volume > RUB 5 billion, credit to households/assets > 40%, interest income from consumer loans/interest income > 50%) feature a much higher return on assets (end-March 2013: 5.7%) than the sector on average (2.1%) (CBR, 2013b, p. 37).

<sup>12</sup> Due to the predominant focus on credit and lending, financial deepening is here understood primarily as a demand-side factor; however, financial deepening is obviously also related to the rising number of bank accounts and thus can equally be perceived as a supply-side factor (see also “deposit boom” below).

Table 1

**Russia: Selected Banking Sector Stability Indicators (2009–13)**

	End-2009	End-2010	End-2011	End-2012	September 30, 2013
<b>Credit risk</b>	%				
Total loans (excl. interbank loans, ratio to GDP) <sup>1</sup>	42.1	39.7	42.4	45.1	46.1 (end-June)
Annual real growth	-10.0	+3.5	+21.0	+12.1	+11.3
Loans to households (share in total loans)	21.9	22.1	23.5	27.4	29.5
Annual real growth	-18.2	+5.1	+28.1	+30.8	+23.5
Mortgage loans (share in loans to households)	28.3	27.6	26.6	25.8	25.8 (end-May)
Nonperforming loans (share in total loans incl. interbank loans, narrow definition) <sup>2</sup>	9.7	8.3	6.8	6.3	6.6
Nonperforming loans (share in total loans, incl. interbank loans, broader definition) <sup>3</sup>	19.5	19.7	17.2	15.4	15.1
Ratio of large credit risks to total banking sector assets <sup>4</sup>	23.1	25.8	28.8	25.8	25.2 (end-May)
<b>Market and exchange rate risk</b>					
Foreign currency loans (share in total loans)	23.4	21.8	20.2	16.3	16.5
Foreign currency loans to households (share in loans to households)	11.3	8.8	5.8	3.2	2.7
Foreign currency deposits (share in total deposits)	32.8	27.7	24.9	25.2	26.3
Deposit rate, households <sup>5</sup>	8.6	6.0	4.4	5.5	6.0 (end-May)
Deposit rate, enterprises <sup>5</sup>	..	..	3.6	5.3	5.6 (end-May)
Lending rate, households <sup>5</sup>	..	..	23.8	24.5	24.6 (end-May)
Lending rate, enterprises <sup>6</sup>	15.3	10.8	8.5	9.1	9.7 (end-May)
<b>Liquidity risk</b>					
Total deposits (excl. interbank deposits, ratio to GDP) <sup>7</sup>	33.4	34.2	36.3	38.1	39.7 (end-June)
Annual real growth	+9.7	+12.5	+20.3	+10.6	+15.2
Loan-to-deposit ratio	126.2	116.1	116.8	118.3	118.8
Ratio of highly liquid assets to total assets	13.3	13.5	11.8	11.1	11.7 (end-June)
Banks' external assets (share in total assets) <sup>8</sup>	14.2	13.4	14.3	13.0	13.7
Banks' external liabilities (share in total liabilities) <sup>9</sup>	11.9	11.7	11.1	10.8	10.5
Liabilities to the CBR (share in banks' total liabilities) <sup>10</sup>	4.8	1.0	2.9	5.4	5.8
<b>Profitability</b>					
Return on assets	0.7	1.9	2.4	2.3	2.0
Return on equity	4.9	12.5	17.6	18.2	16.1
<b>Shock-absorbing factors</b>					
Capital adequacy ratio (capital to risk-weighted assets)	20.9	18.1	14.7	13.7	13.4
Loan loss provisions (ratio to total loans)	9.1	8.5	6.9	6.1	6.1
Claims on the CBR (share in banks' total assets) <sup>11</sup>	6.0	5.4	4.2	4.4	3.5
<b>Memorandum items</b>					
Total banking sector assets (ratio to GDP)	75.8	73.0	74.6	79.1	80.2 (end-June)
Share of majority state-owned banks in banks' total assets	43.9	45.9	50.2	50.4	..
Share of majority foreign-owned banks in banks' total assets	18.3	18.0	16.9	17.8	14.7
EBRD index of banking sector reform	3–	3–	3–	3–	..
International reserves of the CBR (incl. gold, ratio to GDP)	34.2	31.5	28.8	26.1	25.6 (end-June)

Source: Bank of Russia, author's calculations.

<sup>1</sup> Loans and other placements with nonfinancial organizations, government agencies and individuals.

<sup>2</sup> Share of problem loans (category IV) and bad loans (category V) according to CBR regulation no. 254 (2004).

<sup>3</sup> Share of doubtful (category III), problem (category IV) and bad loans (category V) according to CBR regulation no. 254 (2004).

<sup>4</sup> Large credit risks refer to borrowers holding loans in excess of 5% of regulatory capital.

<sup>5</sup> Weighted average rate on ruble deposits with credit institutions for a term of up to one year.

<sup>6</sup> Weighted average rate on ruble loans with a maturity of up to one year.

<sup>7</sup> Deposits and other funds of nonfinancial organizations, government agencies and individuals.

<sup>8</sup> Funds placed with nonresidents, incl. loans and deposits, correspondent accounts with banks, securities acquired.

<sup>9</sup> Funds raised from nonresidents, incl. loans from foreign banks, deposits of legal entities and individuals.

<sup>10</sup> Loans, deposits and other funds received by credit institutions from the CBR.

<sup>11</sup> Accounts with the CBR and authorized agencies of other countries.

lines the pivotal importance of increased deposit funds for financing the credit boom. Furthermore, banks' net liabilities to the monetary authority and to government agencies rose during this period (from below zero to 2%–3% of GDP), pointing to the additional factor of CBR and government liquidity assistance that supported the lending boom in its most dynamic phase (from the second half of 2011).

### 2.2.2 Large State-Owned Banks in the Forefront of Lending Expansion

Large majority state-owned banks' (SOBs') lending activity has been in the forefront of the credit boom. In light of their generally big size<sup>13</sup> and extensive

networks, their strengthened post-crisis market positions (after they had taken over failed private banks in 2008–2009), their favorable access to funding and the possibility of being price setters on the domestic deposit and loan markets, SOBs have had the means to be particularly assertive in lending expansion. Overall, SOBs increased their market share in sector assets from 44% at end-2009 to 50% at end-2012 (see table 1). Sberbank, Russia's state-owned market leader, has been one of the "locomotives" of the consumer credit boom and expanded its retail lending by 34% (in real terms) in 2012 (Neue Zürcher Zeitung, 2013b).

Box 1

#### Foreign Banks' Modest Withdrawal from Russia Has Not Thwarted the Credit Boom

*A factor that has not been driving the credit boom, yet removed a possible impediment to it, was the rather small market shares of euro area banks compared with their presence in other CESEE countries. This smaller presence reduced Russian exposure to possible deleveraging actions. Also, as a net external creditor for some years now, the Russian banking sector has become more resistant to deleveraging. Majority foreign-owned banks' (FOBs') share in total loans (excluding interbank loans) slightly declined from 2010 to 2013 (from 17.1% at end-2009 to 16.6% at end-May 2013). The contraction of FOBs' share in retail loans was slightly more pronounced (from 25.1% to 22.4%) than that in loans to enterprises (from 14.8% to 14.2%). Thus, FOBs on average participated in the (retail) credit boom, but on a disproportionately smaller scale.*

*Still, a number of foreign banks withdrew from the Russian market, which was only partly motivated by problems they experienced in home markets or by regulatory tightening at home. Also, some of the foreign banks with the greatest experience and the strongest presence in Russia did not curtail their activities.*

<sup>13</sup> The four biggest Russian banks, measured by assets, are majority state owned and account for slightly less than half of total sector assets: Sberbank (over one quarter of sector assets at end-2012), Vneshtorgbank (VTB, including the Bank of Moscow acquired in 2011), Gazprombank, and Rosselkhozbank (Russian Agricultural Bank).

Table 1

### Recent Withdrawals of Foreign-Owned Banks from the Russian Retail Banking Market, 2010–13

Foreign-owned bank (parent bank)	Country of origin	When established in Russia	When left Russia/ discontinued retail operations or announced intention to do so	Reason for leaving/ winding down retail operations	Acquiring or negotiating investor
Santander Consumer Bank (Banco Santander)	Spain	2006	Dec. 2010 (carried out)	Cost cutting; stiffer competition from large Russian SOBs	Orient Express Bank (private Russian bank)
Swedbank	Sweden	2005	July 2010 (announced)	Refocusing on core markets; stiffer competition in Russia; cost cutting	Raiffeisen Bank International (RBI)
Rabo Invest (Rabobank)	Netherlands	1997 (representative office)	Feb. 2011 (carried out)	Refocusing on core investments	No investor; cancellation of Rabo Invest's banking license by CBR
BNP Paribas	France	2006	Sep. 2012 (carried out)	Efficiency adjustments	Sberbank (establishment of consumer finance joint venture "Cetelem"; ownership: 70% Sberbank, 30% BNP Paribas)
HSBC Russia	United Kingdom	2009	Late 2011 (carried out)	Stiffer competition from large Russian SOBs (notably Sberbank, VTB) and more established FOBs; cost cutting; problems in parent bank's home market	Citigroup Russia
Barclays Russia	United Kingdom	2008	Oct. 2011 (carried out)	Impact of Great Recession on Barclays' business in Russia; stiffer competition from large Russian SOBs; cost cutting	Group of investors incl. Igor Kim (Russian banker)
Handelsbanken	Sweden	2005	June 2012 (announced)	Stiffer competition from large Russian SOBs	No investor; request to CBR to cancel Handelsbanken banking license
Promsviazbank (Commerzbank: minority shareholder)	Germany	2006	June 2012 (carried out)	Parent bank's sell-off of nonstrategic assets to cover capital needs	Promsviaz Capital B.V. (majority owners of Promsviazbank: Alexey and Dmitry Ananiev/Russian businessmen)
Absolut Bank (KBC)	Belgium	2007	Aug. 2012 (announced)	Parent bank's realization of restructuring/ deleveraging plans and requirements; refocusing on core markets	Blagosostoyanie (pension fund of Russian Railroads)

Source: Author's compilation.



As the above table shows, banks that left Russia recently (as from 2010) had arrived relatively late. Well-established banks like Société Générale (Rosbank), Raiffeisen, UniCredit, Citigroup or OTP stayed on.<sup>1</sup> The most important reasons for leaving cited in the press were: increased competition,<sup>2</sup> notably from Russian SOBs, cost cutting and efficiency-enhancing measures, and a refocusing on core markets and investments (i.e. in the home country). The most important investors taking over leaving banks' Russian operations have been Russian private or state-owned banks (like Orient Express Bank in the case of Santander Consumer Bank or Sberbank in the case of the majority takeover of BNP Paribas Russia) and well-established FOBs (like Raiffeisen Bank International, which acquired Swedbank Russia). The fact that some of the largest and most dedicated FOBs in the country participated in the takeover of less fortunate foreign-owned competitors underlines the assessment that overall FOB divestment is but modest in Russia. In a credit boom environment, this is not surprising.

<sup>1</sup> The "troika" of big foreign-owned lenders in Russia (Société Générale, UniCredit and Raiffeisen) has remained among the top ten credit institutions (in terms of assets) of the country, although the combined market share of the "troika" has shrunk somewhat from about 5.7% at end-2009 to 4.6% at end-2012 (Raiffeisen Research, 2013, p. 55).

<sup>2</sup> This corresponds to findings that higher competition can lead to higher failure of banks, as shown in Fungáčová and Weill (2013).

### 3 Risks Related to the Credit Boom

The main risks associated with the credit boom are partly long standing and partly newly emerging. Surging unsecured retail lending is a relatively new phenomenon, while widespread connected lending in the corporate sector is a familiar problem in Russia. The same goes for elevated levels of NPLs, which may, however, swiftly rise if the consumer credit boom derails.

#### 3.1 Surging Unsecured Consumer Lending

Although the share of retail credit is still relatively modest in Russia compared with peers, not only does the consumer credit boom remain strong, but it has also been substantially driven by unsecured products such as direct cash loans, credit card loans, and point

of sales loans (loans granted for the acquisition of durable goods directly at the store where the purchase occurs). As a result of aggressive expansion, uncollateralized consumer loans increased by about 44% in real terms in 2012 and accounted for no less than 60% of total household loans at the end of that year (CBR, 2013c, p. 34; BOFIT Weekly, 2013a).<sup>14</sup> At end-September 2013, the growth rate (real, year on year) of uncollateralized retail loans had substantially declined, but stood at a still perky 27%. This lifted the share of these loans in total household loans to 62.5% (Sosyurko, 2013). Given such rapid expansion, one may doubt the capacity of banks to reliably verify the quality of the numerous incoming credit applications.<sup>15</sup> Meanwhile, mortgage lending only comprises about a quarter of total retail credit, which also distinguishes Russia from a number of other coun-

<sup>14</sup> Direct cash loans reportedly grew by 31% and credit card loans by 50% (in real terms) in the twelve months to end-June 2013 (Serafimovich, 2013).

<sup>15</sup> In order to boost efficiency, cut costs, and raise market shares, some Russian banks have automated loan decisions, e.g. for car purchases (using, inter alia, social media-supported data-driven models) (Alexander, 2013, pp. 70–71). Proof of such strategies' efficiency is certainly not attainable over a couple of boom years and will probably have to await the passing of the business cycle.

tries.<sup>16</sup> Mortgage loans have since mid-2010 expanded at around the same pace as total consumer credit and as yet do not constitute a sizeable risk factor.

While Russian households' overall liabilities do not give rise to concern and fewer than one in five Russians owns a credit card, there is certainly a group of households particularly vulnerable to overindebtedness, namely younger people and families with high material needs and yet little financial experience (O'Neill, 2013, p. 80; *Ekonomika i Zhizn*, 2013). In the first half of 2013, Russian households that had taken out credits spent on average over one-fifth of their income on servicing debt, which is a higher share than that paid by Turkish or some European consumer-borrowers (Aris, 2013; Sosyurko, 2013). Moreover, Russian households' income is not growing as fast as their debt. A large amount of retail credit is short term with rather high interest rates; in 2012, the average annual rate for short-term retail loans equaled 25%.

This very high interest rate level goes a long way in explaining why Russian households' interest burden in relation to GDP slightly exceeds the comparable euro area indicator despite the fact that the euro area households' debt-to-GDP ratio dwarfs Russia's (Ponomarenko, 2013). On top of this, no less than 30% of Russian household borrowers have reportedly taken out three or more loans (Noskova, 2013; Vasileva, 2013). As at end-March 2013, the NPL ratio (narrow definition) for

household loans (6.9%) was even somewhat higher than the respective ratio for total loans (6.5%) (CBR, 2013c, p. 36). This was the case despite the more recent and very fast buildup of the household loan portfolio, which would have suggested a lower retail NPL ratio. This, in turn, may give rise to concern.<sup>17</sup> With the ongoing slowdown of retail lending growth, a further, possibly substantial increase of the household NPL ratio may be expected.

Some of the most dynamic participants of the retail credit and unsecured lending boom are Sberbank, Vneshtorgbank (VTB, which opened a mass-market bank called Leto<sup>18</sup> Bank) and several other large banks, including Russia's biggest privately owned credit institution, Alfabank, as well as a number of specialized small to medium-sized private banks (e.g. the Home Credit Group, majority controlled by a Czech businessman; Tinkoff Credit Systems, a credit card specialist partly owned by Goldman Sachs; and Renaissance Credit, recently bought by the Russian businessman Prokhorov).

### 3.2 Widespread Connected Lending in the Corporate Sector

While the surge of consumer lending and related risks have most recently become the focus of attention, connected lending remains a long-standing and costly problem in Russia (as well as in some other countries). Connected or related-party lending refers to loans extended to banks' owners or managers and/or to their related businesses

<sup>16</sup> For instance, mortgage lending makes up an average of 2/3 to 3/4 of total EU household credit. The difference can be attributed, *inter alia*, to two causes: First, real estate is much more expensive in Russia (in relation to per capita GDP) than on average in the EU; and, second, about 80% of Russians – as opposed to a much smaller average share of Europeans – tend to own their dwellings (since the post-Soviet privatization of apartments in the 1990s) (Orlova, 2012, p. 77).

<sup>17</sup> Overdue consumer loans have surged from 2012, and the volume of new retail credit used to repay previous debt has equally been on the rise (Fedotkin, 2013; Yalovskaya et al., 2013, p. 7).

<sup>18</sup> Meaning "summer."

(OECD Proceedings, 1998, p. 256). According to expert estimates, about 10%, in some cases up to between 25% and 30% of Russian banks' loan portfolios are made up of loans to related parties, which may be concealed through specific schemes like holding companies (Orlova, 2012, p. 76).<sup>19</sup> High single-party concentrations are another indicator of possible related-party lending: As shown in table 1, in recent years the ratio of large credit risks (i.e. borrowers whose loans exceed 5% of regulatory capital) to total banking sector assets has exceeded one quarter.<sup>20</sup> Connected lending is facilitated if the credit institution in question actually operates like a "pocket bank," i.e. an extended financial department or treasury of one or a small number of owner firms (OECD Proceedings, 1998, p. 255).

It was not repercussions of the Great Recession or of the business cycle, but excessive connected lending, entrenched pocket banking and weak corporate governance that seem to have been largely responsible for the insolvencies of Mezhprombank (International Industrial Bank, a mid-sized private credit institution) in 2010 and of the Bank of Moscow (Bank Moskvyy, majority owned by the Moscow municipality and, at end-2010, the fifth-largest credit institution of the country) in 2011 (Hosp, 2011). After former Russian president Medvedev had dismissed the Moscow mayor Luzhkov in 2010, the majority government-owned

VTB launched a hostile bid and took over about half of the Bank of Moscow, fired its management and eventually detected that about EUR 7 billion or around 30% of the institution's credit volume was "bad." The Bank of Moscow had reportedly been able to disguise the true quality of these delinquent assets by using special purpose vehicles (SPVs) often located in offshore jurisdictions, many of which were affiliated with previous managers. According to its own account, the bank's former management had extended loans of EUR 5.4 billion to "entities linked to the bank"; management had, inter alia, carried out real estate projects which gave rise to allegations of fraudulent lending at below market rates without sufficient collateral (Mauldin, 2011).

In order to bail out the Bank of Moscow, the largest bank rescue package of Russian and CESEE history was assembled, providing for an injection of funds of EUR 9.8 billion: About two-thirds of the bailout sum were financed by a low-interest CBR loan (disbursed via payments through the Deposit Insurance Agency); VTB contributed about a quarter of the amount by raising its share in the Bank of Moscow's capital to 75%.<sup>21</sup> The dimension of the distress that had suddenly erupted around the Bank of Moscow raised questions about CBR oversight of the sector. While the central bank still seems to lack sufficient authority to effectively address connected lending,

<sup>19</sup> In 2012, a high-ranking CBR official visiting the OeNB in Vienna put it this way: *There are still many Russian banks whose principal beneficial owner is also their principal borrower, and this remains a serious supervisory problem.*

<sup>20</sup> *However, related-party lending is not the only likely explanatory factor for high single-borrower ratios. The latter also reflect the concentrated structure of the Russian economy, which is dominated by certain industries with rather few large companies holding sway over the respective markets (Yalovskaya et al., 2012, p. 12).*

<sup>21</sup> *While raising VTB's market shares with respect to loans and deposits, the takeover of the Bank of Moscow increased the acquiring credit institution's capital needs. In May 2013, VTB issued shares on the Moscow Exchange. The majority owner, the state, did not participate in the share issue, which reduced the state's interest from 76% to 61% and increased the bank's capital by about EUR 2.5 billion. Among the largest investors were the sovereign funds of Qatar, Norway and Azerbaijan.*

some progress has been made recently in upgrading the supervisory framework in this direction: Legislative amendments have enhanced the CBR's authority over bank holding companies and related parties. Professional judgment can now be used (to a greater degree than before) in applying laws and regulations to individual banks (IMF, 2012, p. 28; IMF, 2013, p. 3). Nevertheless, one cannot exclude the possibility that connected lending-triggered banking turmoil reappears sooner or later.

### 3.3 Still Elevated Levels of Nonperforming Loans, Modest Provisioning

Although they have been declining during the credit boom of recent years, NPL ratios (nonperforming loans to total loans including interbank loans) remain at relatively high levels (narrow definition: 7%, broader definition: 15%) in Russia. From mid-2010 to end-September 2013, NPLs in real terms increased by about 5% (narrow definition) or around 15% (broad definition). Therefore, one can conclude that banks in fact did not use the boom years to reduce bad loans, but that NPL ratios only declined due to swiftly growing credit volumes. In this situation a later increase of NPL ratios is not precluded and is even probable once portfolios season and repayment obligations mount. Also, the current slowdown of the economy as well as of lending may entail an eventual increase of NPLs. At least for purposes of international comparison, the broader definition of NPLs

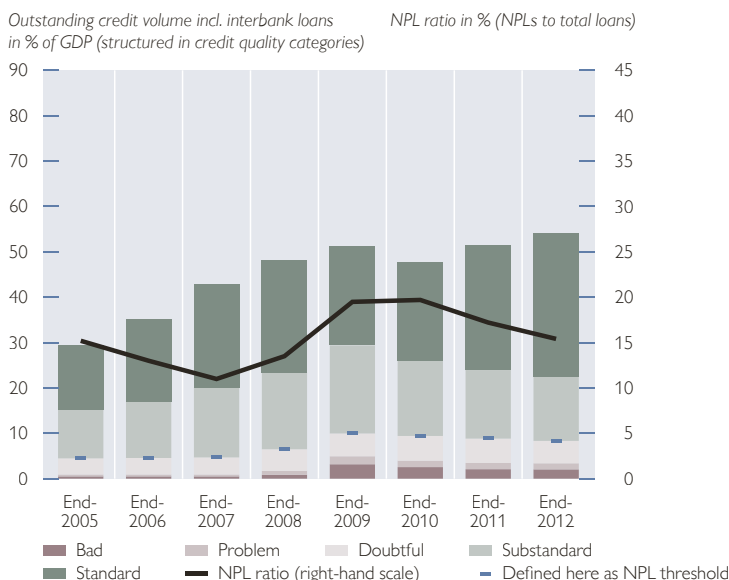
(comprising the shares of doubtful, problem and bad loans, see footnote 8 above and chart 3 below) is more adequate, as explained in Barisitz (2011, pp. 52–53) and Barisitz (2013, p. 70). If one chooses the broader definition, only less than half of impaired loans are covered by loan loss provisions, i.e. Russian banks' provisioning is insufficient by a considerable margin.

Moreover, NPLs are potentially underreported. For instance, restructured loans, which account for around one-third of all large loans, are often of doubtful quality (Jafarov, 2013, p. 32). “Evergreening” (the repeated restructuring or rolling-over of loans of delinquent or troubled borrowers) seems to be widespread (Bugie et al., 2012).<sup>22</sup> The same goes for the practice of transferring distressed assets to affiliated off-balance sheet entities not subject to consolidated supervision. Furthermore, the indicated level of provisions may actually be misleading due to a wide variation of collateral quality (Oura, 2012, pp. 38–40). As can be easily inferred from the above subsection, connected lending can raise the risk of loans turning nonperforming because related parties tend to be less strictly vetted when applying for a loan and their offered collateral tends to be weaker (Hosp, 2011).<sup>23</sup> Like in a number of other CESEE countries, incentives may not be sufficient for in-depth NPL resolution/workouts, more specifically legal/judicial obstacles to the enforcement of collateral are likely to persist.

<sup>22</sup> *Evergreening may be a strategy by banks to circumvent the inefficiently functioning judicial system to seek repayment. In this sense, credit institutions may be betting on better times and trying to “grow” their way out of trouble (O’Neill, 2012, p. 103).*

<sup>23</sup> *On the other hand, group-internal social pressure for respecting one’s obligations may be higher (as long as the group of related parties remains intact).*

Chart 3

**Russia: Credit Quality**

Source: Bank of Russia, Rosstat.

#### 4 The CBR's Policy Reaction to the Credit Boom and Reasons for the Most Recent Slowdown of Lending Growth

The monetary authority reacted, from 2012 onward, to the lending boom and resorted to some credit growth containment measures (following the CBR's and the government's probable contribution to swift loan growth through above-mentioned liquidity-enhancing measures). After the monetary authority had – from the spring of 2012 – repeatedly expressed its concern about the rapid expansion of retail lending, CBR officials in late 2012 met the heads of some of the biggest retail lenders and requested that consumer credit growth not exceed 30% (in nominal terms) in 2013.

- This moral suasion initiative was followed in early 2013 by some prudential measures:
- The doubling of minimal loan loss provisioning requirements for unsecured consumer loans, without overdue payments or with payments overdue less than 30 days, extended after January 1, 2013;
- the establishment of a new minimal amount of 100% reserves for unsecured retail loans whose repayment is more than 360 days overdue; the requirements entered into force on March 1, 2013;
- the increase of coefficients for the calculation of capital adequacy for unsecured consumer loans extended after July 1, 2013 (CBR, 2013a, p. 103; CBR, 2013d, p. 65).

The CBR also warned that banks that expand lending too aggressively may face sanctions. In response, some of the country's biggest retail-focused lenders declared their intention to comply with the regulator's demand and to rein in lending growth for 2013 (Weaver, 2013a; Triebe, 2013a)<sup>24</sup>. If necessary, as pointed out by officials, the CBR might set a maximum interest rate level for retail loans or limit the maximum share of income that a borrower is required to pay on debt (Russia & CIS Banking and Finance Weekly, 2013, p. 24; Weaver, 2013b).

While influenced by the CBR's policy reaction and credit containment measures, which probably started to have an impact in early 2013, lending growth was already slowing down from mid-2012.<sup>25</sup> This deceleration was likely to have been triggered by the general economic slowdown that had set in in the second quarter of 2012. In recent months,

<sup>24</sup> At end-July 2013, nominal retail lending growth (year on year) still came to 34%.

<sup>25</sup> Declining fixed investment, large-scale destocking, a disappointing external economic outlook, and stagnating and lately even declining oil, gas and metals prices (see chart 2) contributed to the general slowdown.

the onerous terms of many consumer loans (including short repayment periods and steep interest rate changes) probably contributed to rising loan losses and thus dissuaded some potential borrowers from taking out loans.<sup>26</sup>

Macroeconomic model-based stress tests of the banking sector conducted by the CBR and published in July 2013 provide for two scenarios, dependent on the degree of potential deterioration of the global economy and the oil price: a pessimistic and an extreme scenario. The first scenario, inter alia, provides for a drop of the oil price of 25%–30%, triggering a decline of Russian GDP growth to 1.2%.<sup>27</sup> The second scenario

depicts a severe recession (GDP: –5.0%). In the pessimistic case, the banking sector's losses could amount to 25% of total sector capital; in the extreme case, this ratio could reach 42%. Operating profits of the sector (after deduction of above losses) would come to RUB 600 billion to RUB 700 billion and RUB 100 billion to RUB 150 billion, respectively. Capital adequacy in the pessimistic scenario would decline to 11.1%, in the extreme scenario to 10.6%. This, the CBR points out, implies that the Russian banking sector is able to withstand a serious shock in the case of a crisis (CBR, 2013c, pp. 38–39).

Box 2

### Like the Russian Banking Sector in General, Austrian Banks in Russia Have Recently Recorded High Consumer Loan Growth Rates and Declining Capitalization Levels

**David Liebeg<sup>1</sup>**

*Austrian banks were among the first banks to enter the Russian banking market. For Raiffeisen Bank International and UniCredit Bank Austria, their operations in Russia constitute a major share of their overall business, while their market share in Russia is relatively small (about 3% in mid-2013). DenizBank in Austria, whose parent bank was bought by Sberbank in 2012, also operates a small subsidiary in Russia.*

*In the first quarter of 2013, Austrian banks' (including foreign-owned banks') exposure in Russia made up 11% (EUR 39 billion in terms of ultimate risk exposure) of their total exposure in the CESEE and CIS region but accounted for more than one-third of the profits generated in the region. As a case in point, their combined RoA in Russia ran to no less than 3.1% in the first quarter of 2013.*

*In comparison to the overall region, Austrian banks' subsidiaries in Russia also exhibit a high degree of operational efficiency (reflected by a cost-income ratio of 36% in the first quarter of 2013), a relatively low relevance of foreign currency lending (with a share of 9% for household loans and of 55% for corporate loans, where the latter has to be seen from the perspective of a generally highly dollarized corporate sector in Russia), and low nonperforming loan (NPL) and loan loss provisioning (LLP) ratios (4.9% and 3.8%, respectively, as at end-2012), which have been continuously declining since mid-2010.*

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<sup>26</sup> The above-mentioned substantial slowdown in lending to enterprises may not reflect a supply problem, as one might infer. According to a poll by the Gaidar Institute for Economic Policy in late January 2013, 56% of the firms questioned (which is more than at any time in the past 18 years) responded that their investments were sufficient. Only 11% indicated difficulties with accessing credit, and 13% pointed to overcapacities giving rise to concern (Neue Zürcher Zeitung, 2013a; see also the assessment in IMF, 2013, p. 4).

<sup>27</sup> As of October 2013, this scenario does not appear very far fetched, at least with respect to weakening economic activity.

*Declining NPL and LLP ratios are, however, a natural consequence of the high growth rates of loans to nonbank borrowers, which peaked at +19% year on year in real terms (+23% nominal) in the first quarter of 2012, but fell to +5% in real terms (+12% nominal) in the first quarter of 2013. Growth rates of consumer loans (+32% year on year in real, +41% in nominal terms as at end-2012) exceeded these figures and exhibited dynamics similar to those of the aggregate Russian banking sector. Still, Austrian banks' assets continue to be dominated by corporate loans (EUR 16.5 billion vs. EUR 6.0 billion in household loans as at end-2012). Nonbank deposits grew at a similar pace as loans, leading to a general decline of the combined loan-to-deposit ratio from more than 140% at the end of 2008 to less than 100% at end-2011. However, by March 31, 2013, it had increased again to 109%.*

*Another similarity to the aggregate Russian banking sector is the decline (albeit at a slower pace) in capital levels recorded by Austrian banks. While the combined capital adequacy ratio of Austrian subsidiaries stood at 16.8% at the end of 2010, it dropped by 3 percentage points in the course of two years (to 13.8% at the end of 2012).*

*Peer-country comparisons of levels in indebtedness and private sector loans as a percentage of GDP still signal further room for financial deepening. However, the high growth rates in the consumer lending sector in combination with a deteriorating capital base also warrant caution for future growth in Russia. Moreover, these developments reveal the need to shore up risk-bearing capacities as well as to make sure adequate risk management systems are in place to cope with such a high rate of expansion.*

## **5 Other Substantial, if Partly Eroding Shock-Absorbing Factors, Including Capital, Profits, Provisions, Deposits and External Claims**

Shock-absorbing factors are important, but some have been weakening over the last couple of years: As mentioned above, capital adequacy, while still at a fair level, declined from mid-2010 to end-September 2013 by more than five percentage points. Profits recovered, but are substantially lower than before 2008. Depending on the NPL definition, loan loss provisions are hardly sufficient or plainly insufficient. Credit institutions' net claims on the CBR spiked at end-2010 at 3.2% of GDP, in 2012 turned negative and, at end-June 2013, came to -1.1% of GDP. The liquidity ratio (ratio of highly liquid assets to total assets) also gradually receded, before slightly rising again, as table 1 shows.

Still, as mentioned above, the deposit boom was even somewhat stronger overall than the credit boom and the loan-to-deposit ratio is now (119%)

much lower than in the years preceding the crisis of 2008–2009 (e.g. 2007: 143%). Depositor confidence continues to be high. At about one-quarter, the share of foreign currency-denominated deposits in total deposits is smaller than it is in many peers. The share of foreign currency loans in total loans has declined to about one-sixth, and to a negligible level in the case of household loans – largely freeing Russian retail borrowers from foreign exchange risks, which are quite present in a number of other countries. Credit institutions' external assets, which were built up in the post-crisis years, are almost one-third higher than their external liabilities.

The CBR as well as the government maintain considerable room for maneuver. The enhanced flexibility of the monetary authority's exchange rate policy reduces potential policy conflicts with ensuring financial stability. While the government has lately rebalanced its budget, the Russian state's debt remains very low at about 10.5% of GDP (end-2012). And gross international reserves (including gold) remain

ample (EUR 388 billion at end-October 2013), if steadily declining as a ratio to GDP (mid-2010: 34.1%, end-June 2013: 25.6%). An institution that should add to the availability of information and transparency for lenders and in this way indirectly act as a shock-preventing factor is the National Bureau of Credit Histories (Natsionalny biuro kreditnykh istorii or NBKI), which is owned by a number of Russian banks and is the biggest of a couple of dozen credit reporting agencies active in the country.<sup>28</sup> Finally, one could refer to the overall relatively low point of departure of the Russian credit boom and to the still modest size of consumer lending as a cushioning factor. In other words, the country remains structurally “underbanked” in this respect.

## 6 Outlook

Apart from the considerable but latent risk of another large bank unexpectedly succumbing to problems with related-party lending, most interest is currently focused on risks linked to the Russian credit boom. As mentioned above, since the second half of 2012 loan growth has been decelerating and the credit boom has been “landing.” So far, it has been a “soft landing,” which has already progressed relatively far with respect to enterprise loans and the total credit volume (the latter: +11.3% at end-September 2013 in real terms), but not yet that far in the field of retail lending, notably unsecured loans (the latter: still +30% at end-June 2013).

Given the current domestic modest growth and weak but not dramatic

global economic situation and given the CBR’s intervention via moral suasion and prudential measures, the most probable outlook is a continuation of the soft landing, flanked by the still sizeable shock-absorbing instruments available to the authorities. Russia’s introduction of Basel III in 2013 and 2014, respectively,<sup>29</sup> may accentuate the soft landing. Basel III is expected to provide for a tightening of risk weights and for a stricter definition of capital, which should entail a reduction of the sector’s measured capital adequacy (possibly by 1%). This in turn may make it necessary for a number of banks to raise additional funds and withdraw potential resources from lending expansion (Wirtschaftsblatt, 2013; Triebe, 2013b). Alternatively, any reacceleration of consumer credit growth in the near term would have to be monitored very carefully and might give rise to concern with respect to eroding capital buffers and weakening financial stability.

Summing up: Swift Russian credit expansion has benefited from the strong recovery of the oil price and a robust upswing of domestic demand. Credit risks of connected lending in the corporate sector and in particular of surging unsecured consumer lending are most prominent. The recent economic slowdown as well as the CBR’s prudential measures have contributed to an ongoing soft landing of the credit boom. While further improvement of risk management systems appear important, shock-absorbing factors remain sizeable.

<sup>28</sup> As at April 1, 2013, the NBKI had gathered data on 115 million loans extended by more than 1,500 creditors (Sergeev, 2013, p. 3).

<sup>29</sup> The new requirements have formally come into force on April 1, 2013. Initially, capital and capital adequacy calculations in compliance with Basel III are made only for analytical purposes, while these indicators are to be used for regulatory purposes (including bank reports) as from January 1, 2014 (CBR, 2012, p. 26; BOFIT Weekly, 2013b).



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