Bank Rescue in Russia: The Tale of PSB and The Brothers Ananyev

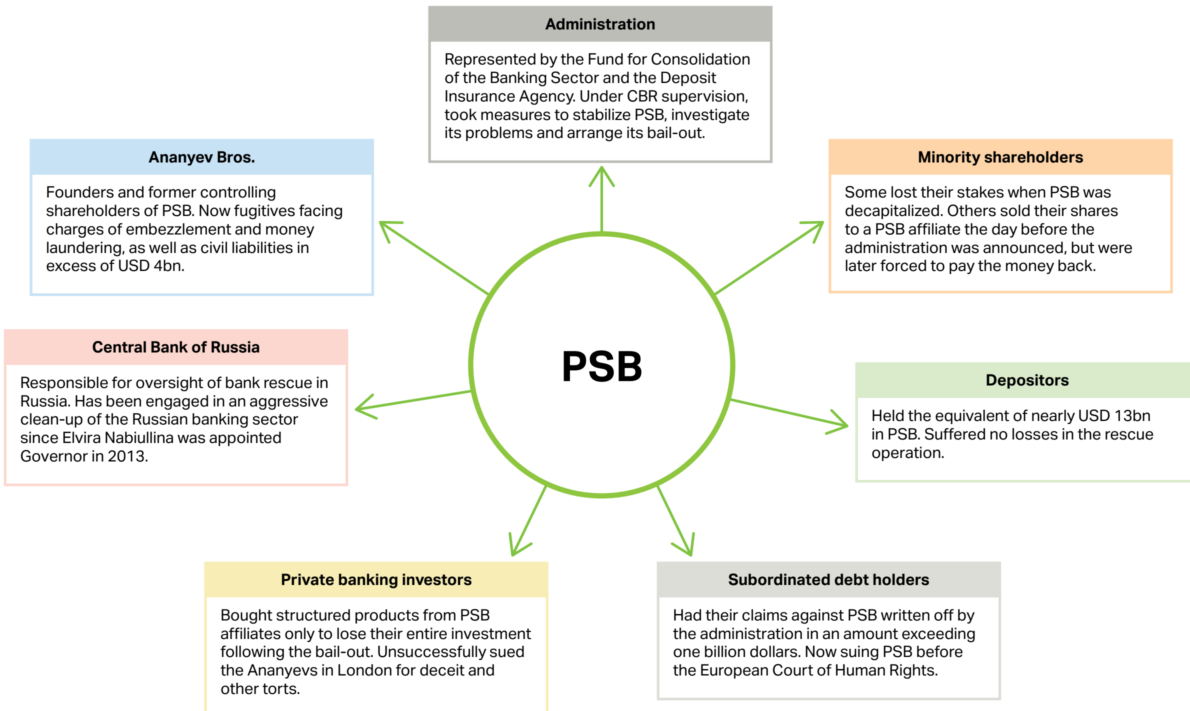
By **MATTHEW FISHER**

Life in 2012 was good for Aleksey and Dmitry Ananyev. Having flung open the doors to their exquisite collection of Socialist Realist paintings a few months earlier, the brothers – then worth a combined USD 3.8 billion[1] – had their eyes on a public offering of a different type. Promsvyazbank (or PSB), the jewel in the crown of the Ananyevs' business empire and third-largest non-state bank in Russia, finally appeared ready to join the elite, to conduct an initial public offering on the London Stock Exchange.

It was never to be. Things progressively went downhill for PSB, and the Ananyevs' hopes were dashed definitively just five years later. In August 2017, Alfa-Capital analyst Sergei Gavrilov sent his clients a now-infamous list of four banks he considered critically unstable, PSB among them. It turned out he was right: by December 2017, the Central Bank of Russia (CBR) considered PSB dangerously undercapitalized and required PSB to increase its capital reserves by over RUB 100 billion (USD 1.6 billion). Dmitry Ananyev proposed a plan to do so over three years; the CBR gave him three days. On December 15, 2017, with PSB still undercapitalized, the CBR announced that PSB was to be put into administration[2] as a precursor to being bailed out and taken into public ownership.

PSB was not the first and not even the largest Russian bank to be bailed out in 2017 (that dubious honour goes to Bank Otkritie, Russia's then second-largest non-state bank, whose bail-out was announced at the end of August that year). Yet, two years on, 'The Tale of PSB and the Brothers Ananyev' bears repeating. Like no other, it illustrates the dynamics of bank bail-outs in Russia: the historical drivers, the dysfunctionality of the previous regime, the serious consequences for key stakeholders, and the market-consolidating effect of the recently revised regime.

Dramatis Personae



Bail-outs have resulted from historical peculiarities of banking in Russia

PSB reached breaking point in 2017. Arguably, however, the die was cast for PSB (and certain other bailed-out banks) many years before, at the very birth of the banking system in modern-day Russia.

The fall of the Soviet Union created a wealth of business opportunities in Russia. However, there was initially a shortage of capital to exploit these opportunities, as the Russian commercial banking system was in its infancy and foreign banks were not yet lending to local businesses. In the absence of regulation, many Russian entrepreneurs solved this problem by opening banks of their own, which they used to channel capital in support of their businesses. The legacy of these so-called 'pocket banks' continues to be felt to this day, with a significant number of Russian banks failing to spread their risk across a sufficiently broad range of clients and industries. In some cases, these so-called 'concentration risks' are combined with default risk resulting from the overly rapid expansion of loan books. In the most serious cases, these risks have led to government intervention.

PSB is a case in point.

Concentration risks

PSB was founded by the Ananyevs in May 1995 as a pocket bank to provide funding to customers of Technoserv, the Ananyevs' systems integration business. Although PSB rapidly diversified its business—at its peak serving 2.5 million retail customers, 200,000 SMEs and 10,000 major corporates—it never fully broke with its past as a pocket bank:

— PSB was subject to sector concentration risk.[3] In the early days, PSB made loans mainly to businesses in the telecoms sector. By the time of its bail-out, this sector made up only 2% of PSB's loan portfolio. In the meantime, however, PSB had developed sizeable concentration risks in other sectors, notably real estate. Loans connected to real estate represented 22% of PSB's loan portfolio by the time of the bail-out. To make matters worse, PSB's balance sheet somewhat unusually included a speculative portfolio of buildings and land that represented nearly 5% of the bank's total assets. Worse still, a further 20% of PSB's loans were made to customers in the trade and oil and gas sectors, which are – like real-estate – dependent on the economic situation in Russia.

— PSB was subject to single-name concentration risk. In less euphemistic terms, PSB made a large proportion of its loans to a small group of borrowers. Specifically, PSB's top-20 borrowers represented one third of PSB's loan portfolio and 307% of its own capital – significantly higher than the Russian average of 226%, itself one of the highest concentration ratios in the world.[4] To top it off, the CBR discovered that loans to the Ananyevs and their companies represented more than 100% of PSB's own capital.[5]

The correlation between these concentration risks and PSB's origins as a pocket bank does not seem coincidental. The other two major Russian banks bailed out in 2017 also harboured high concentration risks and also began life as pocket banks: Bank Otkritie was originally a captive bank of the ICT Group private equity firm, while B&N Bank was founded to fund other companies within the B&N industrial group.[6]

Default risk

With the need for capital growing ever more acute and in the near-absence of regulation, thousands of small banks were set up in the early 1990s. By the end of 1994, the number of banks in Russia had peaked at 2,439.[7] What followed was a period of market consolidation, in which the more successful players devoured smaller banks in an effort to win market share and rapidly boost their balance sheets.

PSB was one of the banks pursuing this aggressive expansion strategy. It acquired AvtoVAZbank, Bank Nizhny Novgorod, Pervobank, Volgoprombank, Vozrozhdenie Bank and Yarsotsbank, among others. This shopping spree allowed PSB to grow at a blistering pace. Within three years, PSB was one of Russia's top-100 banks, and between 2001 and 2008, its assets grew at an average rate of 65% per year.[8] Even in its final years under the Ananyevs, PSB continued to grow rapidly, doubling its assets in the four years to the end of 2016.[9]

This growth came at a cost. Lurching from one acquisition to another left little time to integrate and manage the assets acquired, some of which were of poor quality (see below). This contributed to PSB accumulating a significant portfolio of bad loans. Shortly before the bail-out was announced, 19% of PSB's loan book was overdue or otherwise impaired (compared to 12% among Russian banks on average).[10]

Bail-out as a historical likelihood

The high concentration risks and low quality of PSB's loan book can be traced back to PSB's origins as a pocket bank and the rapid consolidation of the Russian banking sector. These risks, when combined with the worsening economic conditions in Russia starting in 2014 and increasingly stringent CBR capital requirements, led to the bail-out of PSB and a number of other banks like it. In this way, the bail-out of PSB demonstrates how the bail-out of Russian banks is often a direct consequence of the traumatic birth of banking in modern Russia.

Bail-outs under the old regime have begotten bail-outs under the revised regime

The bail-out of PSB was necessary, in part, because PSB had participated in the bail-outs of other banks under the credit scheme regime that was favoured prior to 2017.

Russia had no bail-out regime when it was hit by crisis in 1998; after all, Russian banking had then existed for less than seven years in the market economy. Accordingly, although ruinously expensive attempts were made to support the banking sector, millions of Russians were left in misery when swathes of banks collapsed, including Russia's then-largest non-state bank, SBS-Agro. This painful experience prompted the government to put in place Russia's first bailout regime. By 2008, this had evolved into the highly unconventional 'credit scheme'. Instead of the government injecting capital directly into failing banks (the usual practice worldwide), the credit scheme provided for stable banks voluntarily to acquire failing banks in return for cut-rate long-term loans from the government. In theory, by on-lending the cheap government money at a higher interest rate, the stable banks could generate handsome profits that could be used to recapitalize the failing banks.

PSB was a keen participant in this idiosyncratic arrangement: most of the banks it acquired in its haste to expand (see above) were failing banks acquired in the context of the credit scheme. According to the CBR, the financial burden of rescuing failing banks, particularly AvtoVAZbank, was a key driver behind PSB itself failing in 2017.[11] What the CBR meant by this is not certain, as it provided no further explanation and documents relating to credit scheme

bail-outs are not a matter of public record. However, the CBR's comments hint that PSB was affected by the moral hazard inherent in the credit scheme.

Moral hazard

The government has an interest in maintaining the stability of the financial system at all costs. Credit scheme participants therefore found that the government could be prevailed upon to provide additional credit or to roll-over existing credit where a failing bank continued to fail after its acquisition under the credit scheme. In addition, some credit scheme participants were able to redirect some of this money to their own businesses. Accordingly, credit scheme participants had little incentive to stabilize the failing banks they had acquired; to do so would bring an end to the cheap government credit, provided at a yearly interest rate of 0.51%.[12]

Safe in the knowledge that the government would foot the bill, some credit scheme participants even transferred bad loans to the failing banks they were supposed to be rescuing. This became a way for credit scheme participants to improve the appearance of their balance sheets, and PSB was reportedly no stranger to the practice.[13] The loan book of AvtoVAZbank, for example, swelled to nearly five times its original size within two years of being acquired by PSB, as a result of credit transfers. It appears, therefore, that PSB succumbed to the moral hazard posed by the credit scheme. As a result, PSB found itself financially responsible for an increasingly toxic failing bank, which may well have contributed to PSB's downfall.

Transition to the revised regime

By the mid-2010s, it was clear the credit scheme was in most cases not fit for purpose. An overhaul of the bank rescue regime in June 2017 finally provided the opportunity needed to break with the flawed practice. Since then, direct government intervention has been the favoured mechanism.

The revised regime is governed by the Federal Law on Bankruptcy, chapter IX, section 4.1. The law sets out circumstances indicative of a bank with serious liquidity or capitalization problems. These circumstances are grounds for initiation of the bank rescue regime. In the case of PSB, it was likely a violation of CBR capital adequacy requirements that provided grounds for intervention.

The first step under the revised regime is to put in place a temporary administration, which stabilizes the bank in the short term, investigates the severity of the problem and develops a long-term rescue plan. To facilitate this, the powers of the shareholders, management and executive organs are suspended and almost all decisions at the bank become subject to approval of the administration. The law provides the administration with extensive powers. Among other things, it may:

— access all documents, premises and personnel;

— take measures to preserve assets, including by nullifying unlawful transactions, clawing back management remuneration, or imposing a moratorium on withdrawals and other claims;

— change the shareholder and management structure;

— write off certain debts; and

— apply for criminal investigation where it finds evidence of unlawful behaviour.

In PSB's case, the temporary administration wasted no time getting to work. Within days it had established a bail-out plan, requested a criminal investigation into suspicious pre-administration transactions, and written off PSB's subordinated debts in the amount of USD 1.3 billion, as well as debts owed to management and Ananyev-controlled entities.[14] Interestingly, no moratorium was announced, which reportedly led to depositors withdrawing tens of millions of roubles per minute after the temporary administration was announced.[15] Although denied by the Ananyevs, it has been reported that the brothers were among those making withdrawals. They allegedly withdrew RUB 4.5 billion (USD 70 million) of their savings from the bank, using trolleys to carry off over 140 kilograms of banknotes.[16]

Once the temporary administration has prepared the ground, the authorities may take bankruptcy prevention measures. The key measure is the provision of financial aid – the bail-out proper. This is achieved by the authorities subscribing for a new issue of shares from the troubled bank, and is subject to three conditions:

— the bank's subordinated liabilities must be extinguished, along with any debts the bank has to its directors, management or controlling shareholders;

— the bank's share capital must be reduced to match the bank's own funds; and

— the issue of new shares must result in the government holding at least 75% of the voting shares of the bank.

In PSB's case, the temporary administration had already taken care of the first condition. The authorities therefore moved immediately to reduce PSB's capital in mid-January 2018. As PSB's liabilities exceeded its assets (i.e., it had negative own funds), the authorities reduced PSB's share capital to the minimum of one rouble. Finally, in March 2018, the authorities injected RUB 113 billion (USD 1.8 billion) into PSB in return for a 99.99% stake.

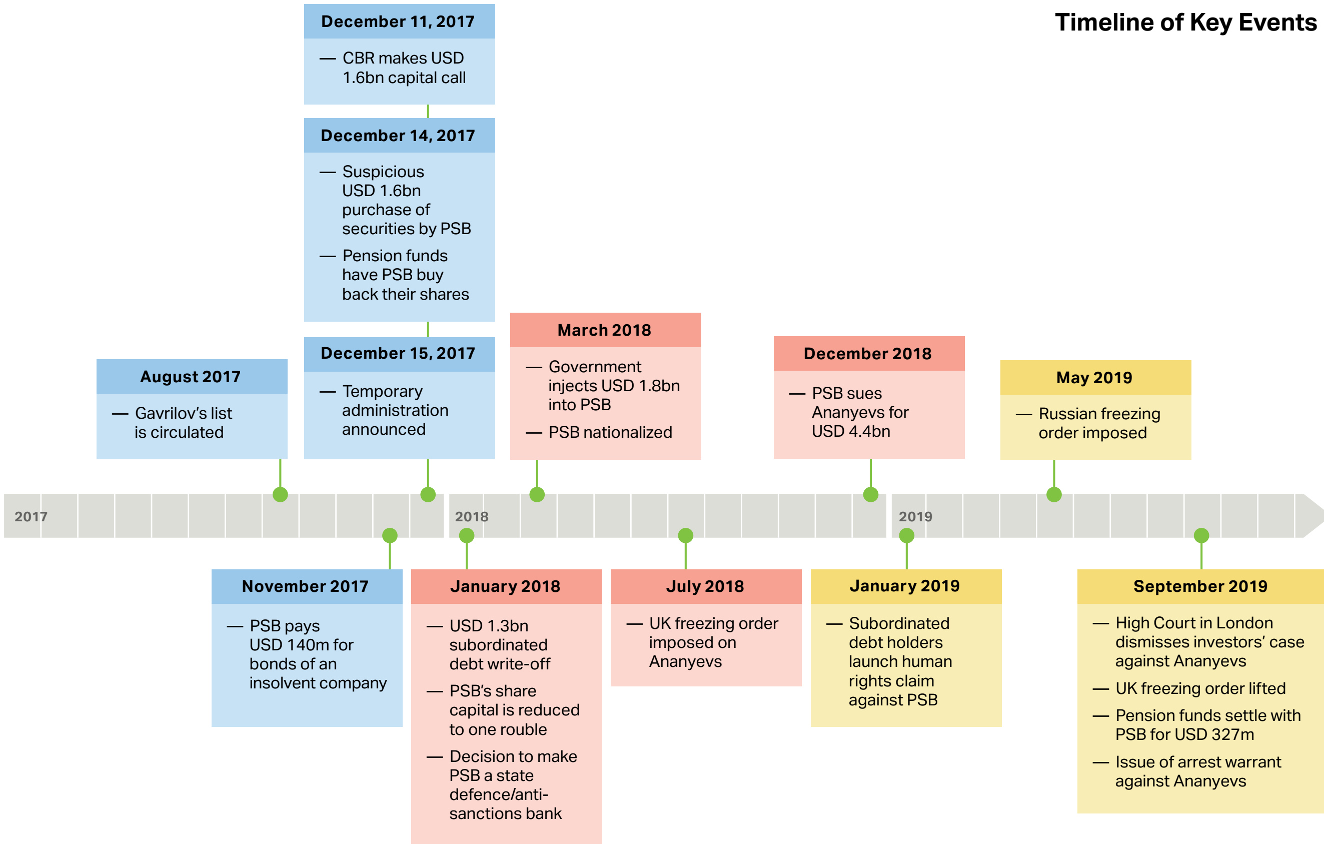
Russian non-state banks: hoisted by their own petard

Instead of safeguarding financial stability, the credit scheme merely served to exacerbate the risks inherent in the expansion strategy pursued by privately owned Russian banks. Not only were the likes of PSB, Otkritie and B&N acquiring other banks at reckless speed, but the credit scheme encouraged them to acquire unstable banks and to keep them unstable. Eventually, the instability spread to the credit scheme participants themselves. The irony is that banks like PSB would likely never have needed bailing out had they not participated in the bail-outs of other banks.

Bail-outs have left bank owners and investors in deep water

The purpose of bailing out a bank is to prevent the wider destabilization of the financial sector. On this metric, PSB's bail-out was successful. Depositors did not lose their savings and PSB now functions normally: it meets its obligations to other banks, repays deposits on demand, operates 8,000 ATMs and employs 12,800 people across 299 branches.[17]

The Ananyevs and investors in PSB have not fared so well.



The Ananyevs

According to Dmitry Ananyev, the bail-out of PSB was a government conspiracy to gain control of the bank and cow the Russian banking sector at large. He says PSB was solvent and had sufficient liquidity, but smear campaigns orchestrated by the CBR allowed the bank to be "shot and its skin thrown to the [authorities]".[18]

Conspiracy or not, the CBR took control of PSB and its books. They revealed a number of suspicious transactions completed in the run-up to PSB being taken into temporary administration. Among the most concerning allegations were the following:

— The purchase by PSB of securities from Ananyev-linked entities at above-market prices. These transactions, concluded the day before the CBR's intervention, cost PSB RUB 102 billion (USD 1.6 billion).

— The purchase by PSB of bonds issued by its finance subsidiary. PSB funded this purchase by taking out a subordinated loan from its finance subsidiary. The finance subsidiary had funded this loan by issuing the bonds to the market. The effect of this circular scheme in late summer 2017 was that PSB had purchased bonds that would only pay out if PSB repaid the subordinated loan. As the subordinated loan was soon to be written off as part of the bail-out, the bonds were worthless. Still, the purchase price for the bonds represented another RUB 44 billion (USD 688 million) safely beyond the reach of the soon-to-be-appointed administration.

— The purchase by PSB of the bonds of an insolvent company. In November 2017, PSB spent RUB 9 billion (USD 140 million) purchasing the bonds of a company owned by Dmitry Ananyev. The company had filed for insolvency some months earlier, making the bonds practically worthless.

PSB, at the direction of the CBR, is suing the Ananyevs and their associates for RUB 282 billion (USD 4.4 billion) in connection with these dealings and others. While the case is still in progress, PSB has convinced a Moscow court to freeze the Ananyevs' most valuable assets, including their paintings, private jets, apartments and luxury cars.

Worse still for the Ananyevs, an international warrant has been issued for their arrest on charges of grand embezzlement and money laundering under articles 160 and 174 of the Russian Penal Code. The brothers face up to ten years in a penal colony if found guilty.[19]

The Ananyevs have gone into hiding. Aleksey Ananyev nonetheless managed to transfer his assets to his wife, while the paintings subject to the freezing order disappeared from the Ananyevs' gallery. In late 2019, a court annulled Aleksey Ananyev's marriage and the paintings (including an oil painting of Alexey Ananyev in the Socialist Realist style) were discovered in a lock-up on the outskirts of Moscow. The brothers' whereabouts, however, remain unknown.[20]

PSB investors

PSB's bail-out secured a good outcome for depositors, but the bank's shareholders, subordinated debt holders and structured product investors suffered heavy losses.

The shareholders – the Ananyevs, but also the European Bank for Reconstruction and Development and certain other minority shareholders – were wiped out when the authorities reduced PSB's share capital to one rouble. Seeing that the writing was on the wall, a number of private pension funds with significant minority shareholdings in PSB attempted on the eve of the administration announcement to avert financial disaster by effectively having PSB buy their shares back. This gambit was, however, ultimately unsuccessful, as a lawsuit brought by the temporary administration resulted in a settlement agreement requiring the pension funds to pay nearly RUB 21 billion (USD 327 million) in long-term deposits into the bank.[21]

PSB's subordinated debt holders faced a similar fate. They lost the entire amount owed to them when the authorities exercised their power under the Federal Bankruptcy Law to write off PSB's subordinated debts. Somewhat imaginatively, the erstwhile subordinated debt holders sued Russia in January 2019 before the European Court of Human Rights, claiming that the write-off was a breach of their right to property, for which they were entitled to compensation. The case has yet to be heard.

Even retail investors lost out in the bail-out. In an attempt to see a fractionally greater return on their savings than regular depositors, customers of PSB's private banking arm had ploughed tens of millions of dollars and euros into PSB group structured products in 2017. They allege that PSB marketed the investments as benefitting from the personal guarantee of the Ananyevs. In fact, the products were guaranteed by an intermediate holding company ultimately owned by the Ananyevs. Soon after PSB was put into administration, the issuer of the products, along with its now-insolvent guarantor, defaulted on its obligations to the investors.

A group of around 100 of the out-of-pocket investors, who had together sank approximately USD 80 million into the products, sued the Ananyevs in London for conspiracy, causing loss by unlawful means, misrepresentation and deceit.

While the investors were twice successful in having the Ananyevs' assets in the UK frozen, their claim was ultimately thrown out by the High Court.[22] A conspiracy theory attributes this to the Ananyevs being recruited as British intelligence assets.[23] The court provided a more sober explanation: the mere presence of UK companies in the chain of ownership linking the guarantor of the structured products to the Ananyevs was not enough to give the court jurisdiction to rule on the substance of the dispute.

A no-win situation

The Ananyevs have lost their pride and joy, become branded "financial terrorists", and face enormous civil liabilities and serious criminal charges.[24] Investors in their business have lost millions. Even the Russian taxpayer ended up spending a total of RUB 243 billion (USD 3.8 billion) on the rescue operation.

As the PSB saga goes to show, there are no winners in a bail-out.

Bail-outs have increased state control over the banking sector

The revised bail-out regime obliges the Russian state to take a controlling stake in any bank to which it provides direct financial support. As PSB and the other banks bailed out in 2017 were among Russia's biggest, their bail-out has effectively nationalized a large portion of the banking sector.

The presence of state-run banking behemoths Sberbank and VTB has always guaranteed the Russian government influence over the banking sector. However, the bail-out and nationalization of PSB and others has increased that influence further still. State-owned banks now account for over 80% of lending to corporates and 70% of lending to individuals.[25] By comparison, Alfa-Bank, Russia's largest non-state bank and fifth-largest bank overall, accounts for just 4% of lending.[26] State concentration of the banking sector is so acute that even the competition regulator recently commented that the nationalization of banks "pushes [Russia] even further into state capitalism, and a state monopoly over the economy is not democracy – as history well shows…".[27]

President Putin has sought to calm concerns over state participation in banking, reassuring the population that "nobody is planning on smothering every bank in Russia".[28] This tallies with CBR policy, which is to re-privatize bailed-out banks as soon as possible.[29] However, it has been over two years since 2017's wave of bail-outs and, if other countries are anything to go by, "as soon as possible" likely implies years more state ownership. For example, it took the British government nearly a decade to return Lloyds Bank to the private sector after its bail-out in 2008.

As for PSB, it will never return to private ownership. In early 2018, PSB's status as a state bank was made permanent as a precursor to the government conferring on it a particularly sensitive mission. PSB is now tasked with providing financing to sanctioned entities and enterprises within Russia's military-industrial complex.

The idea is to reduce the efficacy of US sanctions by ensuring sanctioned persons and persons at risk of being sanctioned have a reliable source of funding. A Russian bank financing a sanctioned person may itself be sanctioned by the United

States. Any person that continues to deal with such a bank can expect to be sanctioned in turn. Russian banks that wish to avoid mass desertion of their customers, creditors, suppliers and other counterparties are therefore forced to eschew sanctioned persons, thereby doing the bidding of the US authorities. PSB, however, is intended to be impervious to this outside pressure: it can operate at a loss indefinitely thanks to state support; it makes loans to companies that are already sanctioned or to defence companies whose sole customer is the Russian government; its operational currency is the rouble; it does not rely on foreign financial infrastructure; and its financial statements and the identity of its directors have been made state secrets.[30] At least in theory, imposing sanctions on PSB should have little effect on its lending activities.

While PSB may be the most extreme example, there is no doubt the revised bank bail-out regime has contributed to the creeping control of the Russian state over the banking sector.

A happy ending?

The Tale of PSB and the Brothers Ananyev recounts how banking in Russia has been dogged by its difficult past and forced to retrace its steps in search of a bank rescue regime that works. The journey has been fraught with danger, particularly for ambitious, expanding banks and those that chose to invest in them. The road ahead for the Russian taxpayer and the remaining privately owned banks looks no less treacherous.

The dust is now starting to settle. While the CBR has spent the equivalent of 2.4% of Russia's GDP (RUB 2.5 trillion/ USD 39 billion) on financial support for banks since the revised rescue regime was introduced, its intervention does seem effective.[31] No systemically important Russian bank has been targeted for bail-out since the end of 2017. The financial system appears stable.

Stable does not mean robust, however. The proportion of overdue loans (i.e., NPLs) in the Russian banking sector stubbornly hovers around 10% (compared to 4.5% in other major emerging markets).[32] This indicates that even a relatively modest worsening of economic conditions could spell trouble for Russian banks, which are no doubt keen to reduce their NPL exposure.

Distressed debt investors should not get too excited about this.

For one thing, the NPL market in Russia remains underdeveloped, with political risk and the absence of reliable legal and market infrastructure driving low transaction volumes.

In addition, it appears the very substantial NPLs attributable to PSB, Otkritie, B&N and other bailed-out banks are not for sale anyway. The government has pooled RUB 2 trillion (USD 31.5 billion) of these NPLs into another failed bank – Trust Bank. The idea is to remove the NPLs from the balance sheets of the bailed-out banks and simultaneously put them in the hands of a single 'bad bank', which should be able to realize whatever value is left in the NPLs efficiently. Although Trust sold NPL portfolios worth RUB 26 billion (USD 409 million) in 2018, the head of Trust has recently indicated that the bad bank does not intend to sell any more and will instead manage the NPLs itself: "selling [NPLs] just so someone else can recover something from them and get the money for themselves is not our model".[33]

As the government embarks on the long journey of squeezing the last drops out of the substandard assets left behind by PSB and other bailed-out banks, the Russian banking sector would do well to reflect on the events of 2017. The expense and state domination of banking that have resulted from bail-outs raise the question of whether further reform of the bank rescue regime is needed. One possibility would be to have the creditors of a failing bank converted into shareholders of the bank, with the aim of reducing the bank's debt burden sufficiently for it to recover. This so-called 'bail-*in*' technique involves no injection of public funds nor any acquisition of shares by the state, thereby avoiding the key shortcomings of Russia's present bail-out regime.

If the PSB fiasco can at least start a conversation about the future of bank rescue in Russia, The Tale of PSB and the Brothers Ananyev may yet have a happy ending. ■

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Matthew is grateful to Kristina Belyaeva for her assistance with this article.