

SELECTED ECONOMIC ASPECTS OF THE BANKING CRISIS

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Abstract:

The subject of this work is the problems and trends of occurrence and development of the crisis of the Russian banking system, as well as a set of financial and economic relations and general cause-and-effect relationships that form the conditions for their development. Objectives of the study: to investigate the problems of the Russian banking system, which led to the crisis in the banking sector; to identify the main risks of the growth of crisis phenomena and some ways to prevent them. The study is based on the aspect approach using monographic and analytical methods. The study reveals the main risks of the crisis phenomena growth and some ways to prevent them, as Russia is currently experiencing another banking crisis. The study showed that the main threat to the stability of the Russian banking system are the risk of political interference, tougher sanctions by the United States, the risk of emerging markets. A key indicator of the stability of the banking system is the trust of the population and the interaction of banks with customers through social networks.

Keywords: banking system, monetary policy, financial system, crisis, banking crisis

JEL codes: E59, G21, H12.

I. INTRODUCTION

In spite of the positive statements by the monetary authorities regarding the recovery from the recession, in the banking sector several of the country's biggest banks in terms of their assets, namely "FC Otkritiye", "Binbank" and "Promsvyazbank", appealed to the Bank of Russia for help. The restructuring of these

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banks was funded by the Banking Sector Consolidation Fund – the regulator’s management company, which now owns three quarters of the bank’s capital (Ivanter, 2017:16).

According to the Central Bank of Russia,

out of 11 systemically important banks 6 banks are under the direct control of the state while three banks are the Russian subsidiaries of big international financial groups (Italian Unicredit, French Societe Generale and the Austrian Raiffeisen) and two banks with private resident owners (Alfa Bank, MKB) (Dubrovskaya et al. 2017:88).

The peculiar feature of the current stage of development of the Russian economy as a whole and of the financial system in particular is the emergence of several negative trends in the economy and financial sphere, which led to the deepening of the financial crisis. The analysis of the emergence and causes of the crisis indicates that a successful functioning of any company and the need to prevent crisis situations implies the creation of a reliable and effective system for the protection of all factors and conditions of its activities (Loktionova et al. 2016).

The financial success of the banking business depends on the balance between at least three economic parameters: profitability, financial stability (sufficiency of one’s own funds) and liquidity (adequacy of assets and liabilities by maturity)” (Yanina – Loktionova 2017:809).

It is impossible to restructure the national economy without a competent functioning of the banking and financial systems capable of providing the necessary resources for production and business (Bondarenko 2017:115). The contraction of the corporate lending in rubles during the current banking crisis turned out to be deeper and longer than the peak of the 2008 global financial crisis. Therefore, the consequences of such negative dynamics will be extremely unfavorable for the real sector of the economy. This demonstrates the lack of a systematic monetary policy aimed at modernizing and restructuring the Russian economy, as well as the lack of control over the financial resources, which in most cases are used by banks for speculation. This indicates the existence of serious contradictions between the policies of the Central Bank of the Russian Federation and its role in stimulating the growth of the national economy through the provision of financial resources.

On the one hand, the banking business (in its classical form) in Russia is strongly influenced by a large-scale implementation of modern computer and financial technologies. On the other hand, the political aspect has a powerful influence, which is based on the increased role of the state in the economy, including in the financial sector, and on the presence of a narrow group of people in all big businesses closely associated with it, with the continuing structural crisis of the national economy, as well as the pressure on small and medium businesses. The importance of small and medium-sized businesses grows during crisis periods. Due to their inherent mobility and flexibility, small and medium-sized companies mitigate negative processes in the sphere of employment, ensure social adaptation of employees released by big enterprises, form new market niches and points of economic growth (Loktionova et al. 2017:489–490).

II. LIST OF NEGATIVE TRENDS (FORMAL CRITERIA) IN THE RUSSIAN ECONOMY AND FINANCIAL SPHERE:

- The ongoing *nationalization* in the banking sector.
- The amount of *money spent by the state to support stability* in the banking system (Akhmetshin – Osadchy, 2015).

Today, this indicator fairly objectively reflects the crisis in the sector. The government's expenditures on containing the crisis should exceed two percent of GDP *according to the IMF standards*: since 2013 the compensation of deposits of bankrupt banks along with the costs of bank restructuring reached 2.7 trillion rubles (Fitch ratings). At least another 1.5 trillion rubles will be spent on the restructuring of "FC Otkritiye" and "Binbank" – therefore, the standard will be exceeded by more than two times excluding "Promsvyazbank".

- The *share of bad debts in the total loan portfolio* (today it is about 7% instead of the established 10% or more) and a wide-spread panic of depositors (so far it is restrained by the resources of the Central Bank and its deposit insurance system).

Therefore, formally there is no full-scale banking crisis yet. The key factor in this situation is the fact that the crisis is a phenomenon that affects almost every participant. A crisis is a sudden undesirable tendency arising due to certain reasons (Yanina – Loktionova 2017:6). This is confirmed by the recent events on the banking market. Their participants are very big banks, which can be described as too big for the regulator to allow them to leave the market (too big to fail).

- *Violation of safe conditions in the functioning of companies and organizations*. There are many violations in the functioning of enterprises while the authorities, which regulate them, reveal many violations and errors in the activities of organizations (Yanina et al. 2017:9).

- *Sharp decline in tax revenues* and to considerable *increases in government spending* (Reinhart – Rogoff 2011:206).

- The *credit system* of Russia has serious problems.
- For four years in a row the *number of operating banks has been reduced* by about 10% per year.
- Neither the availability of strategically significant and influential shareholders and depositors, nor the size of assets, give the *guarantees of survival* to banks.

In some regions (Oryol, Smolensk, Arkhangelsk, Bryansk regions, etc.) there are no local banks left. In some regions the network of bank branches has decreased two-fold over the last three years while more than 300 credit institutions are in bankruptcy proceedings (Ivanter 2017:19).

- Existence of the *crisis of confidence, the crisis of management, the crisis of over-regulation and the crisis of private small banks*.

- It is also a *crisis of big private banking groups*, which for certain reasons are not able to cope with management. The consequence of this is a rapidly growing share of the state's role in this sector.

- The *reduction of the resource base, assets and capital* reaches phenomenal proportions. Of the currently operating banks every third bank in Russia is unprofitable.

- *New banks practically do not appear* on the market, which also reflects a systemic crisis – a whole concrete type of business is rapidly losing its attractiveness and interest to investors. Such crisis may not necessarily be financial, and that it is not directly related to *the number of revoked licenses*.

The causes of the current crisis are in the banks themselves and in the fundamentals of the Russian banking business.

III. THE CHRONOLOGICAL SEQUENCE OF THE CURRENT CRISIS IN THE RUSSIAN BANKING SECTOR

1) Obviously, the current banking crisis has unresolved contradictions in the banking system itself and a trigger mechanism, which was a starting point and marked the existence of a crisis situation as such. The beginning of the current crisis in the banking sector can most likely be attributed to *the collapse of "Peresvet" in the fall of 2016*. This collapse generated a banking micro-crisis in Tatarstan, the revocation of the license of "Tatfondbank" and a number of other banks.

2) This regional micro-crisis ended in April with a revocation of the license of "Spurt bank".

3) After that the license was *withdrawn from "Ugra Bank"* with a serious resonance in the banking environment and in the media followed by the *reorganization of "FC Otkritiye", "Binbank", "Promsvyazbank" by the Central Bank of Russia* – these were the elements of one common crisis process. This process is slow, protracted and not moving into an active phase just because the Bank of Russia is relatively successful in allocating money to solve this problem. While the money supply in the economy is shrinking the real sector of the economy continues to be in a critical situation and experiences a "money hunger" losing financial resources for large-scale restructuring, these much-needed funds are used to reorganize the banking sector.

It should be noted that the analyzed crisis in the banking sector occurs against the background of a relatively good financial performance of the banking system as a whole, as stated at the international banking forum "Banks of Russia – XXI Century" in Sochi, by the Head of the Bank of Russia Elvira Nabiullina:

"In eight months of 2017 the assets of the banking sector increased by 4.5%, the loans to the economy – by 3.5%, the loans to non-financial organizations – by 2.3% (Dubrovskaya et al. 2017), and in 8 months of 2017 the profits of the Russian banks reached almost 1 trillion rubles (Glazyev 2017). It is natural that in the structure of these profits the leading positions are occupied by big banks with state participation."

4) Since July 2013, when Elvira Nabiullina initiated a reform of the banking sector, by August 1, 2017, the number of operating banks decreased by almost 400, to 582. The concentration of assets in the

country's five biggest banks ("Sberbank", "VTB Bank", "Gazprombank", "VTB 24" and "Rosselkhozbank") rose to 56%, and after the reorganization of "FC Otkritiye" (8th bank in terms of assets) in late August, "Binbank" (12th bank in terms of assets) in September and "Promsvyazbank" in December, the state's share in the assets of the banking system exceeded 60% (Official website of the Federal state statistics service). This figure is likely to grow despite the statements of central bankers about the lack of such intentions and the existence of plans to look for private investors for both banks under reorganization. The financial market's participants say that in today's economic conditions of excessive over-regulation of the banking sector and the levels of distrust towards the regulator's policies it is unlikely that these banks will be privatized (Dubrovskaya et al. 2017).

5) The state's share in the banking sector will continue to grow due to the revocation of licenses. Analytical Credit Rating Agency (ACRA) states that today private banks demonstrate the worst quality of assets in the banking sector. This is the only group of banks whose share of bad debts exceeded 15% at the beginning of 2017 (15.6% against 11.1% for banks with state participation and 9.5% for subsidiaries of foreign banks). The quality of their loan portfolio is assessed as "poor", the main reasons for this assessment are the following: more aggressive business models; increased risks due to the need to preserve their market share on the market of banking services against the background of steadily strengthening positions of banks with substantial state participation; slow recognition of losses on loans due to more modest opportunities of owners regarding additional capitalization and the "legacy" of the past crisis periods (by early 2017 some loans issued in previous years had been restructured five or more times) (Dubrovskaya et al. 2017).

IV. PROSPECTS AND RECOMMENDATIONS ON RESTRUCTURING A BANKING SYSTEM IN RUSSIA

- *According to the Head of the Central Bank,*

"the banking business should be focused on banking, not on investments", because the key problem of the restructured banks is in lending to the related parties – into businesses of banks' owners (in this case, the family of Gutsieriev "Russneft" with its development businesses, etc.) financed by banks' creditors, including depositors (Official website of the Bank).

This scheme works successfully when the economic system is stable. But the problem is that within the framework of such a scheme credit risks are replaced by entrepreneurial risks that banks cannot assume, which leads to significant reduction in the effect of diversification. With interim administration it is impossible to get anything from such a bank, because, by crediting its business, the owner does everything possible so that, if necessary, the connections of this business with the bank safely disappear (Osadchy 2016). The essence of this problem is in deep contradictions and very high risks. The scheme of such lending is used because of the extremely high risks of lending. Bankers have to lend to their own businesses in cases when others do not return the money. This is a deep problem that can be solved by nationalization. This is not the best option, since a state bank is not as effective as a private one. The nationalization of the banking sector can lead to a decrease in the

efficiency of the entire sector and the economy as a whole.

The above-mentioned facts confirm the lack of a stable banking system capable of providing the necessary resources for businesses and the real sector of the economy. Instead of using the available resources for the creation of a banking system that meets the requirements of modernization, the Central Bank of the Russian Federation funnels large-scale amounts to close gaps in such banks as "Otkritiye", which fundamentally contradicts the goal of modernization and economic growth proclaimed by the Russian President.

A sluggish banking crisis is obvious. With the continued development of the existing trends only state-owned banks can remain as it happened before: a bank for foreign trade, a bank for agriculture, a group of sectoral banks and a savings bank — a bank for the public. The economic authorities will again start to talk about the lack of competition in the banking sector.

It should be noted that the mechanism of reorganization used for "FC Otkritiye", "Binbank" and "Promsvyazbank" radically changes the configuration of the banking sector in Russia: from mega-regulator the Central Bank is becoming the main participant of the system, which is increasingly assuming the functions of direct management instead of regulation. The Central Bank consolidates the sector: if earlier big banks absorbed smaller ones (with the help of the previously failed reorganization mechanism), now the regulator itself is engaged in such absorption. It is likely that in addition to Sberbank and VTB Group a new third giant state banking group will soon emerge in Russia from those credit organizations that are now being reorganized by the Central Bank, which will become a logical development considering the current regulator's policy. The priority of reorganization before revoking a license is logical: when a bank has big obligations to creditors, reorganization is more attractive than revoking a license, because it is possible to avoid big losses. It is important for those whose funds are not insured. The relatively recent situation with Lehman Brothers in the United States clearly shows that such a scenario cannot be allowed.

- *According to Andrey Movchan*, Head of the economic program at the Carnegie Moscow Center,

the state should "make a step forward away from the outdated and, therefore, very conservative European banking system" and motivate the market to separate credit and settlement businesses by stimulating the emergence of non-bank credit institutions and the formation of a market place for credit market (Official website of the Bank).

For Russia, with the tasks it faces (restructuring of the economy, stimulation of development of the economy's real sector, development of small and medium-sized businesses), the nationalization of the banking sector is a serious systemic problem. After all, the sources of funding for small and medium businesses will only be private with all the ensuing limitations and problems.

For private investors the reduction in the number of banks will lead to the reduction in comprehensive proposal. Products will not be so diverse. So far the market has developed in a highly competitive environment. State banks have an opportunity to work more slowly, while private banks have to implement advanced

technologies, for example, several years ago "Tinkoffbank" abandoned customer service offices and fully transferred this system to digital space doubling its capitalization on the London Stock Exchange in a year.

At the same time in their development state-owned banks have many internal and external restrictions, for example, the imposition of sanctions. Consequently, a substantial increase in the share of the state in this sector is not desirable. It is difficult to predict how exactly "Sberbank" will be funded under the imposition of the fourth package of sanctions: the reliance only on domestic resources with a freely convertible ruble.

If the state wants to leave this segment of the economy in private hands, then the banking system must be represented by reliable private banks. Obviously, weak assets remain a systemic problem for private banks and the banking sector needs to be reorganized and reformed. But this goal must be achieved systemically by working individually with each bank. The Central Bank has all the necessary instruments for this goal.

- *According to the study "Forecast of the development of the banking sector in 2018":*

The share of the Russian banks with inefficient business models reached 25%, the crisis of the business model" of the Expert RA agency. Analysts say that this testifies to the incompleteness of the process of recovery of the banking sector. The crisis of this business model will lead to inefficient players' leaving the market already in this year. Expert RA's analysts predict that at least 60 players, of which five are in the top 50 banks in terms of their assets, might lose their licenses (Official website of the Rating Agency "Expert RA").

- In February *the Head of the Central Bank of Russia* said that

in 2017 the regulator completed the work aimed at improving the banking sector, but the system still had problems leading to the collapse of some banks.

- *According to ACRA analysts,*

in 2018 the tension in the Russian banking sector will continue against the background of a decline in confidence in the system and the growing share of the state (Official website of the Bank of Russia).

- *"Expert RA" analyses the situation with the profitability and viability of Russian banks since 2013, in the middle of which E. Nabiullina was appointed the Head of the Bank of Russia. From that moment on, she began the process of improvement in the banking sector leading to the massive revocation of licenses. According to the study of "Expert RA":*

1) "it is too early to consider the process of improvement in the banking sector complete, since in 2013 the share of unprofitable banks with inefficient business models increased from 10 to 25%". "In 2018 we expect the rate of revocation of licenses to accelerate" (Miller 2017).

2) The main problems in the banking business include the inability of placing funds in profitable assets, the prospect of losing access to the core business, as well as insufficient capital to cover losses on loans. These are the factors that will lead to the application of regulatory actions to banks, such as license revocation or reorganization.

3) in 2018 some banks will find themselves in a risk zone. These will be the banks that fail to adapt to the new paradigm of risk-oriented supervision and shift to less risky credit policies and an adequate reserve level. The most volatile will be captive banks with poor corporate governance, as well as banks with increased levels of dependence on a single source of income, a narrow group of clients or economic conditions in a certain region or industry (Official website of the Rating Agency "Expert RA").

4) The biggest Russian banks in the top 50 in terms of assets include five banks that might lose their licenses in 2018, believes "Expert RA" not naming any specific banks (Official website of the Rating Agency "Expert RA"). The agency's analysts believe that the main problem for banks from the top 50 is insufficient level of capital to cover credit risks. According to their calculations, since 2014 the share of bad loans in the total loan portfolio increased from 6 to 10%.

At the same time, in spite of the two-fold increase in the volume of reserves created in 2017 above the level of 2016, the reserves still do not cover even bad loans (the risk of financial losses is 51–70%) and non-performing loans (risk of non-payment – 71-100%). Excluding "Promsvyazbank", "FC Otkritiye" and "Binbank" in 2017 the volume of reservation of funds decreased by 23% (Mikheeva – Pashutinskaya 2018). According to the estimates of Expert RA, the share of potentially bad loans with insufficient levels of reservation is at least 7.5% of the corporate loan portfolio (Official website of the Rating Agency "Expert RA").

What is happening in the banking system is not only a continuation of the global economic crisis of 2008 – 2009, not only a further concentration of capital and assets in an even smaller number of banks, but the collapse of one banking system and the emergence of a new one. The analysis shows that the presence of commercial banks and other deposit institutions in the economy is determined by: the level of development of the economy, its financial depth; the model of financing of business prevalent in the economy; the role of the Central Bank (Mirkin 2011:69).

V. MAIN RISKS OF THE RUSSIAN NATIONAL BANKING SYSTEM

In the banking system the Bank of Russia is now not only its regulator, but rather its owner. Its financial investments help conceal problems without actually solving them, which makes the crisis process lengthy and difficult to predict (Bolshakova – Melnik 2017:91). The main objective of the mega-regulator should be to create conditions for the earliest possible beginning of sustainable economic growth through the provision of resources to the real sector of the economy to implement its restructuring and modernization. The new banking system should stop servicing business interests of bank owners and highly dubious business projects. It is necessary to change the very environment in which banks operate. Ignoring the restoration of industry and production it is impossible to talk about a reliable banking system, since it is supposed to provide this production with financial resources, rather than focusing on speculation and the problems of internal relations.

We will consider the main risks of the national banking system:

1. The main threat to the stability of the Russian banking system is *the risk of political interference and the tightening of sanctions by the United States*. In case of the adoption of the Graham bill the six biggest banks of the Russian Federation will not be able to carry out transactions with non-cash dollars. The consequences of such development could be the exclusion of Russia from the dollar environment and its de-dollarization.

2. Another risk is *the risk of developing markets*, which also contributes to destabilization. The trade war between the United States and China leads to the outflow of funds of international investors from the developing markets, including the national market of Russia.

3. These two risks contribute to the *strengthening of the currency and equity risk*: the outflow of capital from Russia is increasing, non-residents withdraw funds from domestic securities, mainly from Federal Loan Obligations (OFZ bonds), converting the obtained rubles into dollars and euros and transferring them abroad. Due to the outflow of capital the risk of currency liquidity increases, which is manifested in the growth of rates for currency instruments.

4. Among the most common reasons for revoking licenses from banks is a violation of Law 115-FZ "On Countering the Legalization (Laundering) of Proceeds from Crime and Financing of Terrorism". This is one of the manifestations of *the risk of crime*: involvement in money laundering. One of the most common reasons for the revocation of licenses is the formation of a large amount of distressed assets on the balance sheets of banks. The common reasons for license revocation include related lending, risky business models, inadequate reporting, asset withdrawal and capital losses. It should be noted, however, that only small and medium-sized banks are subject to license revocation. Big, systemically important banks — too big to fail — are restructured in critical situations.

5. The restructuring of banks 2014 – 2016, *when troubled banks were transferred to bigger ones*, turned out to be an inefficient waste of public money, an attempt to help some big banks adapt to external sanctions. The restructuring of 2017, unfortunately, had similar consequences, but it is too early to make

conclusions, because in the current situation the Banking Sector Consolidation Fund can become the foundation for its creation and development, a key element for the formation of a new banking sector in Russia and a new stage of stable economic growth.

6. Meanwhile, the financial pressure in the form of *payment obligations* for outstanding short-term debts and diminishing asset values mean that financial tensions can lead to financial collapse. Only refinancing can prevent a full-fledged crisis (Minsky 2016:68).

7. It should be noted that *public confidence* is a key indicator of the banking system's stability. A study conducted by the National Agency for Financial Research in 2017 showed that the level of confidence of the Russian citizens in banks is falling. In comparison with 2016 this indicator decreased by 7%. A little more than half of the population, or 60% of the population, have confidence in banks, with 14% having complete confidence and 46% - partial confidence (Reinhart – Rogoff 2011).

8. Particular attention should be given to the consideration of interaction between banks and customers through *social networks* – a way recognized in the world as one of the most effective ones for banks, but still insufficiently regarded by Russian banks as a competitive advantage. The National Agency for Financial Research discovered that half of the people who have accounts in various social networks are subscribed to the news pages of banks. One of the main inhibiting factors for greater coverage of the population with banking information through social networks is the lack of people's interest in the information provided by banks, as well as the low level of awareness of citizens despite the fact that personification of customers has become one of the major trends for the further development of the banking system and its recovery from the protracted crisis. There is lack of interest in banks' pages in social networks as a possibility to provide feedback to banks or a place to communicate with other bank customers – only 3% provide banks with feedbacks informing them about their opinion, which is primarily due to the minimal interest in the information provided by banks. 16% of the users of social networks indicated that they were ready to interact with banks by examining the information posted in networks, but previously had not been informed about this possibility (Official website of the National Agency for financial research (NAFI)).

9. One of the main threats to the banking business is *the growing segment of the latest financial technologies or fintech*. According to the research of PricewaterhouseCoopers, the traditional banking business is exposed to the risks of reduced market share, profits, information security and confidentiality, possible outflows of customers considering the high competitive component of the new fintech segment. The main possibility to minimize the threats existing in the banking system in this field is its interaction with the segment of financial technology aimed at cooperation rather than confrontation (Official website of the audit company Pricewaterhouse Coopers), since traditional banks prefer to act as consumers of the newly created financial and credit technologies, and not their creators.

VI. CONCLUSIONS

The financial system plays a key role in the economy stimulating economic growth, influencing economic performance and economic well-being. This is achieved by means of financial infrastructure, in which companies or funds provide resources to those who have potentially more efficient ways

to invest these funds (Gribkova et al. 2018:8). At present, when the banking system of the Russian Federation and all its participants are functioning in the conditions of a severe financial and economic crisis as well as a structural deficit of liquidity, the importance of effective liquidity and solvency management has increased many-fold (Yanina et al. 2016). The liquidity of the financial market is positive for all its participants, because it helps reduce risks by providing more opportunities for buying or selling at an affordable price (Loktionova et al. 2016:218).

It is important to ensure the development of the national financial market to solve the problems of insufficient openness of the financial market, its insufficient competitive position in comparison with foreign countries. It is important to focus on each of the segments of the financial market (insurance industry, securities market, credit market, etc.) (Miller 2017:188). Today the banking segment is one of the most dynamic ones in the implementation of projects in the field of information technologies.

One of the most important risks for traditional banks is the presence of risks associated with insufficient informatization and digitalization of software, since the Fintech segment is developing extremely dynamically, and the lagging of traditional banks in this area would have disastrous consequences for them.

The Tadviser portal, which conducts large-scale research on information technology in the country and in business, revealed *certain trends in banking informatization*:

1. The birth of financial and technological industry.
2. Personalization of banking products and services.
3. Application of cloud technologies and outsourcing.
4. The search for new approaches to data protection.
5. Implementation of quick-impact projects.
6. Growing demand for remote banking services.
7. Increasing role of call-centers.
8. Further development of banking technologies according to the requirements of the Bank of Russia.
9. The emergence of new methods of customer identification.
10. Implementation of the integration of banking systems.
11. Changing approaches to building an information infrastructure for banking.
12. Consolidation of financial organizations.
13. Reduction in the number of bank branches.
14. Broader implementation of risk management and Basel III standards.
15. Uneven playingfield (Official website of Tadviser portal).

Over the past 25 years more than 70 countries around the world have experienced systemic banking crises. As an indicator of all phenomena occurring in the state economy and beyond, the banking system serves as an instant indicator reflecting all positive and negative events taking place in the economic environment. Therefore, it is extremely important to prevent a crisis. For any state it is much more difficult and costly to minimize its consequences.

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