ИНСТИТУТ ФИНАНСОВЫХ ИССЛЕДОВАНИЙ

A FUND FOR BAD DEBTS

BY A. I. KUCHAEV, IFS CHIEF ANALYST, MAY 15, 2009

This year Russia's banking sector might be faced with the second wave of crisis caused by a rise in loan delinquencies.

According to the Central Bank of Russia, loan delinquencies slightly exceeded 2% of the loan portfolio in early 2009, but this parameter only reflects current delinquencies, not the share of bad debts that is obviously much higher. Even if this share stands at just 15%, compared to banks' equity, it will total almost 90%.

In January and February, loan delinquencies rose 32% and 27% respectively, in March – just 6%. The May results might be revealing as production volumes are likely to decrease because enterprises encouraged their staff to take vacations, like they did in January.

Initially, everybody hoped that the state will buy all bad debts. When it did not prove true, banks started to restructure loans. In a large part owing to their efforts, the growth of loan delinquencies slowed down in the first quarter of 2009.

It is clear why the government holds up the bad debts decision. The late 2008 experience (for restoring liquidity on the interbank loans market) had negative side effects – banks received much more money than they needed with no additional requirements (regarding the use of money, payment of dividends and bonuses). As a result, a big part of money was converted into foreign currencies – driving the ruble down.

Obviously, banks can always outplay the state because they are more informed about the real state of affairs. By and large, it is not the state's task to determine the amount of bad debts and the market discount or assess banks' capacity to restructure debts. These are all objects of the market. The state just has to provide a mechanism that would enable the market to give most accurate answers to these questions.

Let us assume that the task is to write off bad debts from banks' balances, or, to be precise, securitize them. One option is to set up a bad debt pool where every bank could allocate its non-performing loans. The bad debt pool should be initially evaluated by an independent appraiser whose key role is to classify similar debts into groups. Then banks set the price for each group using a transparent mechanism (like a clock auction). At the final stage, the state decides what part of the difference between the par and real values it can pay.

The corporate part of this mechanism can be realized through various methods, the simplest of which is setting up a fund, whose shares will be exchanged for banks' bad debts. This fund could also manage assets and sell them in case of bankruptcy.