Research in International Business and Finance 38 (2016) 577–592

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length Article

Western sanctions—Only half the challenge to Russia's economic union

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ARTICLE INFO

Article history:
Received 30 December 2015
Received in revised form 14 June 2016
Accepted 8 July 2016
Available online 17 July 2016

JEL Classifications:
F3
G2

Keywords:
Russia
Sanctions
Financial crisis
Bank capital
State ownership

ABSTRACT

Tensions over Russia's recent actions in Ukraine and the Middle East have resulted in wide-ranging Western sanctions. An understanding the destabilizing regional and institutional effects of sanctions is, therefore, fundamental for policymakers on both sides. Data from 2007 to 2015 are used to analyze the effect of funding, bank ownership and credit quality across Russia's wider Economic Union. Results enable systemic insights into an often opaque region during a period of crises and sanctions. Specifically we find that sanctions result in institutional illiquidity, limited capital market access and a rise in state funding coupled with bank take-overs by governments. Government Institutions exploit their access to state funding to increase market share but the positive effects are limited since there is clear evidence of ongoing poor credit management. An increase in loan loss provisions, lagged abnormal credit losses, suggest that until this second but significant 'weak management' effect is addressed, it will be difficult for institutions in the region to overcome the debilitating effects of sanctions.

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1. Background

As Russia and the West face-off over Syria, Ukraine, the Crimea and the Middle East, Western reaction has been to escalate capital market and trade sanctions targeted at Russia. However, the implications of sanctions go beyond the policy and market isolation of Russia, they are affecting regional systemic stability and becoming a first order issue for all member states in Russia's Eurasian Economic Union (EaEU).[1] Our results show that state funding and ownership support of the regions banks is unsustainable, additionally, in second major challenge to countries in the region, we show that banking institutions are also ill served by weak operational and credit management.

After the collapse of the Soviet Union in the 1990s, regional institutions emerged into a fragmented post-Soviet system with weak macro prudential structures (Galati and Moessner, 2010). As Chernykh (2008) expands, this collapse resulted in Soviet countries inheriting nascent financial institutions with complex ownership legacies, inexperienced management and serious governance challenges. We show that recent sanctions and crises have the capacity to profoundly affect regional capital markets and bank capitalization; ironically, we find that non-state banks are the most affected. This finding of weak

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[1] http://europa.eu/newsroom/highlights/special-coverage/eu_sanctions/index_en.htm

http://dx.doi.org/10.1016/j.ribaf.2016.07.009
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credit management across the EaEU supports the work of Djalilov and Peisse (2016) who find that credit risk effects on profitability and capital are negative in countries that lag transition.

The sprawling EaEU economic block spans a vast area from Europe to China and comprises the former Soviet states of Russia, Kazakhstan and Belarus (Kyrgyzstan and Armenia also signed accession treaties in 2015 (Delcour, 2014)). The EaEU is dominated by Russia and is a segue to the Eurasian Custom Union, which it broadens in order to facilitate wider co-operation on trade, finance, customs and energy markets, as well as stabilize trade and capital flows. Across the EaEU, however, financial institutions are under pressure; low oil prices and sanctions are affecting regional capital markets access, currencies and trade. Additionally, we provide evidence that state ownership of institutions is on the rise and, importantly, that poor management of funding and credit represents a significant second challenge.

In an attempt to replace Western capital market funding lines in the region member states have had to step in and take ownership of faltering institutions and shore up institutional liquidity. We show that they have done this especially for large banks, providing funding and currency support while also taking direct state ownership stakes; an expensive action which has reduced central government stabilization funds by 30 and 25 percent for the period 2014/15 in Russia and Kazakhstan respectively.

Resolution of the sanctions standoff between Russian and, by association, Central Asian regions is, from a government viewpoint, urgent. At the current rate of support, Russian and Central Asian stabilization funds are expected to last 24 months. Against this regional background of institutions in need of structural state support, our analysis suggests a second and arguably longer term challenge: very weak management in banking institutions. We find that weak management use state funding support to make high risk lending, incurring large credit losses and loan loss provision charges against bank capital. These credit losses offset the positive effects of state funding, and if not attended, are likely to extend and compound the effect of sanctions.

The Russian Parliament response has been counter-measures of its own. The Duma in October 2015 mooted limits on information disseminated to Western courts, aimed at blunting the "detailed" enforcement of financial sanctions. Against this fractious backdrop we use a sample of detailed bank data for 86 Russian, 29 Kazakhstani and 21 Belarusian institutions covers the period 2007–2015. Data are used to provide insights essential to understanding prospects for Central Asian and Russian financial stability.

Consistent with Bertay et al. (2015), we observe similar anti-cyclical state support across the EaEU region for banks in crisis, but suggest an important difference—*poor credit management continues* even after state intervention. The net result is that in times of sanctions, Russia and Central Asia institutions are finding it increasingly difficult to extricate themselves from state support for their financial sectors. The impact of sanctions limits funding capacity of states, and, we show, weak credit management simply compounds this difficulty.

More generally, our analysis of market share reflects an observable escalation in state funding and capital support for large banks throughout the crisis and sanction period. Enabling state owned banks to increase their market share. However, state ownership and funding do not translate into high quality lending by bank management, in fact just the opposite occurs; Russian bankers seem to 'charge hard' at the market after receiving state funds. We find clear evidence that *in the crisis and during sanctions* there is a material increase in risk taking, credit risk and loan loss reserves for banks funded and taken over by the state. Results are significant for formulating clear understanding of the state and management effect on the future for EaEU institutions.

2. Literature

The region's ongoing struggle to provide state capital and funding support throughout the crisis is unsurprising since they have been here before. Each country's banking systems have been through massive Post-Soviet structural reforms with state ownership and independence legacy governance challenges (Chernykh, 2008). It is clear therefore that funding is only part of the challenge, transitioning from a planned stated-owned economy to a private market-based private institutions especially under conditions of falling oil prices and rising dollar is proving difficult. As Chernykh (2008) notes, it is doubly difficult when accompanied by management governance and credibility challenges.

Literature remains divided on the efficacy of using state support to survive crises in economies where management and lending quality are poor (Brei and Schclarek, 2013). Notwithstanding, our findings are clear, state support is generous, widespread but often results in ineffective use of funds and poor lending by bank management. A major challenge for regional banks is, indisputably, management quality. We find evidence of poor lending and lagged credit losses which adversely affect capital levels in state-owned banks. Until this management effect is addressed, we suggest that regional banks will find it extremely difficult to sustainably recover from capital market sanctions.

Findings in this study about EaEU banks offer insights which present a counterpoint to USA and EU centric studies. To illustrate; in work by Bertay et al. (2015) comprising 1633 US banks, the focus is on the effect of state ownership on pro-cyclicality of credit, with the authors suggesting that state ownership results in less pro-cyclicality. By contrast in our analysis state support in the EaEU sees state owned banks apply funding to increase market share but at the cost of a dramatic increase in credit risk and non-performing loans—extending the period of pro-cyclicality.

This study is relevant to the literature for two reasons. Firstly, it provides deeper insight in post-Soviet EaEU bank data on ownership and capital as each EaEU state has had to assume a new post-Soviet role of providing effective regulation and supervision of bank risks and capital. Secondly, we do not limit ourselves to the capital side of regional balance sheets, but also

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