Article Title: ARCHIVE | Criteria | Corporates | General: Credit Risk In Russian Financial-Industrial Groups Data: Financial-industrial groups (FIGs) are pervasive in Russia, as they are in most other emerging markets. As visible as they are, they remain poorly understood concentrations of economic power. Individual banks and industrial enterprises that are members of FIGs have emerged in international financial markets as important issuers of Eurobonds and syndicated loans, and more are likely to tap international capital markets as conditions permit. Therefore, it is important to identify and appreciate the complexities that FIGs present in the credit analysis and rating of individual FIG companies. Broadly speaking, these complexities derive from the interconnectedness of companies within FIG structures, and from the poor level of disclosure and transparency about how risks are transferred within FIGs. From Standard & Poor's perspective, key credit risk factors relating to the assessment of individual FIG banks and industrial companies, and the impact of FIGs in Russia more generally, are: FIGs cannot yet be characterized as positive agents for industrial restructuring and corporate governance within Russia. This has implications for the credit assessment of FIG companies as individual borrowers. The standards of transparency and disclosure within FIGs are poor. It is difficult, if not impossible, to gain a true understanding of financial strength and economic relationships within a FIG from public data alone. It is often not possible to assess the credit standing of individual FIG banks or industrial enterprises from a stand-alone assessment of the company's operating and financial risks. Membership in a FIG can have positive, negative, or neutral implications for the credit quality of individual companies. This must be explored on a case-by-case basis. To the extent that insufficient information is available to allow for proper analytical understanding of the relationship between an individual FIG company and the broader FIG structure, a full rating may not be tenable. There have been cases where Standard & Poor's has refused to publish a rating of a FIG issuer when clear disclosure of the broader credit dynamics within the FIG has not been forthcoming. The financial leverage of Russian FIGs is not so high as to create substantial contingent liabilities for the federal or regional governments. However, the failure of a leading FIG bank or FIG corporation could seriously impair investor confidence in the Russian economy, and could result in subsequent liquidity problems. Moreover, the extent to which FIGs do, or do not, progressively embrace enterprise restructuring will play an important role in the development of Russia's real economy and its ability to generate economic value. This can have important micro- and macroeconomic implications, which, in turn, can impact credit quality in both the public and private sectors. (A detailed summary of Standard & Poor's analytical approach to rating FIGs is presented in the Behind The Ratings feature in this edition.) Numerous Examples Around The World Examples of affiliations between financial and industrial firms abound in emerging, and even emerged, markets around the world. There can be a strong justification for such affiliations. Certainly, the keiretsu in Japan and the German bank model were instrumental in reconstructing the economies of these countries after World War II. When risks in the system are high and when industrial structures are in disarray, the cohesion and stability that financial-industrial groups can provide is beneficial. But that kind of cohesion, based upon interrelatedness tracing to ownership interests, means also that transactions can be performed on other-than-market principles. The nature of such transactions, and indeed of the ownership relationships, can be murky. This lack of transparency is challenging for investors interested in taking either equity or credit positions. Longer term, as economies become stronger, the disadvantages of these affiliations can begin to outweigh the benefits. Given the extent to which Russian industry requires restructuring, a logical case can be made for the creation of FIGs. Their role is to recreate the vertical chain of production and intercompany payments that are critical in replacing the institutions of the command economy. If they bring in activist, reform-minded management to replace the old "red directors," or Communist bosses, who were so often handed control of the factories they managed, FIGs can facilitate the transition to a market economy. If, on the other hand, they contribute to the creation of giant monopolies, concentrating financial resources in the hands of a few oligarchs, they can inhibit needed change. Attempts to measure the size of Russian FIGs relative to the Russian economy as a whole have produced varied results. Some sources suggest that FIGs control about 10% of Russia's GDP. Other estimates have ranged in excess of 50%. Precise measurements are difficult, in part because the definition of a FIG is elusive, and a case can be made that most formerly state-owned enterprises belong to a FIG. This is complicated by questions of disclosure and transparency. Whatever the case, FIGs represent a significant economic and political power base in Russia, and continued concentration of economic power within the leading FIG structures provides a disproportionate amount of influence among a very small group of individuals. Structure of Russian FIGs Russian FIGs come in many varieties. Their form is determined by their history and the purpose they were meant to serve. One such variant, the most colorful one, is the bank-led FIG. The banks in these FIG's generally were founded by the scions of the old Communist elite or by enterprising young men who made their fortunes in various commercial endeavors. In late 1989 and 1990, they seized the opportunities presented by liberalized banking laws to found banks. Initially, opportunities for profit were present in foreign exchange trading and voucher privatization. Often they even helped each other by swapping small cross-shareholdings to augment capital. By 1994, investing in government bonds at fabulously wide spreads generated further profits. In 1995, an even greater opportunity presented itself: the ability to acquire state-owned enterprises at substantially below-market prices as a result of privatization schemes. The lure of such rich bounty unleashed a less seemly competition among the bankers that has intensified as the prizes became richer, and fewer. Some were successful in acquiring huge companies in the natural resources and extraction industries through the loans-for-share schemes and at auctions: for example, Yukos, Sidanko, Tyumen and Eastern Oil companies, Norilski Nickel, and Svyazinvest. Others scoured the country to purchase privatization vouchers from the population, with which they brought controlling stakes in manufacturing companies in sectors such as lumber, steel, and confectionery. Another common feature is the control of major media and publishing organs. Generally, the companies acquired dwarfed the FIG bank in assets, revenues, and number of employees by many multiples. Thus evolved the gang of seven banking "barons", or the "syemi-bankirshchina" as they are called in Russia. These seven bankers (Vladimir Potanin—Unexim; Boris Berezovsky—AvtoVAZ; Alexander Smolensky—SBS Agro; Mikhail Khodorkovsky—Menatep; Michael Friedman—Alpha Group; Vladimir Gusinsky—Most Group; and Vladimir Vinogradov—Inkombank) exert tremendous political influence—an influence that reflects the scope of the empires they control. The origin of their power may have begun with the bank. However, as the industrial empire has grown, many of these bankers gradually shifted their interests and official positions to the industrials, and distanced themselves from the banks. Table 1 Top 20 Russian Banks (Mil. $) BANK LATEST AVAILABLE DATA ASSETS CAPITAL RATING Sberbank 1996 25,267 7,207 SBS-Agro 1997 5,127 501 B+/Negative Inkombank* 1997 4,862 412 B+/Negative Unexim* 1997 3,725 814 Vneshtorgbank 1997 3,719 1,143 Menatep* 1997 3,384 304 IIB 1996 2,642 575 Rossiyskiy Kredit Bank* 1997 2,135 314 B/Negative National Reserve Bank* 1996 1,868 326 Mosbusinessbank* 1997 1,601 78 Avtobank* 1997 1,484 260 Bank Imperial* 1997 1,301 196 B/Stable MFK-Renaissance* 1996 1,299 320 International Moscow Bk 1996 1,277 164 Tokobank* 1997 1,219 233 Promstroibank 1996 1,122 186 Alfa Bank* 1997 1,090 164 B/Watch Neg Vozrozhdenie Bank 1997 909 107 B+/Negative Most Bank* 1996 735 48 Gazprombank* 1996 667 110 *FIG bank. Sources: U.S. Chamber of Commerce (BISNIS), Standard & Poor's, Bankstat. The data are on an IAS basis where available. Another variant is the industry-led FIG. With the dissolution of the command economy, the ministries that operated various branches of industry often were transformed into industrial groups; with them, the government officials were transformed into managers and often at least part-owners of the industries. Gazprom, AvtoVAZ, and UES are examples of such FIGs. Other types of FIGs include the regional FIGs. Enterprises finding themselves in a particular region (Mayor Yuri Luzhkov's Moscow FIG for example) also have banded together into a group. FIGs can also be divided into official and unofficial ones. The Law on Financial-Industrial Groups established a licensing procedure for FIGs, and basic rules of structure. It also was intended to provide certain incentives for the formation of such groups, principally tax and funding. However, these benefits do not appear to have been implemented. Thus, while there are over 70 officially registered FIGs, many of the most powerful ones actually are unregistered, and the law appears largely to be irrelevant. Unexim—Interros Financial Industrial Group United Export-Import Bank (Unexim) has grown very rapidly to become the third-largest Russian bank in a few years, with total assets of Russian roubles (Ru) 22,522 million ($3.7 billion) at year-end 1997. Unexim is at the center of the Interros financial industrial group, which is one of the few FIGs that are actually registered as such. According to the company, the Interros Group consists of companies that produce over 4% of Russia's GDP and 7% of the nation's exports. Standard & Poor's views the bank and thus the FIG as having a relatively

privileged position in the new Russian economic and political order. At the end of 1994, the bank looked much like most other de novo Russian banks of the time, with a high degree of speculative income from securities, foreign exchange, and the interbank market. By year-end 1995, it was transformed. In that year, the bank together with its sister company, MFK (International Company for Finance and Investments, which subsequently has merged with another investment bank to become MFK Renaissance Group) were notably successful in gaining control of several major state enterprises, such Norilsk Nickel (the world's largest nickel company—Unexim) and Sidanko (a major energy company—ICFI), under the "loans for shares" scheme. In 1997, the bank purchased Svyazinvest, a telecommunications holding company. Concurrently, lending became the dominant asset item on the bank's balance sheet. On the funding side, Unexim also enjoyed a privileged relationship with, for example, the State Customs Committee, which has remained a major depositor with the bank, despite a number of changes and threats to place these funds with the State Savings Bank, Sberbank. The political clout implied by these factors reached their apogee when the former President of the bank, Vladimir Potanin, became a First Deputy Chairman of the Russian Federation in 1996, at that time, the only banker to have such high level involvement. The undoubted advantages afforded to the bank in its early years, many of which continue to subsist, have provided it with a head start on competitors, as well as providing a degree of protection from the otherwise hostile operating environment. However, as the third-largest bank, with a solid reputation and a growing client list, it is contended that the bank's franchise is established. Concurrently, the bank has a balance sheet that is as strong as any Russian bank, with high capital levels by system standards, a relatively clean and expanding loan book (with problems well reserved), and earnings that increasingly reflect quality revenues. As part of the Interros Financial and Industrial Group, Unexim has a ready source of clients, but is not limited to these. The bank argues that its close links with these companies is beneficial, given the lack of a reliable legal and regulatory framework in Russia, since it has better knowledge of and influence on such clients. However, from Standard & Poor's perspective, there is also potential downside owing to high client concentrations and a lack of diversity. This remains the case despite Potanin's announcement by spring 1998 that the Interros group was to be restructured under the holding company model for greater transparency. Additionally, while equity investments have the potential to produce considerable gains, the group's decision to allocate scarce liquid resources to illiquid investments, especially when these are often in need of considerable restructuring, may yet prove to be misplaced. Analytical Contact: Richard Thomas, London (44) 171-826-3627 The FIG structures can vary. Cross-shareholdings may or may not exist; the members may be wholly or only partly owned. Generally, there is no clear holding company that owns the stakes. How control over the companies is held and by whom is often shrouded in mystery. At times, the group appears to operate on the basis of personal relationships and favors returned, rather than on ownership issues.
com.spglobal.ratings.services.article.services.xsd.Object@6cfad922 Role Of Banks In FIGs The banks in FIGs evolved in a variety of ways. Accordingly, they can perform numerous functions for the group. However, they tend to share one very important characteristic: they are very small—almost insignificant—relative to the industrial conglomerate around them. This necessarily restricts the role they can play in the group, but may also save them from one of the worst perils of mingling finance and industry: that the bank will be tempted to provide financing to protect its equity investment in the industrial corporation, rather than to cut its losses. Yet, at least the banks in the bank-led FIGs aspire to perform a function outsize to their proportions. Their strategy generally is to assemble and control a vertically integrated chain of production in a particular industry. At this stage in the development of Russian industry, this is critical in working out bottlenecks in the chain, and the cascade of nonpayments of intercompany debt that currently bedevils the country. Generally, the industries in question are the oil and gas, and metals and mining industries, which require massive investments to modernize. The banks cannot even begin to finance such investment needs. They hope, instead, to be instrumental in helping those enterprises access funds in the West. As many of the enterprises owe massive amounts to the government in back taxes and penalties, the banks often help negotiate deals to reduce or defer tax bills. They also can help unshackle the enterprise from the "social obligations"—to perform the municipal services for the towns in which they are located. In short, they often serve the function of the finance department of a conglomerate. Generally, their ambitions extend

further, to restructuring the operations of these companies, which could well prove challenging to existing management, as it is questionable how much the bankers, who are uniformly young and inexperienced even as bankers, could know about running steel mills or oil companies. What they can be is a catalyst for change. As new shareholders, they can unseat entrenched former Communist bosses who continue to run these companies. Also, they can hold managers accountable to a set of performance benchmarks. In theory, they can also bring in Western expertise through joint-venture arrangements, though mostly they have been reluctant to do so, preferring to maintain control. The banks that are owned outright by or could be seen to be indirectly controlled by industrial groups (AvtoVAZ Bank and Bank Imperial, for example) also tend to focus their business on the financial needs of the group, and exhibit the same balance sheet concentrations. However, they are less interventionist in trying to manage the industrial companies. Some industrials own several banks (for example Gazprom owns parts of Bank Imperial, National Reserve, Gazprom Bank, and now Inkombank), with the different banks specializing in providing different services for the parent. Just as banks are reluctant to lend to clients over whom they can exert no ownership control, so do industrial enterprises seem unwilling to entrust their funds to banks which they do not own. Table 2 Major FIGs and Financial/Industrial Holdings FIG - LEADER KEY FINANCIAL HOLDINGS KEY INDUSTRIAL HOLDINGS Alfa Group - Friedman Alfa Bank Tyumen Oil, Eastern Oil, Alfa Ecco (Food, Cement) GAZ Avtobank, NBD Automobile (GAZ) Gazprom-Vyakhirev Bank Imperial, Gazprom Bank, National Reserve Bank, Inkombank Gazprom, Media (NTV) Inkombank - Vinogradov Inkombank Chocolate, Food Industry LogoVAZ - Berezovsky AvtoVAZ Bank, Obyedinyonny Bank AvtoVAZ, Aeroflot, Sibneft, Media (ORT, Nezavisimaya Gazeta) Lukoil Bank Imperial Lukoil, Media (Izvestia) Rosprom - Khodorkovsky Bank Menatep Yukos, Chemicals (Exochim) Most - Gussinsky Most Bank Media (NTV, Segodnya) Moscow City - Luzhkov Bank of Moscow, GUTA-Bank, Troika Dialog, Mosexim Bank, Tokobank, Mosbusiness Bank Rossiyskiy Kredit Rossiyskiy Kredit Bank Steel (Lebedinsky, Mikhailovsky), Lumber, Hotels Interros - Potanin, Vavilov Uneximbank, MFK- Renaissance Sidanco, Norilski Nickel, Svyazinvest, Perm Motors, Kuznetsk Steel, Media (Russky Telegraf, Expert Magazine, Izvestia) Bank Menatep—Rosprom Financial Industrial Group Bank Menatep, with total assets of Russian roubles (Ru) 20,459 million ($3.4 billion) at year-end December 1997, is one of Russia's leading financial institutions and also one of its oldest, since it can trace its origins as far back as 1987. Bank Menatep can be seen as the nervous system of the Rosprom financial industrial group. Rosprom itself is a management company, not a holding company. The Rosprom empire extends across industries as diverse as chemicals, mining, textiles, construction, and food. At the heart of this group is the Yukos oil conglomerate, which is one of the largest oil companies in Russia and in the world. Yukos was purchased under a "loans for shares" arrangement in 1995. Menatep has long enjoyed a privileged position in new Russia and has for many years had a leading role in state-supported transactions, whereby the bank funds projects that carry the guarantee of the Russian Federation with respect to both principal and interest. At year-end 1997, about 23% of the bank's commercial loan portfolio was state-related loans, though this is down from the 69% of the previous year. The close relationship that Menatep enjoys with the government is evidenced by the 2.5% stake that the Russian Federation purchased in 1995; budgetary constraints are understood to have reduced the actual stake the government could buy. Whereas many of the FIG banks finance their shares in industrials via opaque holdings, most presumably offshore, which do not generally appear on their balance sheet, Bank Menatep's are relatively transparent: "investment loans" of Ru8,002 million at year-end December 1997 on the balance sheet refer to the bank's financing of investors' shares in the underlying companies. In this case, 71% of investment loans are collateralized by 30% of the outstanding shares of Yukos. These loans do not pay interest, though the bank reserves the right to collect accrued interest. The liquidity risk connected with these investment loans is mitigated somewhat by their being funded by deposits from Yukos' corporate accounts. Menatep therefore is able to manage the cash flows of Yukos, but also has a significant role in financing the operations of the Rosprom group of companies and its other clients. Compared with Yukos, these operations are considered to be minor however. Given the depth of the relationship with Yukos, and the heavy concentrations on both the asset and liability side of Menatep's balance sheet, Standard & Poor's believes that a consideration of the creditworthiness of Yukos to be an essential prerequisite for any assessment of the creditworthiness of

Menatep itself. Analytical Contact: Richard Thomas, London (44) 171-826-3627 Even though the banks usually do not fund equity investments in the industrial companies of the FIG, their fortunes nevertheless are intertwined with those of the industrial group. At least for now, many of their operations are focused on the group. This can result in significant exposure concentrations to individual borrowers. Typically, there are concentrations of loan exposure to members of the group; at the same time, a large portion of the funding also comes from the group. The loans generally are for working capital purposes and are at least in part secured by the cash flows generated by the enterprise, which are required to flow through the bank in the form of deposits. As the banks perform the cash management for the enterprises, many of their other deposits are from the group as well. com.spglobal.ratings.services.article.services.xsd.Object@2bd56a41 Unique Feature Of Russian FIGs Russian banks within FIGs are distinguished by how much they focus their activities on other corporates within the FIG, compared with banks in other countries where the linkage between the corporate and financial sectors has been somewhat less close. In the German model, and more indirectly, the Japanese keiretsu model, banks display more stand-alone strength, and also tend to have a vibrant business with clients outside the group.. The Korean chaebol often are represented as a close parallel to Russian FIGs. However, the Korean banks are not related to the chaebol, which are family-owned, industrial conglomerates. They merely lend to the chaebol, having been encouraged to do so by the government in the interests of furthering economic development. In fact, they lent very heavily, amassing large concentrations of loans, safe in the knowledge that the government, as was its habit, would compensate the bank if a chaebol ran into problems. Part of the collapse of the Korean banking system in 1997 can be explained by these exposure concentrations. Thus, issues affecting the creditworthiness of the banks are not those of ownership relationships between banks and industrials, but those of risk concentrations and the cozy relationships that can arise between government, industry, and banks. Other examples closer to the Russian model of common ownership of banks and industrials by a business tycoon or a family group are abundant in other Asian countries (Thailand, Indonesia, and Malaysia), in Latin America (Argentina, Brazil, Columbia, and Chile), and in Italy. Where they have contributed to lack of transparency and to concentrations of loans to related parties, the uncertainties they introduce have been detrimental to credit quality. In Mexico, on the other hand, many industrial groups (Vitro and Femsa, for example) have been strong conglomerates, with good access to markets in their own right and the corollary of good disclosure of their financial condition. This has been a neutral, or even positive, element with regard to their credit quality. Promoting Economic Transition At least thus far in Russia's economic transition, it would appear that the main benefit of FIG membership has been to offer industrial enterprises a base of relative financial and operational stability, rather than to actively support market restructuring. How effective FIGs are in promoting economic transition remains open to debate, and it will a take longer period of measurement before meaningful conclusions can be reached. To the extent that economic transition is measured by adaptation and restructuring of the financial and productive sectors to cope successfully with global market forces, the Russian economy as a whole still faces considerable challenges. While in theory FIGs have the potential to facilitate restructuring, experience thus far does not suggest that FIGs on the whole have been positive agents for change. In the case of industry-led FIGs, the privatization of many enterprises resulted in firms with existing managers and staff assuming economic control. The lack of meaningful outside investor pressure has kept enterprises averse to change, holding back needed process restructuring, and keeping in place managers and control structures that date back to the Soviet era. A reluctance to dilute economic power through issuance of new share-capital also has kept many industrial FIGs short of the financing required to provide needed working capital and longer-term capital investment. Bank-led FIG structures remain characterized by opportunistic accumulation of investment holdings with no, or limited, overarching industrial strategy or strategic intent. This has been described as a "buy now, think later" process of formation, with inevitably short-term perspectives on the part of FIG owners and managers. It also poses significant questions on the manageability of the FIG companies individually and FIG structures as a whole. In many cases, scarce capital has been used to acquire new industrial assets, rather than to restructure existing ones. The relatively small size of FIG banks relative to FIG industrial companies means that, in many cases, the financial arm of the FIG is not in a position to invest sufficient capital to promote meaningful restructuring. Consequently, in practical terms, bank-led FIGs have played a less significant role in the process of restructuring of Russian enterprises than might have been anticipated initially. Moreover, the process through which many bank-led FIGs were formed often has been at odds with the principles of an arm's-length, contract-based market economy. Although the loans-for-shares transactions did result in the privatization of large Russian firms, they did so in a way that transferred assets to bank-led FIGs at prices far below market value. This was achieved in part because these FIGs encouraged legislation to limit the participation of foreign companies in the privatization auctions. Within FIGs, cross-subsidization and insider business relationships also can contradict the disciplines of market competition that Russian firms ultimately must submit to if they are to succeed in a global market context. Corporate Governance And Transparency Studies to date suggest that Russian corporate governance generally is poor, and there is no indication that FIG companies are an exception. The need for responsible corporate governance is central to economic transition and enterprise restructuring. A healthy governance system can play a critical role in attracting needed capital investment. A weak governance system can have the opposite effect. Lack of transparency is perhaps one of the FIGs' most fundamental governance problems. The opaque structure of relationships within FIGs makes it difficult, if not impossible, for outsiders to gauge an accurate understanding of the management of FIG companies—particularly with regard to intercompany financing. Moreover, the large ownership blocks created by FIGs can raise questions as to the preservation of minority shareholder rights or the rights of other stakeholders, including creditors. This can discourage potential external equity or debt investment, and in part explains why Russia's share of foreign direct investment has been relatively low compared with other emerging economies. Looking Ahead The transition of the Russian economy is still underway, and the nature and role of FIGs in the economy is evolving. Despite existing structural problems, positive changes are occurring, and, in some cases FIGs have promoted or are involved with market reforms. For example, Interros (Unexim) has replaced the management of its holding Norilski Nickel. Hopefully, future auctions of state-owned companies will fill state coffers by bringing in foreign investors able to pay a fair market price. Presumably, such investors will demand the kind of reforms necessary to achieve adequate returns. A positive example is the 1997 auction of the Russian telecommunications company, Svyazinvest. Unlike other large auctions, this brought in foreign investors and had a final sale price significantly above the starting price. The forthcoming sell-off of the energy firm Rosneft will be an important indicator of whether the Svyazinvest auction was a one-off, or whether FIGs will begin to bid for state firms at prices that more fairly reflect their economic value. As the health of Russian banks and enterprises stabilizes, and as the asset-grab for large stakes in Russian enterprises wanes, there is the potential for FIGs to evolve from merely providing a relatively stable base for Russian enterprises to promoting needed market restructuring as transition moves to a more advanced stage. It is the bank-led FIGs rather than the industry-led FIGs that show the greater potential for leadership in this direction. Indeed, leaders of some bank-led FIGs have begun to express publicly the need for strengthening shareholder/stakeholder rights and for improved corporate governance.