

Russian Banks on the Route of Fragile Recovery

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Largely thanks to the recovery of the real economy, the situation of Russian banks has improved again. After month-on-month loan growth had quickly ground to a halt in late 2008, banks contributed to Russia's deep economic slump in 2009. The share of nonperforming loans had tripled to 10% of total loans by late 2009 and has since remained at about this level. An incipient recovery of lending made itself felt only in the second quarter of 2010. However, as the national authorities had delivered a comprehensive policy response which helped sustain or reestablish confidence, Russia did not experience any major bank run or failure. Temporary deposit withdrawals after the collapse of Lehman Brothers were followed by a rapid expansion of deposits, starting from early 2009. Following a modest crisis-triggered rise, the share of foreign currency loans declined again to about one-fifth of total loans. Banks' access to international capital markets improved from late 2009/early 2010. Profitability, having plunged to zero in mid-2009, subsequently recovered but is still modest. Thanks to recapitalization exercises, capital adequacy is satisfactory. The stabilization of the banking sector has allowed the authorities to start exiting from crisis response measures. Banks face a vulnerable environment given the world economy's post-crisis fragility and Russia's undiminished dependence on the oil price and capital flows, which is exacerbated by persisting structural weaknesses. Nonetheless, the existing shock-absorbing factors are sizeable.

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1 Macroeconomic Background: From Crisis-Triggered Slump to Recovery

Russia suffered a deep economic contraction in 2009 and is now slowly recovering again. While banks had contributed to the severe slump, they are not yet among the driving forces of the recovery. After having contracted by 7.9% in 2009 – notwithstanding the authorities' comprehensive anti-crisis policy package – GDP is estimated to have expanded again in the first eight months of 2010, namely by around 4% year on year. The plunge and recovery of oil and metal prices as well as substantial capital outflows and their subsequent partial reversal contributed to the downturn and to the following upswing. In the downturn, gross fixed capital formation and inventory stocks collapsed, while imports slumped more than exports and, hence, the contribu-

tion of net exports limited the extent of recession. In the upswing, export expansion was followed by both private consumption and finally fixed investment recovery.

The ruble's nominal effective exchange rate depreciated from end-July 2008 to end-February 2009 by 18%, before regaining 13% until end-August 2010. Most recently, the Central Bank of the Russian Federation (CBR) rendered exchange rate policy more flexible, which allowed for increased volatility of the ruble in September 2010. Reappreciation and the persisting output gap were largely responsible for CPI inflation touching a post-Soviet low of 5.5% (year on year) in July 2010. Inflation rose again to 7.0% in September due to the impact of this year's summer heat wave. The CBR continued to make use of the window of opportunity that low inflation offered to support

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Table 1

Macroeconomic Indicators

	2006	2007	2008	H1 09	2009	H1 10
Real GDP growth (annual change in %)	8.2	8.5	5.2	-10.2	-7.9	4.2
Inflation (average-of-period CPI, annual change in %)	9.8	9.1	14.1	13.3	11.8	6.7
Inflation (end-of-period CPI, annual change in %)	9.1	11.9	13.3	12.0	8.9	6.1
Budget balance (general government, % of GDP)	8.4	6.0	4.9	x	-6.3	x
Current account balance (% of GDP)	9.6	6.0	6.1	3.4	4.0	7.5
Net FDI inflows (% of GDP)	0.7	0.7	1.1	-1.1	-0.6	-0.6
Total gross external debt (% of four-quarter rolling GDP)	30.1	33.2	30.4	32.5	36.6	37.0
Gross external debt of the banking sector (% of four-quarter rolling GDP)	9.7	11.6	10.4	9.9	10.0	9.9
Gross international reserves (% of four-quarter rolling GDP)	29.2	34.3	27.0	28.7	34.4	37.4
RUB per 1 USD (average of period)	27.2	25.6	24.8	33.1	31.8	30.1
RUB per 1 EUR (average of period)	34.1	35.0	36.4	44.1	44.1	39.9

Source: Bank of Russia, Federal State Statistics Service, Thomson Reuters.

economic recovery and fight the crisis-triggered credit crunch: It lowered the refinancing rate from 13% in April 2009 to 7.75% at end-May 2010. Since then this key rate has been kept unchanged. As table 1 shows, total gross external debt (with private corporates accounting for the lion's share) has remained manageable at 37% of GDP in mid-2010 and is matched by the size of the foreign exchange reserves.

2 Impact of the Crisis on the Banking Sector

Sizeable capital outflows (both on the assets and the liabilities side of the economy) in the fall of 2008 hit the already feebly functioning interbank market, whose interest rates spiked in early 2009. Given the liquidity squeeze, some small and medium-sized banks, which often had limited deposit bases, grew illiquid and defaulted. Month-on-month expansion of loans² ground to a halt in late 2008 and the loan stock

started to decline. Given the real economy's downturn, credit quality started to deteriorate: The share of nonperforming loans (narrow definition, NPLs) in total loans more than doubled to 7.6% in the year to mid-2009, and continued to rise.³ The increase in NPLs also outstripped growth of provisions. In late 2008, the financial market turmoil and the pressure on the ruble temporarily hit depositors' confidence, as savers withdrew ruble deposits. While there was no major run on banks, redollarization tendencies reemerged, as part of the withdrawn money was switched into foreign currency-denominated deposits. Despite the rise of the latter, total deposits declined. Also driven by exchange rate effects, the share of foreign currency-denominated deposits in total deposits of the private sector doubled to about one-third from mid-2008 to end-March 2009. Profitability (ROA, ROE) plunged to almost zero in mid-2009, before starting to recover.

² In this article, loans and deposits are defined as related to the private sector, i.e. they exclude interbank loans and deposits.

³ NPLs as defined in Russian Accounting Standards (RAS) do not correspond to international standards. NPLs according to a wider definition (see also table 2) or measured in line with IFRS are about twice as high.

3 Comprehensive Policy Response

The Russian authorities' policy response was comprehensive and included important measures to inject liquidity (on the part of the government and the CBR). A case in point was the placement of CBR deposits in banks' portfolios; such deposits rose from almost nil to about 14% of banks' balance sheet total at end-March 2009, before declining again. Other measures included (1) the introduction of regulatory forbearance by easing loan classification and provisioning requirements, (2) selective governmental capital injections into large state-owned banks (Vneshekonombank/VEB, Vneshtorgbank/VTB, Sberbank and Rosselkhozbank), partly for bailing out four medium-sized banks, (3) closures of some smaller banks, (4) a more than two-fold increase of the deposit insurance limit and (5) a controlled step-wise devaluation of the ruble from mid-November 2008 to late January 2009.⁴ The authorities' entire crisis-response package, which was not exclusively aimed at the banking sector, is estimated at about 10% of annual GDP; according to government calculations, it mitigated GDP contraction in 2009 by about 2%.

Banks' and other entities' sizeable capital outflows (downsize of external liabilities and buildup of external assets) in the fourth quarter of 2008 implied purchasing foreign currency assets with rubles, which contributed to depreciation pressures. The CBR limited the currency depreciation to a controlled step-wise devaluation by means of substantial foreign exchange interventions. This implied a major loss of foreign exchange reserves, which were effectively transferred to commercial banks and companies. From end-August 2008

to end-February 2009, the CBR's foreign exchange reserves fell by about one-third or almost USD 200 billion. As the ruble depreciated further, credit institutions were able to make exchange rate and trade gains. Thus, in the year until end-March 2009, banks' external assets doubled; from mid-2009, they exceeded banks' external liabilities, which had declined as a result of refinancing and funding problems abroad.

4 Recent Developments

4.1 Internal and External Funding Situation Improves

The stabilization of private sector deposits in early 2009 was followed by a rapid expansion over the subsequent one and a half years. The end of the step-wise ruble devaluation policy and the comprehensive policy response seem to have contributed to boosting depositors' confidence. From March 2009 to August 2010, deposits rose by some 24% in real (CPI-deflated) terms. Deposit expansion was mainly driven by ruble-denominated deposit inflows from households. As foreign currency-denominated deposits of the private sector remained rather stable (adjusted for exchange rate effects) following their increase in late 2008 and early 2009, the share of foreign currency deposits declined from one-third in the first quarter 2009 to one-fifth by mid-2010. As deposits increased much more strongly than loans, the loan-to-deposit ratio declined from 175% at end-2008 to 132% by mid-2010 (see table 2).

While deposits increased, tensions on the interbank market faded in the course of 2009, also thanks to policy measures. Money market rates quickly came down from their spikes recorded in early 2009. The improved liquidity

⁴ For more detail on important initial crisis-response activities, see Barisitz et al. (2009), pp. 135–137.

situation in the banking sector allowed the authorities to start exiting from extraordinary liquidity support and banks to repay their debt to the CBR ahead of schedule. Therefore, CBR funds on the liability side of the banking sector shrank. Moreover, banks increasingly deposited surplus liquidity at the central bank and invested in CBR bonds. The net asset position vis-à-vis the central bank, that had turned deeply negative in the first quarter of 2009 (–5% of GDP), became positive again in the final quarter of the year. The higher share of liquid assets in total assets and the increased ratio of liquid assets to short-term liabilities (above 100% at end-2009 and in mid-2010) also illustrate the improved liquidity position of the Russian banking sector.

Following large asset- and liability-side net foreign capital outflows in the second half of 2008 and in early 2009, capital continued to flow out of the Russian banking sector until the third quarter of 2009. On the liability side alone, net flows remained negative until the final quarter of 2009, reflecting debt repayment and tight external financing conditions. In 2010, the external financing situation improved, however, and the banking sector posted net inflows on the liability side in the first quarter of the year and only small outflows in the second quarter.⁵ As the component short-term loans contributed strongly to total outflows in 2008 and 2009, the share of short-term external debt in banks' total external debt fell from one-third in mid-2008 to 18% in

the third quarter of 2009. Due to a reaccumulation of short-term debt and redemptions of long-term loans, this share reached 25% by mid-2010. The Russian banking sector remained a net external creditor until mid-2010, but the position started to narrow from the fourth quarter of 2009 as a result of improved access to (and usage of) foreign funding and a slight decline of assets held abroad.

4.2 Turnaround in Credit Quality and Profitability – Restart of Loan Growth?

After NPLs had risen particularly strongly until mid-2009, the deterioration of loan quality started to decelerate in the second half of 2009 (see chart 1, left-hand panel). In 2010, the share of NPLs (narrow definition) in total loans stabilized at about 10% and was fully covered by provisions. Banks' restructuring of problem loans, the real economic recovery and the appreciation of the ruble – which decreased the debt servicing costs for unhedged foreign currency borrowers – certainly contributed to the easing of pressures on credit quality.⁶ In turn, the stabilization of NPLs went hand in hand with a marked decline in the net creation of loss provisions in the first half of 2010. As a consequence, profitability was pushed up to more comfortable levels despite a noticeable decline in net operating income (that had held up well during 2009), with annualized ROA and ROE reaching 1.7% and 10.9%, respectively, in the first half of 2010.

⁵ Some Russian banks have recently been able to tap the eurobond market. For example, Vneshtorgbank concluded three deals in 2010 (until September) comprising a total of EUR 1.47 billion. This good news has not, however, prevented medium-sized Mezhprombank (which ranks among the country's 30 largest credit institutions) from defaulting on its EUR 200 million eurobond in July 2010 – the first eurobond default by a Russian bank in more than a decade. The market seems to have judged Mezhprombank's default as a one-off case. The CBR repealed the bank's license in October 2010 (Norton, 2010, p. 241; *Ekonomika i Zhizn*, 2010, p. 5).

⁶ While restructuring certainly helped reign in bad loans, precise information seems to be lacking on how many outstanding loans were actually restructured during the crisis (IMF, 2010a, p. 2).

Table 2

Selected Banking Sector Stability Indicators

	2006	2007	2008	H1 09	2009	H1 10
Credit risk						
Loans to the private sector (% of four-quarter rolling GDP) ¹	29.2	36.0	38.8	40.5	40.1	38.3
Real growth of loans to the private sector (annual change in %)	34.3	36.0	18.6	-0.3	-10.6	-5.9
Real growth of loans to the private sector (exchange rate-adjusted, annual change in %)	37.6	38.1	14.2	-6.2	-11.0	-5.2
Loans to households (% of loans to the private sector)	23.8	24.7	24.9	22.8	22.7	22.7
Nonperforming loans (% of total loans, narrow definition) ²	2.4	2.5	3.8	7.6	9.6	9.5
Nonperforming loans (% of total loans, broad definition) ³	x	11.0	13.5	17.3	19.5	20.0
Market and exchange rate risk						
Foreign currency loans to the private sector (% of private sector loans)	22.0	20.0	22.2	23.7	21.8	21.1
Foreign currency loans to households (% of loans to households)	15.9	13.4	11.8	12.2	11.1	10.3
Foreign currency deposits of the private sector (% of private sector deposits)	16.3	13.9	27.1	28.8	25.7	21.9
Deposit rate, households (%) ⁴	6.1	7.1	9.9	10.3	9.2	6.1
Deposit rate, corporations (%) ⁴	5.7	7.2	10.6	11.4	8.7	5.7
Lending rate, households (%) ⁵	15.5	15.0	18.1	20.5	19.2	18.1
Lending rate, corporations (%) ⁵	11.7	11.5	14.1	16.0	13.8	11.7
Liquidity risk						
Private sector deposits (% of four-quarter rolling GDP)	28.6	22.2	22.2	25.1	29.2	29.1
Real growth of private sector deposits (annual change in %)	89.6	-14.5	-5.9	4.1	4.7	15.2
Real growth of private sector deposits (exchange rate-adjusted, annual change in %)	95.8	-13.5	-10.7	-3.0	6.2	17.1
Loan-to-deposit ratio (%)	102.2	162.5	175.4	161.2	137.0	131.8
Liquid assets (% of total assets)	26.8	24.8	25.9	25.7	28.0	27.7
Liquid assets (% of short-term liabilities)	76.8	72.9	92.1	90.5	102.4	101.2
Banks' external assets (% of banks' total assets)	12.2	11.8	16.8	16.7	16.5	14.9
Banks' external liabilities (% of banks' total assets)	20.6	21.3	18.0	16.3	13.4	13.0
Share of short-term external debt (% of banks' total external debt)	39.2	33.0	26.0	21.3	21.7	25.1
Central bank liabilities (% of banks' total assets)	0.3	0.3	13.8	9.0	6.4	3.1
Profitability						
Return on assets (ROA, %)	3.2	3.0	1.7	0.0	0.7	1.7
Return on equity (ROE, %)	26.0	22.6	13.2	0.3	4.9	10.9
Cost-to-income ratio (%)	x	37.9	38.9	29.0	30.6	35.8
Shock-absorbing factors						
Capital adequacy ratio (%)	14.9	15.5	16.8	18.5	20.9	18.9
Loan loss provisions (% of total loans)	4.1	3.6	4.5	6.9	9.1	9.5
Claims on the central bank (% of banks' total assets)	7.9	7.2	7.2	6.0	6.8	8.0
Memorandum items						
Share of majority foreign-owned banks (% of total assets)	12.1	17.2	18.7	17.6	18.3	17.6
Share of majority state-owned banks (% of total assets)	37.8	39.2	40.6	x	x	x

Source: Bank of Russia, Raiffeisen Research CEE Banking Sector Report 2010, OeNB calculations.

¹ The private sector comprises households and corporations.

² Share of problem (IV quality category) and bad (V quality category) loans in total loans. Review of the banking sector of the Russian Federation, table 36.

³ Sum of doubtful, problem and loss loans. Review of the banking sector of the Russian Federation, table 43.

⁴ Weighted average over all maturities; excluding demand deposits.

⁵ Weighted average for loans with a maturity of more than one year.

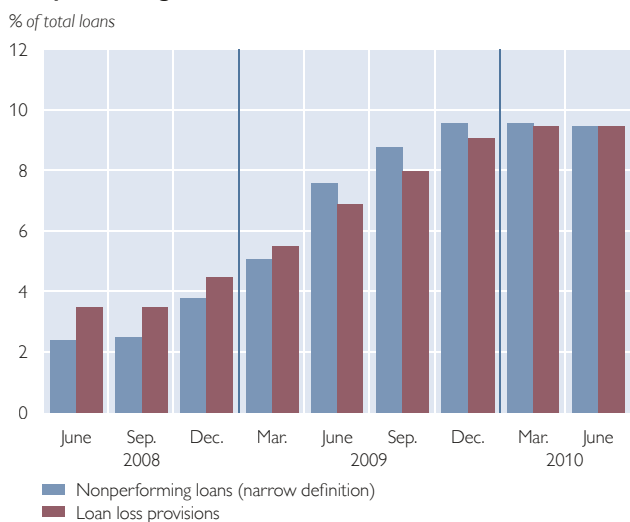
Thus, the profitability indicators of the Russian banking sector currently stand at about half of the precrisis levels.

Due to capital increases, largely by the state and by foreign parent banks, the capital adequacy ratio increased

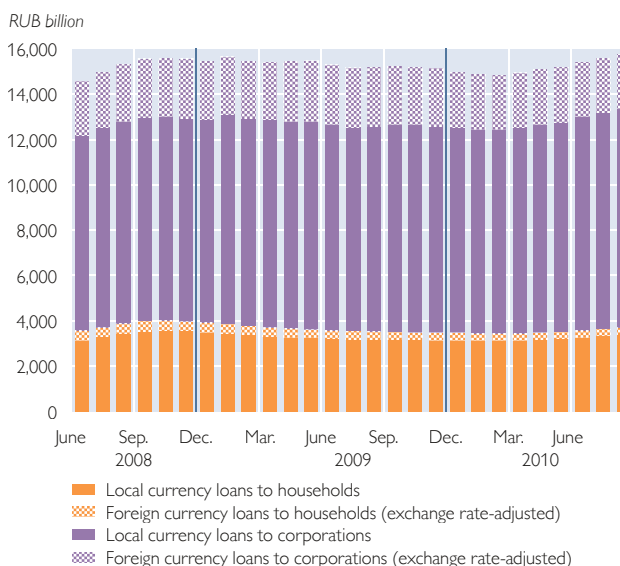
from 16.8% at end-2008 to 20.9% at end-2009, before declining to 18.9% in mid-2010. Hence, on an aggregate level, the banking sector is well capitalized and disposed of a considerable cushion throughout the crisis period.

Credit Risk and Loan Growth

Nonperforming Loans and Loan Loss Provisions



Stock of Domestic Loans to the Private Sector



Source: Bank of Russia, OeNB calculations.

Note: Nonperforming loans refer to the share of problem (IV quality category) and bad (V quality category) loans in total loans. Review of the banking sector of the Russian Federation, table 36.

However, there is reportedly considerable variance in the level of problem loans, provisioning and capitalization among individual Russian credit institutions (Standard&Poor's, 2010, p. 5).

Amid rising NPLs and subdued demand for loans given weak macroeconomic conditions, the domestic loan stock (adjusted for exchange rate effects) continued to shrink until February 2010.⁷ However, improved liquidity conditions in the banking sector (due to buoyant deposit inflows and better access to foreign funding) as well as the leveling-off of the rise in NPLs and the decline in the creation of provisions set the stage for a revival of lending in early 2010. Moreover, the economic recovery gained momentum, which contributed to containing NPLs and

implied increased demand for loans. Starting from March 2010, the domestic private sector loan stock augmented gradually (see chart 1, right-hand panel). This development was driven by lending to companies as well as households. In both segments, loans were predominantly granted in rubles. The stock of foreign currency-denominated loans to households continued to decline, while some borrowing in foreign currency took place in the corporate sector (but average month-on-month loan growth was lower than for ruble-denominated loans). Still, year-on-year loan growth (in CPI-deflated and exchange rate-adjusted terms) remained negative: in August 2010, it stood at about -3%. It will probably turn positive in the fall of 2010.

⁷ In 2009, some temporary increases were caused by lending to companies that was partly supported by government guarantees.

Box 1

Austria and Russia Strengthen Supervisory Cooperation¹

The Austrian Financial Market Authority (FMA) and the Oesterreichische Nationalbank (OeNB) concluded a Memorandum of Understanding (MoU) on supervisory cooperation with the Central Bank of the Russian Federation on October 18, 2010. This MoU is designed to facilitate bilateral cooperation by providing, among other things, for a more explicit regulatory framework for supervisory practice.

The growing financial integration of Austria and the Russian Federation reflects considerable increases in cross-border bank exposure. Among Austrian banks, the Raiffeisen Group and UniCredit/Bank Austria have emerged as the key players in Russia. Austrian banks' overall exposure to Russia totaled EUR 28.5 billion² at the end of June 2010 and mainly consisted of retail banking business, with lending to nonbanks accounting for somewhat more than four-fifths of the exposure volume. Conversely, Russia's VTB Bank does substantial business in Austria.

The signing of the MoU represents an important step in strengthening supervisory cooperation across borders, not least given the important role that Russia has come to play in the world financial system as well as the joint responsibilities the FMA and the OeNB have in the supervision of banking groups. In recent years, the FMA and the OeNB have reinforced cooperation with supervisory authorities and central banks across Central, Eastern and South-eastern Europe to enhance supervisory effectiveness.

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² According to the BIS, total exposure breaks down into cross-border loans and claims of Austrian banks' subsidiaries in Russia. This figure includes the exposure of UniCredit/Bank Austria, although this banking group is majority-owned by the Italian bank UniCredit.

4.3 Stabilization of Banking Sector Paves Way for Exit from Crisis Response

As the situation in the Russian banking sector had stabilized, Russian authorities started to withdraw support mechanisms introduced at the height of the crisis (IMF, 2010b, p.12, and Bank of Finland, BOFIT Weekly 39/2010). As already mentioned, the CBR began to exit from extraordinary liquidity support operations as the need for central bank refinancing instruments declined. Lending limits for uncollateralized loans to banks were reduced in February 2010, unsecured lending was stopped almost completely, interbank market guarantees are being unwound, and the CBR intends to tighten eligibility after having expanded the list of eligible collateral for repo transactions during the crisis. Moreover, regulatory forbearance, in the form of easier provisioning requirements, will be gradually

brought back in line with precrisis norms. A financial emergency decree introduced in 2009 allows banks that suffer losses in two consecutive quarters to continue to take deposits. Under normal conditions, a bank that posts losses in two consecutive quarters is prohibited from taking further deposits. The decree is valid until the end of 2010. Currently, there is a debate in Russia about whether or not it would be justified to extend the emergency policy into next year.

5 Assessment of Current Banking Risks

5.1 Global Economy, Oil Price and Capital Flows Still Cause for Substantial Uncertainty

The Russian economy's generally positive outlook (the Russian authorities as well as independent experts expect GDP to expand by about 4% to 5% both in 2010 and 2011) is supported by rising

domestic demand. Russia nevertheless remains as dependent as ever on energy and raw material prices and the global economy. Given the world economy's post-crisis fragility and Russia's only weak structural diversification and FDI penetration, the whole economy and the banking sector remain vulnerable to swings in global demand and in investor sentiment on international financial markets.

5.2 Connected Lending, Inadequate Risk Management, Regulatory and Supervisory Shortcomings

Connected or related-party lending is a long-standing deficiency of Russian banking practice. It appears to be partly linked to the modest business climate and the – in view of recurrent crises and turbulent times – relatively large number of credit institutions still in existence. Many medium-sized or smaller banks tend to be strongly dependent on a small number of depositors (creditors) and/or borrowers that may be identical with beneficial owners. Often in the framework of “financial-industrial groups,” these “pocket banks” typically function as extended financial departments of owner firms or businessmen. It is in this institutional framework that connected lending, combined with feeble corporate governance and risk management, has remained pervasive. According to CBR estimates, related-party lending (which is often concealed through specific schemes) may account for up to 25%, or in some cases even 50%, of banks' loan portfolios.⁸ This is a persistent source of structural weakness, deteriorating credit quality, serious instability

and crisis-triggered defaults (Moody's, 2010, p. 9). Such problems can materialize due to, among other things, regulatory and supervisory shortcomings, including insufficient CBR authority to conduct consolidated supervision. The authorities plan to adjust the pertinent legislation and regulations to curb intragroup lending.

5.3 Still Sizeable NPLs, Insufficient Loan Classification and Provisioning System

While the share of nonperforming loans has stabilized recently, only narrowly defined NPLs (slightly below 10% of total loans) are just barely covered by loan loss provisions. If NPLs are measured according to IFRS, or based on a wider definition, they would account for about one-fifth of total loans, with only about half (or less) covered by loan loss provisions. Accounting rules, loan classification and provisioning are areas where practices continue to be biased toward the formal and largely backward-looking observance of rules in lieu of substantive risk-based and forward-looking procedures (form over substance approach).

5.4 Strong Shock-Absorbing Factors

Russian banks, and even more so the Russian authorities, boast sizeable shock-absorbing factors. Banks' liquidity is satisfactory, as deposits have expanded substantially in the last twelve months (cutting the loan-to-deposit ratio), and depositor confidence remains high. At about one-fifth each, the shares of foreign currency-denominated deposits and loans in total deposits/loans are not very high and thus much lower than

⁸ As pointed out by Gennady Melikian, First Deputy Chairman of the Bank of Russia, at the International Banking Congress that took place in St. Petersburg, May 26–29, 2010. According to Melikian, these practices became even more widespread during the crisis.

in a number of other transition countries.⁹ Credit institutions hold sizeable external assets: Following a strong increase in the first half of 2009, external assets are still quite high at about 15% of total banking assets, and exceed external liabilities. Claims on the CBR are also elevated at 8% of total assets. Capital adequacy, as measured, is relatively high.

Although they have already launched the exit from crisis response policies, the authorities could quickly reactivate measures if necessary. The CBR as well as the government maintain con-

siderable room for maneuver: Despite its recent uptick, inflation is still relatively low for Russian standards. The enhanced flexibility of the CBR's exchange rate policy reduces potential policy conflicts. Its heightened volatility notwithstanding, the ruble is currently perceived to be neither substantially overvalued nor undervalued. While the government continues to be saddled with budget deficits, the Russian state's debt remains very low at about 11% of GDP. In addition, gross international reserves continue to be generous (EUR 360 billion in mid-October 2010).

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⁹ Moreover, foreign currency-denominated deposits of the private sector have sharply declined from the height of the crisis (end-March 2009: 33% of total deposits, mid-2010: 22%).