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Sorry Medvedev. Putin Won't Sell Off Sberbank

By Kim Iskyan

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Late last week, President Dmitry Medvedev began to lay the groundwork for the state to surrender its controlling stakes in state banks, including the country's two biggest lenders, Sberbank and VTB. If implemented, this would be the most dramatic reconfiguration of the landscape of the country's banking sector in 20 years and possibly signal a wave of far-reaching reform in Putin 2.0.

But it's not going to happen. Everything that Medvedev says has the half-life — and credibility — of a snowflake in May. More important, President-elect Vladimir Putin is more likely to ride a candy apple-red tricycle in Red Square clad in a pink tutu than he is to allow his government to relinquish control over state banks.

If anything, state control over the banking sector is likely to increase, continuing a long-term trend, notwithstanding the anticipated state sell-off next month of a 7.6 percent stake in Sberbank. From 2001 to 2009, the percentage of banking assets under direct or indirect

control of the government rose from 36 percent to 56 percent. Since then, Sberbank (57.6 percent held by the state) and VTB (75.5 percent state-held) have grown faster than the sector overall to account now for two-thirds of total retail deposits and the bear's share of the corporate-banking market. They also have made deep inroads into the investment-banking arena. The two banks are reaping the benefits of sleeping with the state — including too-big-to-fail status, political favoritism, access to cheap capital and a work-with-us-or-work-with-no-one approach to garnering business.

For everyone else, this is bad news. The state's large and increasing role cripples the competitive environment in the banking sector while stifling the economy as a whole. More market-driven borrowers of capital are being deprived by this directed-lending to politically favored projects and to further geopolitical aims — such as a recent extension on a $2 billion loan by VTB to shore up the Ukrainian economy and Sberbank's $3 billion deal last year to invest in railway projects in Kazakhstan. State banks are subject to political whims, such as Putin's cavalier commandeering in February of some $500 million from VTB to compensate retail investors in the bank's IPO. State banks crowd out private capital, as private banks and foreign banks — which are able to access capital only at rates well above those of Sberbank and VTB — are driven out of the market. As a result, customers experience lower-quality and higher-priced service than they might otherwise. Worse, speculation is rife that state bank funds are used to shore up local and federal budgetary funds, a practice that could accelerate with the approach of the 2014 Sochi Olympics and as election-season spending promises face the light of day.

The cost of clogging up the arteries of the Russian economy and banking sector becomes clear when these policies — compounded by a diet of weak sector oversight — result in the financial equivalent of a cardiac event. The Bank of Moscow implosion in the summer of 2011 — the sector's largest ever — required a roughly $10 billion cash infusion from the state to head off a Russian-style Lehman Brothers moment. VTB needed a $5.6 billion bailout of its own in July 2009. A myriad of smaller, wobbly banks have been quietly absorbed by the sector's state giants at an untold and incalculable cost to the state.

Why then won't the madness of dictatorship over the state banks end? Rewind to the economic crisis of 1998, when the lesson that many key policy makers drew from the collapse of the country's banks — and very nearly of the economy — was that keeping the banking sector afloat was critical to ensuring political stability and heading off macroeconomic Armageddon. It wasn't hard for policy makers to draw a short, straight line from angry depositors queuing outside the branches of SBS-Agro to angry citizens shouting on Red Square.

The state's strategy in fighting the 2008-09 economic crisis reflected this lesson. As it became clear that Russia would be sucked into a global macroeconomic hurricane, the Russian government threw everything and the kitchen sink at state banks to ensure that the ATMs stayed open. State banks, in turn, flooded the rest of the banking system with liquidity.

This staved off a complete meltdown of the banking sector. It also allowed for Sberbank and VTB (as well as the nonbank state corporation Vneshekonombank) to be the mules that supported the deadweight of the so-called real economy, throwing a cash lifeline to firms that were deeply indebted to foreign creditors. The fear then — maybe overblown in hindsight but

powerful at the time — was that various key strategic and crown jewel companies could wind up in foreign hands if not for the grace of the state banks and for the unique scope for the state to force state banks to do its bidding.

The government is concerned now that if it were to relinquish control over its banks, it would have one less tool in its economic meltdown first-aid kit, potentially resulting in Russia losing control over some of the companies that make Russia great. Although even the Kremlin recognizes that self-sufficiency in financing is an absurd objective, Putin wants to ensure that state banks will be able to take care of their own if the need arises.

In the meantime, the sell-off of small stakes allows the government to spread the wealth via share options and other vehicles to state bank management. This will ensure their continued loyalty and their willingness to comply with government-funding directives, however misguided or damaging to minority shareholder interests.

There are risks, of course, to setting state banks free. Cutting the state's stakes below 50 percent — even if the state retained operational control — would likely result in an increase in the cost of funding for them because their credit ratings would be cut with the loss of their quasi-sovereign status. Growth and profitability would also suffer as private banks and foreign banks might get some traction. And state bank managers might feel more of a free rein to pilfer at will.

Stepping into the unknown is always a risk. But in the meantime, everyone loses anyway: bank customers, who suffer from shoddy service and pricing; the long-term stability of the banking sector, which remains the economy's Achilles' heel; investors, who only have a vague idea of where the cash goes despite internationally audited accounts; and taxpayers, who foot the bill when banks go spectacularly bust. Last but not least, the ultimate loser is Russia's economic-growth trajectory.

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