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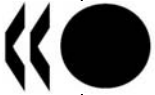
Banking Reform in Russia: Problems and Prospects

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ABSTRACT/RÉSUMÉ

Banking Reform in Russia: Problems and Prospects

This paper examines the state of the Russian banking sector in 2004 and assesses the most important reform initiatives of the last two years, including deposit insurance legislation, a major reform of the framework for prudential supervision, steps to increase transparency in the sector, and measures to facilitate the development of specific banking activities. The overall conclusion that emerges from this analysis is that the Russian authorities' approach to banking reform is to be commended. The design of the reform strategy reflects an awareness of the need for a 'good fit' between its major elements, and the main lines of the reform address some of the principal problems of the sector. The major lacuna in the Russian bank reform strategy concerns the future of state-owned banks. Despite a long-standing official commitment to reducing the role of the state – and of the Bank of Russia in particular – in the ownership of credit institutions, there is still a need for a much more clearly defined policy in this area. The real test of Russian banking reform efforts, however, will be in implementation. The reforms challenge numerous vested interests and their successful realisation will require considerable political will as well as the development of regulatory capacities of a very high order.

JEL Classification: E58, G21, G28, O52, P29

Keywords: Russia; economy; banking; deposit insurance; prudential supervision; accounting; international financial reporting standards; transparency; corruption; state ownership; Sberbank.

La Réforme du Secteur Bancaire en Russie - Les Enjeux et les Perspectives

Cet article examine la situation du secteur bancaire russe en 2004 et évalue les principales initiatives de réforme prises au cours des deux dernières années – la législation sur l'assurance des dépôts, une vaste refonte du cadre de la surveillance prudentielle, des mesures pour renforcer la transparence du secteur, et l'adoption de dispositions visant à faciliter le développement de certaines activités bancaires. De façon générale, il ressort de cette analyse que l'on peut saluer l'approche suivie par les autorités russes en matière de réforme bancaire. La conception de la stratégie de réforme témoigne d'une sensibilité à la nécessité de trouver une «bonne harmonie» entre ces principales composantes, et les grands axes de la réforme s'attaquent à certains des grands problèmes du secteur. La plus grande lacune de la stratégie russe pour la réforme du secteur bancaire concerne l'avenir des banques publiques. En dépit d'un engagement officiel de longue date à réduire le rôle de l'État – et particulièrement celui de la Banque de Russie – comme propriétaire des établissements de crédit, il faut formuler une politique beaucoup plus claire en ce domaine. Cependant, c'est au niveau de la mise en œuvre que l'on pourra véritablement juger les efforts des autorités russes concernant la réforme du secteur bancaire. Les mesures prévues vont se heurter à de nombreux intérêts acquis et elles ne pourront être menées à bien qu'au prix d'une volonté politique résolue et de la mise en place de capacités de réglementation à très haut niveau.

JEL classification: E58, G21, G28, O52, P29

Mots-clés : Russie ; économie ; activités bancaires ; assurance de dépôts ; surveillance prudentielle ; comptabilité ; normes comptables internationales ; transparence ; corruption ; entreprises d'État ; Sberbank.

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BANKING REFORM IN RUSSIA: PROBLEMS AND PROSPECTS

William Tompson¹

The relationship between financial-sector development and economic growth has long been the subject of much debate. However, a growing body of recent empirical work strongly supports the proposition that financial development contributes to long-term growth.² Moreover, there is evidence to suggest that the intermediation-growth link is stronger for less financially developed countries, such as Russia. There are thus good reasons to believe that the development of the banking system in particular will be critical to sustaining the growth of investment and output in Russia over the longer term. Given the limits on its current ability to attract foreign investment and on the capacity of firms outside the resource sectors to finance investment from retained earnings, Russia's growth will depend to a great extent on the effective mobilisation and intermediation of domestic savings.³ A more efficient financial system could also play a role in fostering the diversification of economic activity in Russia. At present, the lack of mechanisms for efficiently allocating investment resources across – and not merely within – economic sectors remains a problem. Arguably, the financial system in its current state reinforces Russia's existing economic structure rather than facilitating change.

In the first instance, the task of mobilising and allocating domestic savings falls primarily to the banking sector. This is not because Russia should, or will, develop a bank-based financial system rather than one placing greater reliance on capital markets, but because banking must precede financial market development. In a weak contracting environment such as Russia's, bank-based intermediation is likely to be more successful because banks are likely to be better able to protect creditors' rights. The institutional requirements of well functioning bond or equity markets are much more demanding than those of a banking system. Even where stable, liquid and well regulated financial markets exist, many firms – particularly new or small ones – are not well positioned to raise capital at a competitive cost by means of stock and bond issues.⁴ Unfortunately, Russia's banking system is not yet capable of playing this role.

¹ Division for Non-Member Economies, Economics Department, OECD, 2 rue André Pascal, 75775 Paris CEDEX 16, France; william.tompson@oecd.org. Special thanks are due to Richard Hainsworth of the Agency RusRating for his insights on the subject of banking in Russia, and also to Val Koromzay, Andrew Dean, Silvana Malle, Doug Sutherland and Rudiger Ahrend of the OECD for their comments on earlier drafts. This paper is based on work done in conjunction with the preparation of the fifth OECD *Economic Survey* of the Russian Federation, and the author is grateful to the many Russian and western officials, experts and businessmen, too numerous to list here by name, who discussed banking reform with the *Survey* team. Special thanks go to Corinne Chanteloup and Anne Legendre for technical assistance, as well as to Muriel Duluc and Lillie Kee for secretarial assistance. Responsibility for any errors of fact or judgement that remain in the paper rests, of course, entirely with the author.

2. See King and Levine (1993); Levine (1997) and Levine and Zervos (1998) on the importance of indicators of financial-market development as predictors of subsequent economic growth. Demirgüç-Kunt and Maksimovic (1998) and Rajan and Zingales (1998) emphasise the microeconomic argument.
3. Tadesse (2001), cited in Berglof and Bolton (2001).
4. See Berglof and Bolton (2001: 26-28); and Rajan and Zingales (1998).

Levels of financial intermediation remain extremely low, compared to both developed western economies and the more advanced transition economies (see Table 1). Despite several years of very rapid growth, bank assets at end-2003 were just 42.1 per cent of GDP and loans to the non-financial sector equal to just 17.0 per cent. Bank credits financed only about 4.8 per cent of fixed investment in 2003.⁵

Table 1. Depth of financial markets in selected economies

	2002				
	Russia	Hungary	Poland	Czech	EU
Per capita GDP (USD)	3100	5150	4600	5500	26000
No. of banks	1329	64	64	37	7219
Per cent of foreign capital	5	66	69	94	n.a.
Assets, per cent of GDP	38	72	67	121	280
Credits, per cent of GDP	20	32	26	36	118
Capital, per cent of GDP	5	8	8	7	120
Deposits per capita (USD)	350	2700	2400	4850	17500

Source: CBR, World Bank, BIS statistics.

Measures to foster the development of financial intermediation are therefore a key structural reform priority and the acceleration of banking reform in Russia since 2002 is a most welcome development. This chapter considers the obstacles to efficient financial intermediation in Russia and the policies needed to overcome those obstacles. The first section provides a short overview of the Russian banking sector. This is followed by an assessment of the environment for commercial banking in Russia. The succeeding sections examine the most important reform initiatives of the last two years: deposit insurance, the reform of prudential regulation, steps to increase transparency in the sector, and measures to facilitate the development of specific banking activities. A further section considers the future of state-owned banks in the sector. The overall conclusion that emerges from this analysis is that the Russian authorities' approach to banking reform is to be commended, but that there remain significant questions about their capacity to implement their chosen strategy effectively.

The Russian banking sector

Size and structure

As is clear from Table 2, the Russian banking sector, though growing rapidly since 1999, remains small and fragmented, with a large population of very small banks. The average Russian bank at the end of 2003 had total assets of around Rb4.2bn (USD 141.7m) and the assets of the smallest 1,100 together amounted to just USD 21.4bn. Many of these 'dwarf banks' are banks in name only and are used by the owners for such purposes as tax 'optimisation' or money laundering. Even the largest Russian banks are relatively small by international standards. In 2003, Russia's largest bank, the state-owned Sberbank, was ranked 155th in the world by tier-1 capital; the largest private bank, Mezhprombank, was 625th.⁶

There is still relatively little foreign involvement in the sector, although there is no limit on the foreign capital share in the Russian banking system and foreign interest in the market is growing. A 12 per cent ceiling on the foreign capital share in the sector was scrapped by the authorities in 2002. Nevertheless, a number of lesser restrictions on foreign involvement remain, including the requirement that the central bank approve any acquisition of shares in a Russian bank by non-residents. However, the Central Bank of

5. Data as at 1 December 2003. Data in this chapter are from the Central Bank of Russia, unless indicated otherwise.

6. 'Top 1000' (2003: 241).

Russia (CBR) is pressing for changes that would subject foreign investors to the same percentage thresholds as domestic investors when it comes to requiring prior approval for share acquisitions.⁷ In any case, the ceiling had never actually had legal force nor had foreign banks come close to breaching it. At the beginning of 2004, non-residents owned stakes in only 128 Russian credit institutions, of which 32 were wholly foreign-owned. The foreign share of the sector's total capital in early 2003 was estimated at 5.2 per cent, down from 10.7 per cent at the beginning of 2000. This contrasts starkly with Central Europe, where local banking systems are now largely foreign-owned. Russia does not necessarily need or want a banking sector dominated by foreign players, but it does need a higher level of foreign involvement in the sector, if only to reap the benefits foreign banks can bring to the sector in terms of skills, technology and credibility.

Table 2. Selected balance-sheet indicators of the Russian banking sector

1998-2003 (per cent of GDP, end of period)

	1998	1999	2000	2001	2002	2003
Number of operating credit institutions	1476	1349	1311	1319	1329	1329
Assets	39.8	32.9	32.3	35.3	38.3	42.1
Capital (own funds)	2.9	3.5	3.9	5.1	5.4	6.1
Funds attracted from physical persons	7.6	6.2	6.1	7.6	9.5	11.4
Funds attracted from enterprises and organisations	10.7	9.7	9.9	10.1	10.1	10.4
Credits extended to non-financial enterprises and organisations (as percentage of total assets)	13.0	9.9	11.0	13.7	15.3	17.4
	(32.7)	(30.2)	(34.0)	(38.9)	(39.9)	(41.3)

Source: Central Bank of Russia.

A large proportion of Russian banks (the majority, according to some observers) are 'pocket banks', controlled by a single large shareholder or a small group of related shareholders, who operate the bank for their own convenience. Most pocket banks are best understood as tools of business groupings or state institutions rather than independent, profit-oriented businesses. Whether pocket banks or not, many larger Russian banks are closely affiliated with large financial-industrial groupings and are chiefly oriented to serving the needs of group members. This tendency is reinforced by factors such as poor creditor protection and lack of transparency, which make intra-group operations less risky than arm's-length transactions. However, this approach increases other risks, notably those arising from highly concentrated portfolios (see below). In general, the banking sector remains highly segmented, with little trust among banks. Russia's banks arguably constitute a sector but not a system. The inter-bank market is underdeveloped, and there is little of the interaction among banks typically found in a well functioning network of financial intermediaries. There is little pooling, trading or sharing of risk.⁸

Formal ownership structures of Russian banks tend to be complicated and opaque even when beneficial ownership is an open secret. A bank's connection to its beneficial owners is often concealed behind a web of nominee shareholders, trusts and offshore companies. This is generally legal; indeed, in an IFC survey conducted in 2003, half of the banks responding admitted that they did not disclose the names of their real owners. In fact, probably rather fewer actually did so. Opacity of ownership reduces both transparency and confidence in the system. It impedes efforts to implement new criteria concerning who is 'fit' to own and/or manage Russian banks and undermines efforts to control related-party transactions.⁹

7. See OECD (2003: 29-33) for further detail on these and other restrictions. There has been pressure from the banking lobby to establish a 25 per cent ceiling on the foreign capital share, but the authorities have so far resisted such proposals, which run counter to their overall policy of seeking to encourage greater foreign participation in the sector.

8. Hainsworth, Yeremenko and Tubin (2001).

9. OECD (2004b).

Many of the problems outlined above were evident in the ‘mini-crisis’ of May-July 2004, when the CBR’s intervention in the case of a bank accused of money-laundering triggered several weeks of turbulence and placed a number of banks under strain.¹⁰ The CBR’s attempt to impose a temporary administration on the bank in question, Sodbiznesbank, was bound to be unsettling – it was, after all the first time such an intervention had occurred *before* a bank had actually defaulted on its obligations. However, the situation was exacerbated by the uncertainty about Sodbiznesbank’s ownership, which led to pressure on banks thought to be linked to it via common owners, and by rumours of a ‘black list’ of banks slated for closure by the authorities, which led to runs on several banks. Lack of trust among banks, as well as the awareness that almost any bank might be found to have shady deals on its books (and thus to be vulnerable to such intervention) led to a drying up of liquidity on the interbank market, putting pressure on the hundreds of smaller banks that are highly dependent on it. While the turbulence eventually abated, the whole episode highlighted problems of opacity and lack of trust, as well as the widespread belief that many banks were engaged in legally dubious activities.

A further important characteristic of the sector is the extent to which it continues to be dominated by the state, despite the presence of an enormous number of privately owned banks. At the start of 2003, there were 23 banks in which the state (federal or regional authorities) held majority stakes.¹¹ Such banks accounted for 72 per cent of retail deposits, 34 per cent of capital, 38 per cent of assets and 39 per cent of credit outstanding to the non-financial private sector. They also accounted for 77.6 per cent of Russian government bonds in the portfolios of Russian banks. In addition, regional authorities held minority stakes in many banks and a large number of state unitary enterprises were part-owners of banks. The most important state-owned banks are the savings monopolist Sberbank and the former foreign trade bank Vneshtorgbank (VTB); they are also the largest banks in Russia in terms of both capital and assets. While ownership of VTB has been transferred to the government, the CBR continues to hold the state’s controlling stake in Sberbank. This presents a number of conflicts of interest: the CBR is at once the sector’s regulator, its largest single creditor and the owner of its biggest bank. It also has considerable control over most aspects of insolvency proceedings in the sector. Finally, many private commercial banks have developed on the basis of close links to state institutions, relying on political connections to secure various benefits. Many regional banks have established near-monopoly positions on local markets thanks to official backing.¹²

There are good reasons for seeing state dominance as a problem. State ownership and state intervention in credit allocation tend to distort competition, to aggravate moral hazard by encouraging the expectation of a bailout, and to undermine the efficiency of intermediation, as banks often pursue policies that reflect the non-commercial requirements of the authorities rather than good commercial sense.¹³ The short history of Russia’s banking sector exemplifies many of these problems, particularly with respect to competition and the imposition of hard budget constraints on banks. State-owned banks (both federal and regional) have continued to derive substantial competitive advantages from state ownership, especially Sberbank.¹⁴ In addition to the explicit state guarantee backing their retail deposits, which was scrapped

10. For details see Hainsworth (2004b), Hainsworth and Keeley (2004b), Boulgakov and Westin (2004), Moiseev (2004), and Kudinov (2004).

11. These figures exclude the former Soviet trade banks abroad and banks under the tutelage of the Agency for Restructuring Credit Organisations. State ownership is confined to federal and regional executive organs, the Bank of Russia and state unitary enterprises. The data do not include stakes held by state-owned joint-stock companies.

12. See OECD (1997:100-02); Tompson (1997) and Tompson (2002). Competition for political favours is, of course, competition of a sort, but it is unlikely to produce more efficient intermediation.

13. Barth *et al.* (2002); Djankov *et al.* (2002); Sherif *et al.* (2002).

14. Sberbank’s position is examined in detail in Tompson (1998).

only at the end of 2003, state-owned banks have enjoyed privileged access to state funds, *de facto* exemption from some regulatory norms and, on occasion, financial support from the state. Their cost of capital is reduced by the perception that the state will stand behind them, an implicit guarantee that is little affected by recent legal changes. Sberbank, moreover, is the only Russian bank with a fully developed (indeed, over-developed) branch network. This gives it a near-monopoly in handling things like pension and utilities payments, which bring with them large volumes of low-cost funds. At the same time, state-owned banks have at times been required to perform unprofitable ‘social functions’ on behalf of the state or to adopt policies that reflect the requirements of macroeconomic management rather than profitability.

Official policy is that state-owned banks should exist, if at all, to correct market failures: their activities should be specialised in sectoral and other niches which the market will not address on its own.¹⁵ In practice, however, the major state-owned banks in Russia have tended to operate as universal banks, with Sberbank, in particular, exploiting its protected retail monopoly to extend its business in other directions. It is now the dominant bank in a number of market segments, not only retail (see Table 3). Sberbank’s size and status thus distort competition in many segments of the banking market, not only in the retail sector. The same might be said, albeit to a lesser degree, of VTB. The inconsistency of state policy with respect to state banks was particularly evident during the summer of 2004, when the CBR, having refused to extend a stabilisation credit to Gута-Bank, which had come under pressure, instead lent money to VTB, enabling it to buy Gута and thus to nationalise one of the country’s larger private banks. At the same time, the CBR appears to have encouraged Sberbank to step up its activities on the inter-bank market in order to ease the liquidity problems of smaller banks. Since Sberbank traditionally does around 90% of its inter-bank lending to foreign banks, this amounted to asking the savings monopolist to undertake a major change in its commercial practices, at very short notice, in order to suit the needs of the monetary authorities. In other words, the CBR once again succumbed to the temptation to use Sberbank as a policy instrument.

Table 3. The relative weight of Sberbank in the Russian banking sector

	Per cent of total sector assets		
	January 2001	January 2002	January 2003
Assets	25.4	26.5	28.4
Household deposits	76.5	72.1	67.3
Balances in clients’ settlement, current and other accounts	18.8	16.7	18.3
Investment in government securities	56.6	62.7	68.0
Credit to the non-financial sector	31.6	30.7	29.8
Credit to other banks	6.5	0.5	10.8

Source: Central Bank of Russia.

15. See ‘Kontseptual’nye voprosy’ (2001); and ‘Strategiya’ (2002).

Post-crisis recovery

The banking system has staged an impressive recovery since 1998. The sector has surpassed pre-crisis levels with respect to indicators such as aggregate capital, assets and real-sector lending, in absolute terms and relative to GDP (Tables 2 and 4). Much of the growth in assets came as a result of very rapid growth in lending to the non-financial private sector (NFPS). Bank claims on the NFPS rose from 9.2 per cent of GDP at the end of 1999 to 17.0 per cent of GDP at the end of 2003. These figures are still fairly low by the standards of more advanced transition countries, let alone developed western economies, but the shift to greater real-sector lending has been remarkable. In the three years to January 2004, the NFPS's share of total bank assets rose by roughly 7.3 percentage points. Moreover, the term structure of credits to the NFPS is gradually lengthening: on the official data, 28 per cent of credits outstanding to the NFPS as of 1 January 2004 were for terms of a year or more, up from 19.4 per cent at the beginning of 2001. These data do not, of course, reflect the practice of repeatedly rolling over short-term loans, which is often necessitated by a dearth of long-term liabilities (see Table 4). As of 1 January 2004, only 7.1 per cent of corporate deposits were for terms of more than a year; the corresponding figure for retail deposits was 43.7 per cent but these terms were not enforceable, owing to Civil Code provisions requiring household deposits to be available on demand (see below). Preliminary data show the sector's aggregate profit at USD 4.3bn in 2003, making for a return on capital of 17.9 per cent and on assets of 2.7 per cent. Both figures were more or less unchanged on 2002. This was a far cry from 1998, when return on assets and capital fell to -3.5 per cent and -28.6 per cent respectively.

Table 4. Selected balance-sheet indicators of the Russian banking sector

1998-2003 (USD billion, end of period)

	1997	1998	1999	2000	2001	2002	2003
Assets	128.9	50.7	58.8	83.9	104.8	130.4	188.3
Capital (own funds)	18.8	3.7	6.2	10.1	15.0	18.3	27.4
Funds attracted from physical persons	28.6	9.7	11.0	15.8	22.4	32.4	50.1
Funds attracted from enterprises and organisations	*	13.6	17.3	25.6	29.9	34.3	46.6
Liabilities to other banks	17.8	9.5	6.4	6.3	6.7	9.9	--
Foreign liabilities	18.0	10.7	15.7	10.1	9.5	12.9	22.9
Liabilities to the monetary authorities	2.6	3.9	N/A	7.4	N/A	7.1	6.8
Credits extended to physical persons	*	1.0	1.0	1.6	3.1	4.5	10.0
Credits extended to non-financial enterprises and organisations	*	16.6	17.7	28.5	40.8	52.0	77.7
Claims on other banks	*	4.9	6.4	7.2	6.5	9.2	--
Claims on the general government	32.7	12.8	21.2	18.9	16.2	21.9	25.0
Foreign assets	12.5	11.2	14.2	17.7	38.6	19.1	20.4

* Comparable data do not exist; figures for 1998 are based on the accounting rules in force as of 1 January 1998.

Source: Central Bank of Russia.

Balance-sheet numbers should not be taken at face value. Many observers have long believed that Russian banks systematically under-report non-performing loans.¹⁶ Even if they do not, there is considerable uncertainty about the quality of loan portfolios, for reasons discussed below. Moreover, as small as Russian banks appear to be on paper, they are even smaller in reality, at least as regards their capital. Pressure to increase capital has led them to adopt a wide range of schemes for inflating reported capital.¹⁷ A CBR audit of 60 of the largest banks uncovered so-called 'technical capital increases' in 28,

16. See OECD (1997:91) for a description of the means used to disguise bad loans.

17. For detailed descriptions of the most common schemes, see Tsentrazvitiya (2002:9-15).

and a subsequent audit of a further 180 found capital inflation in over one-third.¹⁸ Many observers believe the problem is even greater: the CBR itself suggested in 2002 that around 60 per cent of the top 100 banks had inflated their capital.¹⁹ The Development Centre estimates that sector capital was inflated by about 15 per cent overall at the end of 2002 and that up to 40 per cent of the aggregate increase in sector capital between end-1999 and mid-2002 may have been 'technical'.²⁰

These concerns should not obscure the important qualitative improvements in the sector since 1999. While the quality of banks' portfolios can only be assessed on the basis of a detailed study of their accounts, both private rating agencies and the CBR agree that the character of bank intermediation is changing. Related-party lending appears to be in decline, although it remains common. The rating agency Interfax estimates that the share of 'connected loans' in the top 30 banks fell from 20-25 per cent in late 2001 to around 10-15 per cent in mid-2003. Moreover, connected loans are increasingly being extended on reasonable commercial terms.²¹ The CBR, seeking to reinforce this trend, has tightened procedures for approving credits to affiliated parties and forbidden extending them on concessionary terms. There has also been a decline in overall portfolio concentration. The number of banks violating CBR prudential norms concerning exposure to a single borrower (or group of related borrowers) has fallen sharply, as has the share of sector assets held by such banks (see Table 5).

Table 5. Banking sector credit risks

	1.07.98	1.01.02	1.01.03	1.07.03
Volume of 'large credit risks' in the banking sector ¹ (Rb billion)	195.1	982.3	1328.9	1606.7
Large credit risks as a share of total bank assets (per cent)	25.5	31.1	32.1	33.0
Number of credit organisations violating CBR limits on total exposure to large credit risks ²	64	10	1	0
Share of total assets held by banks violating limits on exposure to large credit risks	1.3	1.6	0.17	0.00
Number of credit organisations violating limits on exposure to a single borrower ³	355	83	51	30
Share of total assets held by banks violating limits on exposure to a single borrower	18.7	45.6	42.3	7.8

1. 'Large credit risk' is defined as any exposure to a single borrower (or group of related borrowers) in excess of 5 per cent of capital.

2. The total volume of large credit risks faced by a bank cannot exceed 800 per cent of capital.

3. Or related group of borrowers.

Source: Central Bank of Russia.

Nevertheless, the relative weight of 'large credit risks'²² in bank portfolios has actually risen, from 25.5 per cent of total assets in mid-1998 to 33.0 per cent in mid-2003. A recent analysis of Russia's 100 largest banks helps to resolve this apparent paradox. The ten largest loans in a bank's portfolio accounted for, on average, around 39 per cent of the total loan portfolio in mid-2003, down from 52 per cent two years earlier. However, the share of small loans remained stable at around 32 per cent.²³ This

18. *Vremya novostei*, 11 September 2003.

19. *Finansovye izvestiya*, 24 September 2002.

20. *Tsentr Razvitiya* (2002:9-15); see also Sarkisyants (2003:96).

21. Interfax (2003). Interfax rates many of these banks and thus enjoys privileged access to their RAS and IFRS accounts and other internal financial information. The CBR concurs with Interfax's view but does not provide data on banks' connected lending.

22. Credits to a single entity or group of affiliated entities equal to 5 per cent of bank capital or more.

23. Interfax (2003).

implies some diversification, but mainly via the emergence of a larger number of big borrowers. Given the dearth of attractive small borrowers in most regions, this is hardly surprising. The largest banks' portfolios appear to be more concentrated than most: Standard & Poor's reports that the ten largest credits in the portfolios of the Russian banks it has rated accounted for around 40 per cent of assets on average in 2003 and 170 per cent of capital.²⁴ These portfolios look very concentrated by OECD standards. The top ten credits issued by a West European bank would normally be equivalent to 2-8 per cent of assets or perhaps 30-100 per cent of total capital.²⁵ Ironically, while overall portfolio concentration has declined relatively slowly, lending to small businesses has begun to pick up, bolstered by legislation adopted in 2003 that simplifies procedures for lending to small firms, and consumer credit has exploded in the last two years (see Table 4). This has raised concerns about the possible formation of a consumer credit bubble, but such activity is still relatively limited and most credit is extended on very conservative terms, so as to protect the banks.

Bank balance sheets are also highly concentrated on the liability side. Russian banks typically depend on a small number of clients for their funds. One recent study estimates that the top ten clients of the average Russian bank account for 40-80 per cent of attracted funds.²⁶ Highly concentrated deposit bases mean that many banks can be rendered illiquid overnight – even if the loan book is healthy – by the withdrawal of a single large depositor (who may well also be a shareholder). It was the withdrawal of a large depositor in April 2002 that triggered the collapse of the Investment Banking Corporation, the biggest Russian bank failure since the 1998 financial crisis. In 2004, Guta-Bank likewise ended up in trouble as a result of the abrupt withdrawal of a number of large depositors.

While the sector's post-crisis recovery has been impressive, there remain doubts about the medium-to-long term, not least because the pace of recovery has hitherto outstripped the pace of reform. The financial system has risen on a tide of liquidity generated in the first instance by massive external surpluses and, more recently, by the emergence of net private capital inflows in 2003. Extremely rapid lending growth is likely to come at the expense of portfolio quality, especially where, as in Russia, banks have little experience of lending to the real sector, borrowers do not yet have extensive, meaningful credit histories and the regulatory capacities of the state are limited. So far, the share of non-performing loans has actually declined, but the real quality of portfolios will become clear only when the external environment is less favourable and liquidity tightens.

Concerns about portfolio quality are reinforced by two other factors:

- Russian banks are losing many of their best clients to foreign rivals and to bond markets, as Russia's 'blue-chips' find that they are able to borrow larger sums, for longer periods and on better terms, from foreign banks and capital markets.²⁷ Foreign banks' lending to Russian corporates is growing far faster than that of Russian banks, which in mid-2003 accounted for only about 55 per cent of total bank claims on non-financial enterprises.²⁸ Foreign pressure on Russian banks is likely to increase as restrictions on cross-border capital operations are relaxed.
- 'Bullet loans' remain very common, as does the practice of rolling-over short-term credits as a substitute for long-term loans (which banks are often unable to extend on account of a dearth of

24. Penkina (2004). Sberbank has also come under fire for the concentration of its loan portfolio.

25. Sarkisyants (2003:94-5).

26. Sarkisyants (2003:95). See also *Vedomosti*, 22 October 2003.

27. See Ahrend (2004), figure 10.

28. Interfax (2003).

long-term liabilities). Bullet loans require borrowers to make only interest payments during the term of the loan, repaying the principal in full when the loan matures. Thus, the lender may discover the borrower's ability to repay only at the end of the term, which may be postponed if the bullet loan is repeatedly renewed.

A final cause for concern is that Russia's economic structure means that its banks are subject to a very high level of economic risk.²⁹ Russia's high ratio of foreign trade turnover to GDP (58.1 per cent in 2003) and the predominance of hydrocarbons and metals in its export profile place it firmly in the class of less-diversified economies (LDEs). Typically, LDEs are small economies with relatively limited financial sectors. Banks and industrial firms in the concentrated sector tend to be closely related via common ownership or common customers. LDE financial markets tend to be illiquid and volatile, and a dearth of reliable public information about business performance means that the main flows of institutional finance (modest as they may be) are via banks. Finally, the concentrated sector's market power and its access to external finance mean that banks cannot charge a risk premium for lending to it.³⁰ These generalisations all hold good for Russia. Financial sectors in such economies tend to be highly vulnerable to crises triggered by terms-of-trade shocks, and there is evidence to suggest that the probability and severity of such crises are linked to export concentration.³¹

The environment of commercial banking

Russian banks have often been criticised for their failure to mobilise domestic savings and channel them into productive activities. However, the main reasons for the limited development of bank-based intermediation are to be found in the broader environment in which banks operate. Many of the peculiarities and pathologies that characterised the development of Russian banks in the 1990s were directly traceable to such broader environmental factors as high inflation, fiscal mismanagement, poor creditor protection and the weakness of the rule of law.³² Russia is hardly unique in this respect: cross-national research suggests that financial development may depend more on general features of the contracting environment, such as the level of corruption and the rule of law, than on the characteristics of the financial system itself.³³ It is critical, therefore, to emphasise that banking reform cannot be pursued in isolation from other macroeconomic and structural policies. The development of Russia's banking sector will depend to a great extent on changes in the wider contracting environment. Of particular importance are macroeconomic stability, adequate information and contract enforcement.

29. See Bugie *et al.* (2003); Sarkisyants (2003:95); and Penkina (2004).

30. Narain *et al.* (2003).

31. See Capriol and Klingebiel (1996); Kaminsky and Reinhart (1999); and Wilson and Caprio (2002). Aghion *et al.* (2004) find that economies at an intermediate level of financial development tend to be less stable than very developed or underdeveloped economies. This would suggest that Russia's financial development, while undoubtedly positive in the long run, may well increase the risk of short-term instability.

32. See OECD (1997) and Tompson (1997, 2000).

33. See, *e.g.* Barth *et al.* (2002); Cull *et al.* (2000).

With respect to macroeconomic issues, the fiscal consolidation and inflation reduction achieved since 1999 are extremely important developments.³⁴

- High and volatile inflation in the 1990s discouraged both lenders and borrowers from entering into long-term arrangements. The slow but steady fall in inflation since 1999 has contributed to the expansion of bank lending and the gradual lengthening of loan terms.³⁵ It is important, therefore, that recent progress in reducing inflation continue.
- Large fiscal deficits and government borrowing requirements during the 1990s limited both private firms' access to credit and banks' ability to mobilise domestic savings. The dramatic improvement in fiscal balances since 1998 thus favours the development of financial intermediation and provides a further argument (if one were needed) for the continuation of prudent fiscal policies.³⁶

Macroeconomic stability has also reduced the attractions of foreign exchange speculation and other activities that the banks found so lucrative in the hot-house financial atmosphere of the 1990s, giving them greater incentives to develop their core banking businesses.

Economically rational credit decisions require good-quality firm-specific information about potential borrowers, and depositors require adequate information about the banks to which they entrust their funds. The dearth of such information has been a major obstacle to the development of financial intermediation. This reflects problems with accounting and financial reporting, as well as Russian companies' penchant for secrecy. During the 1990s, these problems were compounded by the effects of inflation, arrears and non-monetary exchange. Although these problems have largely abated, further steps are needed to increase the quality and availability of financial information about both banks and real-sector firms. The CBR's efforts to increase the quality and availability of information in the banking sector are detailed below. No less important will be informational improvements in the real sector, including the move to international financial reporting standards. These are proceeding slowly and at an uneven pace.

In this context, the development of effective credit bureaux could make it far easier for banks to assess potential borrowers. Russian banks' penchant for related-party lending is at least partly a response to the real difficulties of learning the credit histories of potential borrowers they do not already know. Russian corporates tend to be highly secretive, and the bank law states that loan agreements are confidential, so it can be difficult to assess a potential client's credit history (although the new lender can insist on such information as a condition for extending the loan). Credit bureaux would be the logical solution to this problem, and the authorities are committed to adopting a new law on them this year. However, it would be unwise to expect too much from legislative change alone. Repeated attempts to establish credit bureaux have foundered on lack of trust among banks and the suspicions of non-bank corporates about how and by whom such sensitive financial information might be used. The problem of credit bureaux thus illustrates the ways in which problems with the wider contracting environment (lack of trust and of transparency) make it difficult to pursue banking reforms.

34. See OECD (2004c), chapter 1.

35. In some respects, the volatility of inflation is the greater problem, as economic agents could more easily adapt to high inflation if it were at least more or less predictable. However, this is a purely theoretical consideration, since the empirical record in most countries shows that the higher inflation is, the more volatile it tends to be. Long-term commitment is also discouraged by the fact that stabilisation, when it is achieved, can bring about abrupt changes in the relative profitability of different firms and sectors.

36. On the importance of fiscal consolidation for financial development in transition, see Berglof and Bolton (2001).

Banking development will also depend on the progress of judicial reform in a broad sense, no less than on the adoption of legislation concerned specifically with strengthening creditors' rights. The development of arm's-length lending, which extends beyond groups of related companies, depends on the parties' confidence in third-party enforcement of contracts.

Banking reform initiatives

Deposit insurance

Russia's deposit insurance (DI) legislation, which reached the statute books at the end of 2003, is perhaps the most important banking reform adopted in recent years.³⁷ The government's motivations for adopting the DI law, as set out in the 'explanatory note' that accompanied its submission to parliament,³⁸ largely reflect the arguments employed in support of DI elsewhere.³⁹ Above all, DI is meant to increase public confidence in the banking sector and thereby to promote financial stability by reassuring depositors and so preventing socially costly runs in times of stress. It is also intended to help attract into the banking system the large volume of household savings still held as (usually foreign) cash – the population's so-called 'mattress money'. This has been variously estimated at USD 40-80bn, as compared with total household bank deposits of around USD 48bn.⁴⁰ The government also hopes that this will make it easier for the banks to attract badly needed long-term liabilities. Household deposits are normally banks' principal source of long funds, but the Russian Civil Code (GK) currently requires retail deposits to be available on demand, even if they have been contracted for a specified term. In short, all retail deposits are effectively demand deposits. The authorities explicitly linked the adoption of the DI law to the amendment of this GK provision.⁴¹

DI is also meant to enhance competition in the retail sector by 'levelling' the competitive playing field between state-owned and private banks. The main object here is to enable private banks to compete with Sberbank. Creating a more competitive environment in the retail sector is particularly important in view of the rapid growth of both retail lending and retail bank deposits. The household sector is becoming an increasingly important source of funding for banks (see Table 6). However, competitive conditions will not be equalised immediately. Sberbank's DI accounts will remain entirely segregated from those of other banks until its share of retail deposits falls below 50 per cent or until 2007, whichever comes first - meaning that it will effectively remain outside the system for several years. Sberbank's market share is already falling by several percentage points each year. However, pension and other social payments will probably continue to be channelled primarily through Sberbank for some time, which will help it retain a dominant position. Government-sponsored amendments to the DI law submitted to the Federal Assembly in early 2004 would, however, limit the guarantee covering any deposits opened after 1 November 2004 to just Rb100,000, the level of coverage extended under the DI law. Only older deposits would enjoy full state guarantees.

37. For the text of the law itself, see 'O strakhovanii' (2003).

38. 'Poyasnitel'naya zapiska' (2003).

39. Kane and Demirgüç-Kunt (2001:3-4, 21). See also Diamond and Dybvig (1983).

40. For a plausible estimate of around USD 44bn in mattress money, see Hainsworth and Keeley (2003).

41. 'Ob utochnenii' (2003), para. 9.3.

Table 6. Net debtors and creditors of the banking system

Per cent of bank assets

	January 2000	July 2003
<i>Net debtors</i>		
Central Bank of Russia	9.37	11.19
State	6.76	4.28
Non-residents	17.53	2.14
Enterprises	0.91	23.15
<i>Net creditors</i>		
Russian banks	-1.30	-0.03
Individuals	-3.34	-10.11
Securities	-7.99	-16.51
Shareholders	-17.60	-9.58
Other	-4.34	-4.54

Source: Interfax Rating Agency, 2003.

Although DI schemes have proved increasingly popular around the world, there is growing scepticism among economists about their benefits, as well as increasing concern about the risks they pose. A growing body of empirical work suggests that DI can increase the risk of financial instability.⁴² The presence of DI (or even the implicit insurance of an expected bailout) can reduce incentives for regulators and creditors to monitor banks, while encouraging bankers to run greater risks. Cross-national research suggests that the seriousness of this moral hazard problem depends largely on the institutional environment. Where the rule of law is weak, regulation is lax and creditors' rights are poorly protected, DI is more likely to contribute to financial instability and less likely to facilitate financial deepening.⁴³ The implications of this finding for Russia, which matches this description of a poor institutional environment all too well, are clear. The introduction of DI therefore needs to be accompanied – preferably preceded – by major improvements in bank transparency, prudential regulation and the administration of law. The Russian authorities are well aware of this. Their bank reform strategy explicitly links the introduction of DI to the imposition of more rigorous requirements concerning the financial soundness and transparency of banks.⁴⁴

A detailed description of the new DI system and an analysis of the likely impact of various provisions is provided in Annex 1. The general conclusion that emerges from this analysis is that Russia's DI law is unlikely to give rise to a serious moral hazard problem. DI schemes tend to generate greater volatility if they are generous in terms of the scope and extent of coverage.⁴⁵ The Russian scheme is certainly not overly generous. It covers only a limited range of retail deposits and extends coverage only to the first Rb100,000 (about USD 3,400). This is a relatively modest sum, even by Russian standards, as compared with *per capita* GDP in 2003 of about Rb92,265. This ratio of insured maximum to *per capita* GDP is low by the standards of both developed and developing economies.⁴⁶ In short, DI will protect small individual depositors who are least able to monitor banks effectively anyway. There should be no reduction in other

42. See, e.g. Kane and Demirgüç-Kunt (2001); Cull *et al.* (2000); Barth *et al.* (2002).

43. For cross-national comparative work, see Kane (2000); Kane and Demirgüç-Kunt (2001); and Cull *et al.* (2000). For studies of specific cases, see Brewer (1995), de la Cuadra and Valdes (1992), and de Krivoy (1995).

44. 'Ob utochnenii' (2003), para. 9.2.

45. See Cull *et al.* (2000); Demirgüç-Kunt and Detragiache (2000); and Barth *et al.* (2002).

46. See Fantini (2003:6); and Kane and Demirgüç-Kunt (2001:7).

creditors' incentives to monitor banks closely: in the event of liquidation, their claims are satisfied only after those of depositors.⁴⁷ In any case, the ending of state guarantees for deposits in state-owned banks should eliminate an important source of moral hazard.

If the risks posed by DI in Russia are rather limited, the benefits are likely to be as well, at least initially. It is often asserted that the absence of DI is a major reason for households' reluctance to bank their savings. However, it is far from clear that this is the case. The reluctance of many retail savers to avail themselves of the guarantees hitherto offered by state-owned banks suggests that the decision to hold savings in cash reflects something more than just a concern about the soundness of particular banks. Moreover, the very limited nature of the scheme, while positive in terms of avoiding moral hazard, is likely to limit the extent to which the establishment of DI will, on its own, act as a 'magnet' for mattress money. DI should, however, make it easier for private banks to compete with Sberbank for the custom of cautious depositors. Much depends on DI being accompanied by other steps to foster competition in the sector.

The most important benefit of the introduction of DI may well be to strengthen prudential regulation. Banks wishing to enter the scheme will undergo an intense examination by the Central Bank of Russia (CBR) before being admitted. If the CBR finds them wanting, they may be excluded and thus barred from the retail market. The CBR is determined to use the introduction of DI to tighten up prudential supervision. The law's screening provisions are therefore to be welcomed. Implementing them, however, will not be easy. It will require the CBR to conduct thorough reviews of over 1,000 banks in a very short time and to exclude even large, well connected banks from the system if they do not meet the admissions criteria. If the CBR is unable or unwilling to enforce the criteria strictly and to exclude weaker banks, the DI scheme's credibility will suffer, as will the credibility of all CBR regulatory reform efforts. By contrast, the exclusion of significant numbers of banks would – on the basis of transparent criteria, consistently applied – send a powerful signal of the CBR's determination to regulate the sector effectively.

Substance-over-form regulation

Since early 2002, the CBR has been working to shift the system of prudential supervision from a regime concerned mainly with formal compliance to one emphasising a more serious analysis of banks' health and prospects. The arrangements in place since the early 1990s have proved extremely burdensome in terms of paperwork but highly ineffective at preventing abuses or enabling the CBR to intervene proactively when banks were heading into difficulties. The move to 'substance-over-form' regulation is an enormous challenge. Hundreds of pages of regulations and instructions must be redrafted to reflect the new approach. Many of these have already been done, of which the most important is the radically revised draft of CBR Instruction No. 1 'On banks' mandatory norms', which entered into force in April 2004.⁴⁸ Instruction No. 1, which forms the foundation for the CBR's prudential supervision, had remained substantially unchanged for a decade. The new draft exemplifies the shift to 'substance-over-form' regulation and is to be commended. It is likely to lead to a real improvement in the quality of CBR supervision, not least because it reduces both the opportunities and the incentives for banks to manipulate their accounts in order to meet prudential ratios. (For an analysis of the changes made with the new Instruction, see Annex 2.).

The new approach to prudential supervision depends to a much greater extent on the judgement of CBR officials, whose competence and integrity therefore matter more than ever. The establishment of a new chief inspectorate based in CBR headquarters is intended to reduce the scope for the conflicts of interest and opportunities for pressuring or suborning inspectors. However, day-to-day supervision will

47. 'O nesostoyatel'nosti' (2002), art. 49. This provision actually contradicts article 64.1 of the GK, but the Supreme Arbitration Court ruled in favour of the former in February 2003 (Vysshii Arbitrazhnyi 2003).

48. 'Ob obyazatel'nykh normativakh' (2004).

from 2005 be in the hands of individual supervisors called *kuratory*. A *kurator* will be appointed to oversee each bank on an on-going basis. This has caused some concern, since greater official discretion in these matters is seen by some as posing a risk of corruption and/or arbitrary action. *Kuratory* will not be able to sanction banks on their own. They will only propose action to their superiors, who will, if punitive action is recommended, consult the bank affected. While this should prevent *kuratory* from abusing their power at the expense of banks, it will be harder to prevent *kuratory* from colluding *with* the banks they supervise. Opportunities for such collusive behaviour are to be minimised by ensuring that information flows through multiple channels and that key decisions involve more than one level of the CBR hierarchy. The shift to substance-over-form regulation is welcome. However, there will be real difficulties in implementing it. Retraining staff will be a major challenge. The CBR has begun training the new *kuratory*, but it remains to be seen how quickly it can recruit and train staff of sufficient calibre, or how well it will manage to retain them. The *kuratory* themselves may face conflicts of interest, given the likelihood that banks will be eager to hire them away from the CBR.

Finally, it is crucial that the CBR be seen to enforce the new standards consistently and to intervene effectively to prevent incipient problems from developing. This will be difficult, not least because the CBR's long record of regulatory forbearance before and after the 1998 crisis led many banks to believe that they could violate prudential norms and default on obligations with impunity.⁴⁹ The CBR will have to demonstrate exemplary toughness in order to change such expectations. This could be facilitated by the adoption of legislation to streamline the cumbersome and generally inefficient (for creditors) procedures for liquidating failed banks. At present, such banks are often left in legal limbo for years, creating opportunities for insiders to siphon off assets before creditors' claims are met (at any given time, there are several hundred such 'bank-corpses' in the sector). The authorities currently plan to assign the new Deposit Insurance Agency the role of 'corporate liquidator' responsible for acting as liquidation administrator of failed banks. This is intended to make the process faster, more transparent and more protective of creditor interests, but it may create conflicts of interest for the Agency, given its primary (deposit insurance) role.

The CBR's main priority with respect to the *substance* of regulation (as opposed to regulatory procedures) has been capital regulation. A new instruction on the calculation of bank capital for use in prudential ratios both tightens the rules for making such calculations and allows the CBR to assess the economic value of every asset. This is an important initiative. Capital serves as a buffer against losses and also reduces incentives for banks (exploiting their limited liability) to take excessive risks. Very low capital adequacy may be a more serious source of moral hazard than the presence of DI, since it implies little risk of further loss to shareholders and potentially large upside gains if risky ventures pay off.⁵⁰ Moreover, capital regulation is arguably superior to the direct monitoring of assets, because it affects the banks' own incentives and because it is less difficult for outsiders to assess than the quality of assets, lending decisions or risk-management.⁵¹ Since the CBR's regulatory capacity is still limited, it makes sense to focus on the few indicators likely to be most effective, capital being perhaps first among them. The drive to expose technical capital inflation and compel banks to recalculate their capital to higher standards therefore represents a significant step forward. While it would be unwise to pin too much hope on capital regulation alone, in isolation from other features of the regulatory environment,⁵² tighter capital regulation does appear in most environments to be negatively associated with non-performing loans, which suggests that it does indeed curb excessive risk-taking.⁵³

49. For a detailed study of CBR policy during the period to 2000, see Malyutina and Parilova (2001).

50. See Keeley and Furlong (1990); Dewatripont and Tirole (1994); Berger *et al.* (1995) and Brewer (1995).

51. Cull *et al.* (2000).

52. Barth *et al.* (2002).

53. Barth *et al.* (2002).

Capital regulation is also an appropriate priority for the CBR at present, for two reasons:

- Risk-weight capital adequacy ratios remain high enough that, even allowing for capital inflation, it is unlikely that they are yet a serious problem. At the start of 2004, the CBR estimated the sector's risk-weighted capital adequacy ratio to be 19.1 per cent. However, capital-adequacy ratios have been falling, as banks increase assets faster than capital. Tackling the problem of capital inflation sooner rather than later, therefore, should avoid a situation where real (rather than reported) capital adequacy ratios reach dangerously low levels. It should also make it easier to tighten capital regulation without constraining the sector's growth.
- The minimum capital requirement for new banks is to rise to €5m from 1 January 2005 and existing banks must raise their capital to this level by 2010. Only around 35.4 per cent of Russian banks had attained this level by December 2003, although they accounted for 93.6 per cent of the sector's capital – an oblique indication of the number of tiny banks that remain in the system.

Tighter regulation of capital is vital if other measures to ensure transparency and soundness are to be meaningful. It will also increase the pressure for consolidation in the sector, something the CBR is anxious to encourage. Russia still has too many small banks. Regulatory pressure for consolidation is in any case reinforced by developments in the marketplace: margins are falling and banks are increasingly reliant on income from activities like retail business and corporate lending, which impose substantial overheads but also offer significant economies of scale.⁵⁴

Information and transparency

The phasing in of International Financial Reporting Standards (IFRS) marks a further step towards increasing the quality and availability of information in the sector. Russian banks will be required to produce financial statements in IFRS format from the third quarter of 2004, based on transformation rules for converting Russian Accounting Standards (RAS) accounts to IFRS. RAS reporting will continue to be used in parallel through 2005. During this transition period, IFRS reports will be used for analytical purposes only; they will form the actual basis for supervision only from 1 January 2006.⁵⁵ The phasing in of IFRS in this way is intended to help banks adjust to their requirements. These will be financial as well as technical: it is expected that most (though by no means all) banks will show lower capital-adequacy ratios under IFRS and possibly also a larger share of problem assets.⁵⁶ This will have an impact on both confidence in the sector and the banks' financial position. A major cost of the accounting transition, above and beyond retraining accountants and auditors or replacing computer programs, will be shoring up balance sheets in light of the IFRS results.

54. Streamlining procedures for mergers, acquisitions and liquidations will be needed if consolidation is to proceed smoothly.

55. See 'O perekhode' (2003) for the CBR's timetable for the adoption of IFRS.

56. Matovnikov (2001).

It should be emphasised that 2004-06 will see not the adoption of international accounting practices but the mandatory restatement of RAS accounts in an IFRS format. This is a step forward, but three caveats are in order:

- While IFRS is a more analyst-friendly format, banks will not be required to present IFRS reports with notes and commentaries, without which they may be impossible to interpret.
- Banks may draft their IFRS reports as creatively as they have their RAS financials. International standards may prove more flexible than the rules-based RAS.⁵⁷ While IFRS are clearly preferable to RAS, neither can really curtail opportunities for ‘window-dressing’, informal profit-seeking or tax avoidance in the absence of better corporate governance and improved prudential regulation.
- The regulations issued by the CBR for transforming RAS accounts do differ from IFRS in some respects and might not be accepted as IFRS-compliant. Some Russian banks may therefore have to prepare IFRS accounts for potential or actual foreign creditors that differ from the IFRS accounts prepared for the CBR.⁵⁸

The extent to which the IFRS transition makes banks more transparent will thus depend largely on the CBR’s success in improving supervision and on the banks’ own desire to become more open. If banks adopt a strictly *pro forma* approach to IFRS reporting, the shift will be of little value. The actual shift to international-standards accounting is a much more complex process and will, according to the CBR, proceed in tandem with the adoption of IFRS in the real sector.⁵⁹ (See Annex 3 on plans for the financial reporting transition and its significance.)

The other key element of the CBR’s campaign to improve transparency concerns transparency of ownership. Identifying banks’ real owners is a particular priority in view of what happened after the 1998 collapse. Owners of failed banks often managed to shift assets into new banks, leaving the old institutions’ creditors empty-handed.⁶⁰ The law does not authorise the CBR to compel disclosure of beneficial ownership. However, the CBR is increasingly trying to use its regulatory discretion on such issues as applications for licence upgrades, authorised capital increases or admission to the DI scheme to make banks open up. Ownership transparency forms just one part of a broader drive to improve banks’ corporate governance, which tends to be very poor even by Russian standards, owing in part to the fact that almost no banks’ shares are actually traded. Improved corporate governance should serve the banks’ own interests, by making it easier to raise the capital they need to meet higher capital requirements and sustain their growth.

Banks have long needed CBR approval for their top managers, but hitherto the only grounds specified for barring individuals were criminal convictions. Now the regulators plan to extend their authority to a wider range of positions, including seats on boards of directors, and to extend the criteria that may be applied in rejecting candidates. Regulators in many jurisdictions have the power to bar specific individuals from owning or running banks, but the CBR has run into serious opposition not only from many banks but also from critics who simply fear the potential for arbitrary official behaviour, bias and corruption. The

57. On the creativity shown by Russian banks that already produce reports under IFRS, see Matovnikov (2001) and Hainsworth and Tompson (2002:286-88, 295).

58. OECD (2004a:5).

59. ‘O perekhode’ (2003).

60. The problem of opaque ownership returned to the fore in the spring of 2004 in connection with the scandal surrounding Sodbiznesbank, which stood accused of involvement in serious criminal activities. It was not at all clear who the bank’s real owners were; see *Vedomosti*, 28 May 2004.

new ‘business reputation’ criterion has come in for particular criticism, as being excessively subjective.⁶¹ In fact, the list of criteria to be applied by the CBR is relatively long and consists mainly of items involving little or no subjective judgement, such as past criminal or administrative legal violations. However, here, as in the sphere of economic regulation, there will of necessity remain scope for CBR officials to make professional judgements. Given the sensitivity that exists towards any rule that could empower officials to make ‘subjective’ decisions, it will be crucial to ensure that regulators’ decisions are clearly and openly explained. In any case, the new instruction may well have only a limited effect, since it is already the case that the key individuals in many banks occupy second-tier positions in order to keep out of the limelight; in some instances, they have no formal management role at all.

Overall, the reforms’ emphasis on transparency is extremely encouraging, as increased openness will facilitate closer monitoring of banks by private-sector agents. This is not to deny the importance of an effective public-sector regulator. It is critical that the CBR possess the legal authority, resources and will to monitor the sector and to intervene where necessary. However, increased private-sector monitoring is particularly attractive given the rapidly growing complexity of banking and financial markets. The expertise needed to monitor banks in such an environment is more likely to be found in the private sector than in public bureaucracies, and a bank’s major creditors have greater incentives to monitor it than public-sector regulators.⁶² In addition, too much reliance on public regulators is problematic in an environment where private agents tend to fear bias and corruption on the part of the public authorities.⁶³

‘Developmental’ reforms

There are a number of important steps still to be taken with respect to creating a legal basis for banks’ activities. These are the so-called ‘developmental’ reforms alluded to above. The following are among the issues that should be regarded as key priorities for fostering the development of the Russian banking sector’s intermediary activities:

- *Secured lending.* The 2002 bankruptcy law follows previous Russian bankruptcy laws in treating secured creditors in a rather peculiar fashion.⁶⁴ Previously, they simply constituted a separate category under the modified form of the absolute priority rule then employed. Now secured creditors’ claims are satisfied by the proceeds from the sale of their collateral but only *after* the satisfaction of unsecured first- and second-order claims incurred prior to the conclusion of the collateral agreement. Moreover, the Civil Code has not yet been changed: it still contains the old five-category ordering found in earlier bankruptcy laws.⁶⁵ More generally, there is a need for systematic registration of collateral, for better protection of lenders in the event that assets used as collateral are stripped of the value they had at first inspection, and for faster, simpler methods for realising collateral outside of bankruptcy proceedings. Currently, creditors must go to court to enforce collateral claims on defaulting borrowers. It would also be desirable to change the regulatory framework so as to facilitate the use of a wider range of forms of collateral, including intangibles.

61. See, for example, Vasiliev (2003).

62. This is especially true if – as is often the case – public regulators face incentives to help conceal an incipient crisis and postpone the public intervention that might be needed to prevent it from developing. See Kane (2000).

63. Shleifer and Vishny (1998); Djankov *et al.* (2002).

64. ‘O nesostoyatel’nosti’ (2002).

65. ‘Grazhdanskii kodeks’ (2003), arts 25 and 64-65.

- *Term deposits.* As noted above, Civil Code art. 837.2 treats all retail deposits as *de facto* demand deposits. Amending this provision would allow the creation of genuine term deposits, making it easier for the banks to attract badly needed longer-term funds from retail savers. The authorities are committed to revising this provision, but the amendment has yet to be adopted.
- *Mergers and acquisitions.* Given the need for consolidation in the sector, the CBR's streamlining of approval procedures for mergers and acquisitions in the banking sector is good news for banks. However, a major obstacle to mergers remains in the Civil Code. Merging banks must offer all borrowers the option of terminating their lending agreements or continuing them with the new entity. The CBR is pressing for this provision to be changed. The CBR is also pushing for amendments to the law 'On Banks and Banking' that would remove the requirement that any transfer of equity in a Russian bank from a resident to a non-resident be subject to CBR approval. It is proposed instead that CBR permission apply only to transactions involving over 10 per cent of a bank's equity, regardless of the parties' nationalities. Such a change would be consistent with OECD recommendations in this area.⁶⁶
- *Mortgages.* While the adoption of the law on mortgage securities⁶⁷ is to be welcomed and will facilitate the attraction of long funds that can be used for mortgage lending, development of a mortgage market will require further institutional and legal changes, including the revision of legislation that currently makes eviction in the event of default extremely costly, if not impossible. Until the law allows for some reasonable right of eviction, the development of mortgage activities will be severely constrained.
- *Easier branching.* The CBR has called for the revision of secondary legislation on bank branching to simplify this process and reduce the costs involved (including the fee paid by banks for opening new branches). This would enhance competition by making it easier for banks to develop their branch networks and enter new regional markets. Also to be welcomed are proposals to make it possible for banks to open small service points offering a limited range of services to their clients without incurring all the costs of establishing full branches. The legal and regulatory changes needed here should be relatively easy to adopt; much more difficult will be reducing the informal barriers to entry that many regional authorities continue to maintain.

The above priorities have all been included in the most recent versions of the joint CBR-government strategy but progress has been slow.⁶⁸ There has long been broad agreement on most of these issues but legislation is still lacking. In some spheres, the CBR has done what it could in its role as a regulator but remains constrained by the slow pace of legislative change. This is true with respect to mergers and acquisitions (see above) and also to syndicated lending (see Annex 2).

66. OECD (2003:31).

67. 'Ob ipotechnykh' (2003).

68. See the Russian government web site at http://www.government.gov.ru/data/structdoc.html?he_id=102&do_id=1597.

Box 1. Financial market development

At present, Russian financial markets play a very small role in the allocation of investment resources. However, they are growing fast and a number of developments in other sectors highlights the importance of developing transparent, well regulated financial markets. In particular, future development of the banking and insurance industries, as well as the success of pension reform,¹ depend in no small measure on the development of deeper financial markets and of a wider range of instruments in which to invest and by means of which to attract funds. More broadly, financial markets are likely to prove a critical source of long-term resources for investment by large Russian companies; it is likely to be some time before Russian banks are able to lend significant sums for terms as long as those available to major corporates on financial markets.

After more than a decade of development, Russian financial markets have begun to acquire the technical and functional characteristics of mature markets. However, though rapidly growing, they are small and generally illiquid:

* Total stock market capitalisation in early 2004 was around USD 200bn, close to 50 per cent of GDP. This is relatively high for an emerging market but indicators of liquidity and depth were still poor. The shares of only about 7-10 companies (mainly in oil and gas) are actively traded, accounting for around 90 per cent of turnover on the two major stock exchanges. There has been almost no IPO activity in recent years, owing in part, at least, to low valuations. However, several issues were being prepared in early 2004.

* The total volume of rouble-denominated government debt outstanding at end-2003 was equal to roughly 5 per cent of GDP, but only about 40 per cent of this was tradable.² This is a problem inasmuch as a liquid, well functioning market in government debt would help the CBR manage the money supply and sterilise foreign exchange inflows, give banks greater freedom to manage their liquidity and provide a proper market for interest-rate formation. In theory, government debt, as the least risky investment available, should provide a baseline interest rate against which rates on other instruments could be assessed.

* The corporate bond market more than doubled in size in 2003, with the volume of placements reaching USD 4.8bn, but this amounts to only about 1 per cent of GDP. Activity is somewhat more diversified than on the stock market: the oil and gas sector accounts for only about 40 per cent of outstanding issues (though they make up 80 per cent of the market in Russian corporate Eurobonds). Banks have been increasingly active on this market, which is now a major source of financing for them (see Table 6).

* About USD 10bn in unsecured promissory notes (vekselya) was outstanding at the end of 2003. Though vekselya are popular as a liquidity management instrument, they are a riskier investment than corporate bonds, as their issuing requirements are less demanding and their legal status is less well defined. They are also cheaper to issue than bonds, as the latter incur stamp duty, although this has recently been cut.

Russian financial markets are also under-governed, a matter of particular concern in view of their rapid growth. Gaps in Russian legislation exist in a number of key areas, including:

* Insider trading and market manipulation. Work has begun on new bills to deal with these problems, but they could take some time to adopt, as the courts' lack of experience in handling such issues means that the language of the new statutes must be drafted with exceptional care.

* New instruments and activities. The relatively short list of permitted securities set out in Russian statute law is considered to be exhaustive: no one can create new forms of securities without legislation. There is a need to make the existing securities laws more open to financial innovation and in particular to provide a stronger legal basis for such activities as mortgage finance and asset securitisation.

* Derivative instruments. Small markets in instruments such as options and futures exist, but there is still no proper legislation governing derivatives. In the late 1990s, a Russian court found that derivatives contracts fell under the Civil Code provisions pertaining to wagers and so were not subject to enforcement by the courts. There is also uncertainty over the practice of close-out netting, whereby all transactions of a given type are netted at market value in the event of one party's bankruptcy. Such debt set-offs are not permitted in the event of bankruptcy in Russia, which greatly increases the risk for derivatives providers. Finally, the regulatory and supervisory structure for derivatives markets need to be clarified.

The development of financial markets, like that of the banking sector, is in many ways constrained by problems with the larger contracting environment.

* The weakness of the rule of law is a particular problem: markets in securities are markets in legal claims and obligations. Moreover, the contracts involved are often complex and they are generally neither instantly executed nor self-enforcing. This makes the quality of third-party enforcement of contracts particularly important.

* Likewise of exceptional importance are corporate governance issues, including ownership transparency and the extent and quality of disclosure. The desire to raise capital on securities markets is, of course, a major incentive to improved disclosure and governance: for successful borrowers, the bond markets, in particular, offer unsecured credit for longer terms than would be available from banks.

* Corruption and rent-seeking on the part of officials can undermine the effectiveness of even the most enlightened regulatory framework, since the administration of the rules is as crucial for market participants as their content.

The authorities are well aware of the problems listed above and, in many cases, are actively working on measures to address them. Hitherto, conflicts among competing regulatory authorities have bedevilled attempts to develop the non-bank financial sector. It is to be hoped that the creation of the new Federal Securities Market Agency will lead to an acceleration of reform and greater coherence in the regulation of different market segments.

1. See OECD (2004c), annex 1.5.

2. The balance consists of long-term, low-yield non-marketable bonds held by the CBR as a result of the restructuring of government debt after the 1998 financial collapse. The CBR has been working to devise arrangements for making use of this blocked debt in liquidity management.

The future of state-owned banks

The Russian authorities have long been committed in principle to reducing both state ownership of commercial banks and the intervention of state institutions in credit allocation. There has been progress with respect to particular issues. The regulatory privileges enjoyed by state-owned banks have been reduced, and the adoption of DI legislation has deprived all but Sberbank of their explicit state guarantees. (Sberbank's guarantee will lapse no later than 2007.) However, the process of divesting the state of its banks has been slow, as is evident from the data on state ownership presented above. The number of banks in which the state owns a blocking or controlling stake has declined in recent years, but this has mostly involved the disposal of small banks, so the state's relative weight in the sector has changed little.⁶⁹ The sector's largest banks remain in state hands. Planned deadlines for the state's (and, in particular, the CBR's) withdrawal from bank ownership have repeatedly been postponed.⁷⁰ At present, the authorities

69. See the data given for end-2001 in Sherif *et al.* (2002:46).

70. The 1995 central bank law stipulated that the CBR could not participate in the capital of other banks and required it to dispose of its stakes. By the end of 1995, however, the CBR had won passage of a law

plan to divest almost all state unitary enterprises of their bank shares and to reduce the state's share in VTB to below 50 per cent between 2004 and 2007. Regional authorities, for their part, continue to intervene, sometimes quite heavy-handedly, in local banking sectors, suppressing competition and impeding entry to local markets by 'alien' banks. This problem, too, remains to be tackled. Regional authorities often use budgetary accounts as a form of patronage in managing their local banking sectors; the requirement that all sub-national budgets be executed via the federal treasury may therefore help to reduce the opportunities for regional executives to pursue discriminatory policies towards banks in their domains.

The fate of the retail giant Sberbank, which is still controlled by the CBR, remains unclear. Surrendering control over Sberbank would be difficult, as it is a useful policy instrument for the authorities. Moreover, Sberbank is the one Russian bank of truly systemic importance and, in the view of many, the bank that enjoys the greatest degree of public trust. For these reasons, the government and the CBR should undoubtedly proceed cautiously in considering any major changes to its status. It would be imprudent to advocate its rapid break-up and/or privatisation. However, its present status is undoubtedly problematic from the point of view of banking sector development and contributes to poorer performance on the part of Sberbank as a bank. The savings monopolist continues to exhibit many of the inefficiencies and weaknesses commonly associated with state-owned companies that enjoy substantial monopoly power.⁷¹ The current strategy is to allow Sberbank's monopoly to be eroded by the growth of other banks, which will benefit from the introduction of DI and other steps to level the competitive playing field. This is not by any means the worst option available, as Sberbank's gradually but steadily declining market share attests. It will, however, take a considerable time. Moreover, Sberbank and other state-owned banks will probably continue to enjoy a significant competitive advantage in the form of a lower cost of capital, because of the perception that the state stands behind them.

Over the longer term, the authorities will probably want to consider a substantial restructuring of Sberbank, to be followed by its privatisation. One option would be to break it up into several banks – with overlapping markets, so as to foster competition – and then to privatise the successors. In the interim, however, the more urgent priority must be to reduce the distortions caused by Sberbank's current position in the sector and to facilitate the growth and consolidation of private banks capable of competing with it. These might include steps to simplify mergers and acquisitions, and also to facilitate easier branching, as well as the rigorous application of prudential norms to state-owned banks. Above all, the authorities should consider changes to their governance structure that would make possible a credible commitment by the government and the CBR neither to extend special privileges to them nor to intervene in their commercial affairs.

postponing the date by which this had to be done, and in March 1998 it won approval of yet another law, which secured its stakes in these banks for an indefinite period.

71. Sberbank's presentation of its 2003 RAS results provides eloquent testimony to these weaknesses: staff costs rose by 25 per cent in 2003, while interest income actually fell, despite rapid growth of the loan book. The bank's small increase in net profit overall was entirely the result of trading gains, without which the bank would have recorded a net loss for the year. See the report on the bank's own web site (<http://www.sbrf.ru/ruswin/press.htm#040406>). See also Hainsworth and Keeley (2004a).

Conclusion

Overall, the design of Russia's reform strategy reflects an awareness of the need for a 'good fit' between its major elements, and the main lines of the reform address some of the principal problems of the sector. It reflects an understanding of both 'international best practice' and the peculiarities of Russia's institutional environment. The emphasis current policies place on transparency is especially welcome, as greater openness will facilitate greater monitoring of banks by private-sector agents. The major lacuna in the strategy concerns the future of state-owned banks. Despite a long-standing official commitment to reducing the role of the state – and of the CBR in particular – in the ownership of credit institutions, there is still a need for a much more clearly defined policy in this area.

The real test of Russian banking reform efforts, however, will be in implementation. The reforms challenge numerous vested interests and their successful realisation will require considerable political will as well as the development of regulatory capacities of a very high order. In this connection, it must be observed that the authorities' handling of turbulence in the banking sector during May-July 2004 has left many observers in doubt about their ability and willingness to press ahead with difficult reforms. The CBR was slow to react to the crisis as it developed, and when it finally did take action, some of its decisions were difficult to reconcile with its stated policies. The extension of a loan to state-owned VTB, enabling it to buy a threatened but still viable Gута-Bank, stands out as a particularly troubling precedent, as did the apparent attempt to use Sberbank as a lender of last resort on the inter-bank market. However, of greatest concern were the mixed signals emerging from the Kremlin and the government, which suggested that key executive branch institutions viewed the sector's problems rather differently and raised questions about whether the CBR really could count on the political and administrative support needed to press ahead with reform.

ANNEX 1. RUSSIA'S DEPOSIT INSURANCE LAW

Legislation on the establishment of a system of deposit insurance was finally adopted in December 2003, more than a decade after the first proposals were introduced into parliament. The system is intended to strengthen banking sector stability, to protect retail savers, to enhance competition and to foster financial deepening by mobilising the large volume of unbanked savings held by Russian households (so-called 'mattress money') for intermediation by the financial system. Its transitional provisions establish a screening mechanism for banks entering the new deposit insurance scheme that will enable the authorities to use the creation of deposit insurance arrangements as an opportunity to tighten prudential supervision. This appendix provides a short overview of the main elements of the legislation and an assessment of its likely impact, drawing where possible on the growing body of research into deposit insurance schemes elsewhere.

Legislative framework

The legislative basis for the new deposit insurance (DI) system consists of six pieces of legislation approved by the Federal Assembly in the autumn of 2003 and signed into law on 23 December of that year:

- Federal Law No. 177-FZ 'On insuring the deposits of physical persons in the banks of the Russian Federation' sets out the basic arrangements for establishing, financing and administering the system of deposit insurance. Unless indicated otherwise, all references to 'the law' or to specific articles in the discussion that follows are to this law.
- Federal Law No. 178-FZ 'On the introduction of amendments to articles 251 and 291 of the Tax Code of the Russian Federation' ensures that the new Deposit Insurance Agency created to administer the new system will not pay taxes on insurance premia and that banks' insurance premia are classified as costs for tax purposes.
- Federal Law No. 179-FZ 'On the introduction of changes to article 26 of the federal law "On non-commercial organisations"' adds deposit insurance premia to the list of income sources allowed to non-commercial organisations, since the Deposit Insurance Agency will be formed as such.
- Federal Law No. 180-FZ 'On the introduction of changes to article 69 of the federal law "On the Central Bank of the Russian Federation (Bank of Russia)"' deprives the Central Bank of Russia (CBR) of the power to define the arrangements for deposit insurance, as these are now set out in statute.
- Federal Law No. 181-FZ 'On the introduction of changes and amendments to the federal law "On banks and banking"' introduces a dozen minor amendments to the basic banking law in order to ensure its conformity with the new DI law; most of these consist merely of confirming the legal authority of the Deposit Insurance Agency.
- Federal Law No. 182-FZ 'On the introduction of changes and amendments to the Civil Code of the Russian Federation' introduces two changes to the Civil Code, both with the effect of

ensuring that the code's provisions are consistent with the new DI law. The more important of these amendments removes the state's subsidiary liability for the retail deposits of banks in which the Russian Federation or subjects of the federation hold majority stakes (*i.e.* it ends the 100 per cent state guarantee hitherto enjoyed by such banks under Civil Code art. 840.1).

Coverage

The extent of coverage provided under the new system is to be very limited. The law explicitly states that only the deposits of physical persons will be covered: no coverage whatsoever will be extended to corporate or interbank deposits (art. 2). Also excluded will be bearer bonds, deposits opened by physical persons in connection with their business activities,⁷² deposits placed in trustee management,⁷³ and deposits paying exceptionally high rates of interest (art. 5.2).⁷⁴ Deposits held in the foreign branches of Russian banks will not be insured either. Coverage of insured deposits extends only to the first Rb100,000 (art. 11). Although it would reportedly cover around 85 per cent of all retail deposits,⁷⁵ this is a relatively modest sum, even by Russian standards, being not much more than the level of GDP *per capita* for 2003. Since the law does not provide for any indexation of this limit, inflation will probably erode it further, even as incomes and output continue to rise. The ratio of the insured maximum to *per capita* GDP is thus likely to fall fairly rapidly. By contrast, the US DI scheme covers deposits up to a limit of USD 100,000, almost three times *per capita* GDP, while coverage limits in EU member states range from €20,000 to €103,000, with Italy being the most generous.⁷⁶ In some developing countries, the maximum payout envisaged is 13-15 times annual *per capita* GDP.⁷⁷

The relatively ungenerous nature of the scheme as it is planned should go a long way to mitigating any concerns about moral hazard. Coverage is largely confined to those of a bank's creditors who have the least incentive and the least ability to monitor its activities effectively—small, private depositors. Even many private depositors will still stand to lose in the event of a bank failure, and the incentives facing other creditors will remain unchanged. In the event of liquidation, the demands of a bank's other creditors are met only after those of its retail depositors, so their claims are *de facto* subordinate to those of retail savers.⁷⁸ Moreover, any increase in moral hazard that might result from the introduction of a system of explicit DI is likely to be offset by the reduction in moral hazard that should result from the eventual scrapping of the state guarantees covering deposits in state-owned banks (see below). Finally, given that the authorities are likely to come under political pressure to bail out depositors in the event of a crisis, explicit DI may help the state to *limit* its liability by stipulating *ex ante* what will be insured and what will not.

It is an article of faith for many Russian observers that the lack of DI has been an impediment to drawing mattress money into the banking system. However, there is no solid empirical evidence to support

72. This refers to an established legal category – ‘individuals engaged in entrepreneurial activity without the formation of a legal person’ (PBOYuL). Deposits opened and operated by such individuals for business purposes are not covered.

73. This is to prevent corporates from insuring corporate deposits opened in the name of their employees or affiliated persons and then transferred back to the trustee management of the company.

74. Specifically defined as rates that are more than one-and-a-half times the CBR's refinancing rate.

75. Hainsworth (2004a).

76. Fantini (2003:6).

77. Kane and Demirgüç-Kunt (2001:7)

78. Russia has thus, more or less accidentally, acted on a suggestion made by Kane (2000:30) with a view to interpolating a thick layer of subordinated debt between retail savers and shareholders.

this belief. Indeed, the fact that the populace has chosen to keep cash at home despite the explicit state guarantees extended to state-owned banks suggests that something other than the fear of bank failures is at work.⁷⁹ This, taken together with the restricted nature of the coverage envisaged by the scheme, means that the direct impact of the introduction of DI on households' propensity to place unbanked savings into the financial system will be limited. This need not matter a great deal, given that ordinary Russians' inclination to bank their savings appears to be growing anyway. Where DI may well have more impact is in enabling private banks to compete for Sberbank's relatively cautious clientele. Given the growing importance of retail savings as a source of funding for Russian banks, this is a desirable end in itself. Over time, moreover, greater competition might contribute indirectly to the deepening of the deposit base. If, as the authorities hope, competition leads to the appearance of new products and better service on the retail banking market, it may well lead to faster growth of the deposit base.

Financing

The financing arrangements for the system are set out in articles 33-42. The law provides for both *ex ante* funding and, if necessary, further *ex post* state support for the insurance fund. The DI system began with Rb3bn paid in by the Agency for the Restructuring of Credit Organisations (art. 50.1), two-thirds of which will form the basis for the fund and one-third of which will serve to finance the new Deposit Insurance Agency that will administer the scheme (arts 14-25). In addition to this contribution, participating banks will themselves pay each quarter a premium of no more than 0.15 per cent of the average value of their insured deposits in the preceding quarter (art. 36.4). This maximum rate will fall to 0.05 per cent once the fund has accumulated the equivalent of 5 per cent of the insured deposit base (art. 36.6). In specified circumstances, however, it could be raised to 0.3 per cent for up to 18 months (art. 36.5). There is not, however, any actual cap set on the size of the fund, such as exists in some systems.⁸⁰

The actual premia will be set by the Agency's board of directors (art. 36.7). The rate applied will be the same for all banks and will not be risk-weighted (art. 35.1). The fund may also draw income from penalties charged for late payment of premia, from the investment of the fund's assets – the range of permitted investment instruments is specified in article 38.3 – and from other sources not prohibited by law (art. 34.7). Finally, if the fund is unable to meet its obligations, the Agency may apply to the government for budgetary support. The government may make funds available from its cash reserves (art. 40.2) or in the form of zero-interest budgetary loans to the Agency (art. 41.2). If the Agency's expected deficit is to exceed Rb1bn, it may apply for direct budgetary support, in which case the government may have to submit amendments to the federal budget to the State Duma in order to authorise such support for the fund (art. 41.3).

The proposed Russian premia are far higher than those levied in the United States and Western Europe.⁸¹ However, this does not necessarily mean that the Russian premia are too high: Russian banks are indeed riskier than their western counterparts. Moreover, there is reason to believe that some western systems significantly under-price risk, as the FDIC has acknowledged with respect to the US system.⁸²

79. At the very least, one must consider the possibility that tax rather than the lack of DI constitutes the major deterrent to banking one's savings. Lack of faith in the rouble could also be a factor, though this is diminishing. There is widespread public awareness that the currency is strengthening and, in any case, it is not difficult to open forex deposits at Sberbank.

80. Fantini (2003:6) points out that the US DI fund is capped at 1.25 per cent of deposits, which is far lower than the level at which the Russian legislation would cap the premia. If the US fund exceeds this level, the FDIC must lower premia regardless of actual risk.

81. Fantini (2003:6).

82. Fantini (2003:6), drawing on data from FDIC (2001).

Moreover, despite these relatively high premia, there is a good chance that budgetary support will be needed. The basic premia would allow the fund to accumulate a sum equal to well under 3 per cent of the value of the insured deposits over a five-year period, assuming, as is likely, that the volume of insured deposits continued to grow fairly rapidly.⁸³ This might not be sufficient to handle one major bank failure without external support. It would not, of course, be sufficient to handle a serious crisis in the sector, but this need not be seen as a problem. Systemic crises everywhere tend to require state intervention. DI schemes are not established to cope with them, nor should they be: it would be both difficult to accumulate sufficient funds to cope with a large-scale crisis and economically undesirable to tie up such large funds for long periods of time when they might be more profitably invested elsewhere. Major banking crises virtually always require more extensive state intervention.

The financing arrangements set out above raise a number of questions. Some comparative research suggests that *ex ante* funding is time-inconsistent and may therefore induce *more* risk-taking: once premia have been paid, banks have no incentive to reduce their risk exposure and may even choose to increase it in order to justify the cost of insurance. Moreover, premia paid into the fund *ex ante* are sunk costs and thus provide banks with little incentive to monitor their peers.⁸⁴ There is also some evidence to suggest that state funding intensifies the problem of moral hazard, which is mitigated if funds are provided by participating banks.⁸⁵ This is especially the case if the scheme is funded *ex post*. *Ex post* funding by participating banks gives the banks an added incentive to monitor one another, as they may be required to contribute if and when the fund falls below a given threshold as a result of pay-outs to depositors. Participants know that they could in future be liable for each other's errors. A further problem with *ex ante* funding is that it may encourage other bank creditors to expect a bailout. If depositors are covered by the fund, it may be harder for the government to say no to other claimants than it would be if the state were already scrambling to cover small depositors' demands.⁸⁶

In practice, however, the arrangements set out in the DI law might well be better suited to Russian conditions. The credibility of the scheme, at least in its infancy, is likely to require both *ex ante* funding and some subsidiary state support. Depositors are less likely to have much confidence in a scheme that is to be funded *ex post*. There would, indeed, be some basis for their doubts, since the lack of a pool of accumulated liquid reserves in an unfunded system could prevent the authorities from dealing with insolvent institutions quickly. Moreover, in Russia's still relatively weak contracting environment, a commitment by the authorities to collect *ex post* from participating banks would lack credibility, especially given the likelihood that they would be pressed to collect from the banks at a time of financial stress. This does, however, mean that incentives for peer monitoring will be somewhat weaker than otherwise.

Administration

The DI system is to be administered by a new Deposit Insurance Agency, which is to be created using funds transferred from the Agency for Restructuring Credit Organisations (ARKO), the state body created

83. The (understandably) conservative range of instruments in which the fund may invest means that investment income is unlikely to do much to close the gap between actual resources and potential liabilities.

84. See Demirgüç-Kunt and Detragiache (2000); and Barth *et al.* (2002). Cull *et al.* (2000) go further, arguing that this effect may be stronger if premia are high or if they are risk-weighted, although Demirgüç-Kunt and Detragiache think risk-weighted premia may *reduce* incentives to risk-taking by making it more expensive.

85. Demirgüç-Kunt and Detragiache (2000).

86. While *ex ante* systems predominate, three European countries have *ex post* systems and six more operate mixed systems; see Fantini (2003:6).

to deal with the aftermath of the 1998 financial collapse. The Deposit Insurance Agency is to be a state corporation, independent of, but working closely with, the CBR. Its board of directors will consist entirely of representatives of the government and the CBR, along with the general director of the agency itself. The CBR will nevertheless play a crucial role in the administration of the scheme, as banks will be allowed to join it only with CBR approval and will be expelled if the CBR removes their licences to take retail deposits. Banks will not be obliged to join the system, but they will, at the end of the planned transition period, lose the right to work with retail clients if they do not secure admission to the scheme (arts 6, 46-47).⁸⁷ This will not only bar them from accepting household deposits, it will effectively exclude them from a range of other potentially lucrative lines of business, such as handling company payrolls. Requiring all banks taking retail deposits to join the scheme should contribute to stability by increasing the size of the insurance pool and preventing low-risk banks from opting out.

Compulsory membership will be combined with screening, for banks wishing to enter the scheme will have to undergo an intense examination by the CBR before being admitted. The law requires the CBR to examine every bank wishing to join the system in order to assess its fitness with respect to the quality and sufficiency of both capital and assets, management quality (including such issues as ownership transparency, risk management and internal control), profitability and liquidity. Banks who fail to win CBR approval have one month in which to address the central bank's concerns and apply for a second inspection. If they fail the second inspection, or fail to apply for a second inspection, then they will be excluded from the system and thus barred from the retail market. The CBR sees the law as a major opportunity to tighten up its prudential supervision of banks and is determined to make the most of it.⁸⁸ Since most banks will want to retain the right to work with retail clients, this screening process will effectively give the CBR a chance to re-licence most of the banking sector, to higher standards than before.

The implementation of this ambitious screening process will be a tremendous challenge for the CBR, not least because of the very demanding time-scales set out in the legislation (art. 45). The law entered into force on 27 December 2003 (the date of its official publication in *Rossiiskaya gazeta*). The deadline for banks to apply for admission to the scheme expires on 27 June 2004. The CBR in turn must complete its four-stage examination of each bank-applicant within nine months of its application. In short, the CBR will need to conduct intensive reviews of the vast majority of banks in the sector (probably over 1,000) by 27 March 2005 at the latest. Banks rejected at first application and applying for a second review must apply by 27 April 2005, and the CBR is required to act on all repeat applications by 27 September 2005. Banks rejected a second time have one month in which to appeal to the CBR's Committee for Banking Supervision, which must decide such cases within one month of the appeal.⁸⁹ This process will not only stretch the supervisory resources of the CBR, it will also test its ability and willingness to enforce much more rigorous standards in the sector.

The financial turbulence of May–July 2004 has already resulted in an important modification to the arrangements governing deposit insurance during the transition to the new system. Under legislation adopted during July 2004, retail depositors with claims against failed institutions outside the deposit

87. Some critics, including the Association of Russian Banks, object to the requirement that banks dealing with retail clients join the scheme, arguing that this violates the rights of both the banks and depositors. There may be some attempt to challenge this provision on the basis of Civil Code art. 840, which treats deposit insurance as only one of the possible means of ensuring the protection of citizens' deposits.

88. This would appear to have been one of the reasons for the long delay in passing the law. Many banks would not welcome such scrutiny, which might reveal the extent to which they 'window-dress' their financial reporting and could lead to their exclusion from the retail market.

89. Banks that fail to meet the deadlines for application or re-application will not be eligible to enter the system (art. 46). The law is silent with respect to any consequences that may ensue should the CBR fail to meet the deadlines set.

insurance system will be covered for sums of up to Rb100,000. This coverage is subject to the same restrictions as those set out in the basic DI law: the new law excludes such things as bearer bonds, claims transferred to third parties and accounts in Russian banks abroad.⁹⁰ Adoption of this law undoubtedly increases moral hazard in the sector, but this must be weighed against the urgent need to reassure nervous depositors and the temporary nature of the measure. The law will only operate until the transition to DI is complete, since banks not admitted to the system will be forbidden from holding retail deposits.

The status of Sberbank

One of the explicit aims of the DI legislation is to level the competitive playing field between the state-owned savings monopolist Sberbank and its privately owned rivals. The treatment of Sberbank in the transitional provisions of the DI law was therefore a matter of considerable controversy. Sberbank accounted for 64.9 per cent of all retail deposits as of 1 September 2003. While this share is falling steadily by 4-5 percentage points per year, Sberbank's dominance of the retail market means that, if it entered the new DI system immediately, it would provide almost two-thirds of the funding and would effectively be underwriting insurance for its commercial rivals. When the DI law was under discussion, Sberbank executives insisted that their institution should remain outside the new system for some considerable period. The compromise eventually enshrined in art. 49 of the DI law is as follows:

- The state guarantee extended to all Sberbank deposits under the law 'On banks and banking' will remain in force until 1 January 2007. (This guarantee is separate from that extended to other state banks under Civil Code art. 840.1 and is not affected by the amendment to that article discussed above.) However, the DI system will still pay out in the event of difficulties at Sberbank, with the state covering all pay-outs in excess of those stipulated by the DI law.
- Sberbank will pay into the system from its foundation, but Sberbank's DI premia will be maintained in a separate account until its share of household deposits falls below 50 per cent or until 1 January 2007, whichever comes first.⁹¹
- The funds accumulated in this separate Sberbank DI fund may only be used for pay-outs on Sberbank deposits until such time as Sberbank's DI fund is merged with the rest of the fund.

As noted above, the authorities have already begun to modify this position. Government-backed amendments adopted by the Federal Assembly will, when signed into law, restrict the unlimited state guarantee on Sberbank deposits to those opened before 1 October 2004. The guarantee on deposits opened or modified on or after that date will be capped at Rb100,000. This should help to level the competitive playing field in the retail market somewhat sooner than otherwise.

90. For details, see 'O vyplatakh' (2004).

91. To be precise, the provision lapses either on 1 January 2007 or on the first day of the next calendar quarter after the release of CBR data showing that Sberbank's retail market share is below 50 per cent.

ANNEX 2. THE NEW BANK SUPERVISION FRAMEWORK

Central Bank of Russia (CBR) Instruction No. 110, issued in January 2004, replaces the long-standing and much-revised Instruction No. 1 ‘On banks’ mandatory norms’, hitherto the framework regulation for the CBR’s banking supervision efforts.⁹² The new instruction will have a profound effect on the shape of Russian banking regulation. Of particular importance are the new compliance requirements and the new provisions concerning the treatment of syndicated loans. In drafting the new instruction, the CBR sought a balance between radical innovations and evolution from existing arrangements, which enhances the prospects for its effective implementation. Nevertheless, the new instruction fails to address certain regulatory gaps in the risk profile of commercial banks. This annex sets out the most important changes introduced by the new instruction and assesses their likely impact on the development of the Russian banking sector.⁹³

Compliance definitions and reporting regularity

Perhaps the most important innovation contained in the regulation is the requirement for prudential ratios to be available for inspection for every day of a bank’s operation. This single addition to the regulatory regime will have profound implications for banking in Russia. The CBR has hitherto applied the prudential ratio instructions in a very formalistic manner. The ratio value was calculated on the reporting date (the first of each month), and if the bank was not in compliance, the bank could be fined.⁹⁴ Given the relative sizes of Russian banks and their clients, a bank could be at risk of non-compliance if a large client made a sudden deposit or withdrawal on the last day of the period, even if it had otherwise been in compliance during the entire reporting period. This focus on form over substance encouraged banks to manipulate their end-of-period balance sheet accounts to ensure compliance. Liquidity norms, for example, were often met via the creation of ‘triangles’ of NOSTRO accounts. Balances held in NOSTRO accounts are deemed to be highly liquid. Accounts with any single counterparty are netted for purposes of calculating the prudential ratio, but back-to-back schemes involving at least three banks could enable banks with low liquidity to acquire larger NOSTRO balances. Over time, some banks began to window-dress more aggressively. The Investment Banking Corporation, for example, was able to maintain the appearance of normality (as reflected in the ratios it filed) until just before it failed in 2002 – indeed, it had received a corporate governance rating from a western rating agency and had been audited for two years by a major western accounting firm.

Under the new instruction, all mandatory ratios must be in compliance at all times. It is expected that, in due course, all banks will move to IT systems that can provide information on the values of their ratios in real time. In the interim, the CBR will allow banks to present ratios for particular days with a lag. Large banks with expansive branch networks will be give a few days’ lag, while small single-branch banks will be expected to have almost real-time reporting. Although banks will be expected to know their ratios at all times, they will not be required to report more frequently than at present. To deal with the problem of

92. ‘Ob obyazatel’nykh normativakh’ (2004).

93. The new instruction runs to over 16,000 words in the original. In focusing on its most important elements, this annex omits a great deal of technical detail, particularly in discussions of individual prudential ratios.

94. Fines were levied according to a formula. On occasion, the CBR might insist on payment of sums as small as Rb0.04.

temporary fluctuations, the CBR has defined non-compliance as violation of prudential ratios for a period in excess of five working days in any 30-day period. This is reasonable, since any bank in good financial condition will be able to regulate temporary blips within a week.

The new instruction aims to eliminate the motivation for much window-dressing and also to make window-dressing harder (some of the most common techniques, involving end-of-month transfers between 'friendly' banks, will no longer work). The level of window-dressing will fall, at least for more transparent and business-minded banks. This is a significant benefit. Window-dressing distorted the overall financial statements of the entire banking sector. Many banks will become easier for outsiders to understand, and the consolidated figures for the sector will begin to reflect reality more closely. While the necessity to monitor all prudential ratios on a close-to-real time basis will require enhancements to IT infrastructure, the improvements will also increase the safety and manageability of the banks.

Syndicated loans

Russia ought to be an ideal market for syndicated lending. Its banks are small but many of its major industrial companies are rather large. In many cases, these companies have established relationships with banks which they trust but which are unable, on their own, to meet the borrowing needs of such large corporates. Yet local syndicated loans remain extremely unusual. In part, this seems to reflect a lack of trust among banks, who are often reluctant to share information about their clients, but it also reflects the need to make it easier to structure syndicated loans in a manner that does not impose very high transaction costs. This would be especially helpful for Russia's regional banks. Regional banks with large corporate clients would serve as syndication arrangers for their clients, allowing out-of-region banks to share in the risks, thus providing geographical diversification. Until now, the arranging bank had to treat the whole of the loan as being on its balance sheet for the purposes of the prudential ratios.⁹⁵

Three types of syndication are defined in the new instruction:

- *Collectively identified syndicated loans.* Here, the syndicate, the borrower, the arranging bank and the conditions are known in advance.
- *Individually identified syndicated loans.* This provides for the case where a single bank has already extended a loan and then sells down the exposure to other banks.
- *Syndicated loans without defined participants.* This is a somewhat puzzling category. The instruction defines the criteria for recognising a credit as a syndicated loan (no defined syndication sharing), but then assigns the entire loan a risk weight of 100 per cent for the arranger.

For the first two types of syndication, the portion of the loan covered by other members of the syndicate is zero-rated for the arranger. Only that portion on which the arranger has credit risk is included in its risk ratios.

Unless some other obstacle appears, syndicated lending and the trading of banking risk should increase under the new instruction. Since one of the primary functions of a banking system is to trade and diversify risk, this should enhance the efficiency and scale of financial intermediation in Russia. The second form of syndicated loan is likely to emerge rapidly in practice. The Russian subsidiaries of foreign banks have international experience of selling down risk on large loans to each other in order to increase

95. The CBR did, however, allow syndicated loans to be classified as lower in risk for capital adequacy purposes.

diversification and maintain their internal client limits. Since large existing loans could already be sold down and the international banks already understand each other, such activities could begin immediately the instruction enters into force. The development of a syndicated loan market, however, will take longer. One impediment will be the lack of trust of the regional banks towards the Moscow banks. Regional banks fear that Moscow banks will use syndication to establish contact with promising borrowers to whom they can then lend directly on better terms.

Risk weights

Following the scheme set out in the original Basle Capital Adequacy Accord, the CBR has five categories of risk weights:

- Zero-risk: risk weight 0 per cent. This will apply mainly to accounts held at the CBR and government debt of 'developed countries'. Physical cash is to be weighted at 2 per cent.
- Low: risk weight 10 per cent. This will apply to Russian Federation state debt and the government debt of countries not in the 'developed' group.
- Medium: risk weight 20 per cent. This will be the market risk proxy.
- Moderate: risk weight 50 per cent. This will apply to funds placed in banks not in 'developed' jurisdictions.
- High: risk weight 100 per cent.

The original Basle Accord introduced the Risk-Weighted Capital Adequacy measure. However, the CBR has extended the concept of risk-weights to all other ratios that include assets in the denominator. This extension was included in earlier revisions to Instruction No. 1, and so is not really an innovation, although there have been changes to some of the weight categories. A major difference between the CBR weights and the Basle Accord definitions concerns mortgage lending. Under Basle, mortgages are 50 per cent weighted, while the CBR weight is 100 per cent. This reflects the risk that the Russian Civil Code still poses to mortgage lenders – certain categories of dwellers cannot easily be evicted in the event of default. Since prudential ratios will be calculated daily and risk weights are used in several ratios, commercial banks will probably begin to examine the detail of the risk weights to improve their ratios. The result will be to favour certain types of transaction over others. The CBR will need to monitor closely the changes in transaction patterns resulting from the new weights, lest they lead to the emergence of new, unanticipated risks.

Contingent and derivative instruments

Off-balance-sheet items were not systematically included in the ratios in Instruction No. 1. Instruction No. 110 provides methodologies for calculating the credit risk for: contingent liabilities with a credit character and derivatives. This is meant to curtail banks' tendency to manipulate their prudential ratios by re-formulating loan exposures in other ways. For example, a loan might be moved to a friendly bank together with a guarantee. Previously, the guarantee removed the risk from the target bank, but was off-balance sheet for the originating bank and so not covered by prudential ratios.

A crucial factor in the 1998 financial collapse was the use and abuse of derivative instruments. A Russian court has held that derivative contracts should be treated under the conditions provided by the Civil Code for wagers and were therefore not enforceable by the courts. Although legal issues hindering

derivatives trading within Russia remain unresolved, the inclusion of derivatives in the instruction indicates a belief that the expansion of derivative trading, which is still very limited, is not far off.⁹⁶

Prudential ratios

The number of mandatory prudential ratios has been reduced from eighteen to ten (see Table A2.1). Two justifications could be given: reducing the burden of reporting and simplifying the regulatory framework. Reducing the regulatory burden on banks is essential. However, this burden cannot simply be measured by the number of ratios. In the current IT environment, reporting costs come from human intervention, not the number of ratios generated from the same underlying data set. The regulatory burden could thus be decreased without cost to the disclosure levels. Moreover, the CBR has increased the regulatory burden in at least one respect, by requiring daily compliance with the ratios. However, the benefits to individual banks and to the system of this change are clear. Simplification of the regulatory framework will enhance the ability of CBR supervisors to focus on the real risks in a bank. The majority of difficulties will be evident on examination of a relatively small number of ratios. Nevertheless, an overly minimalist approach has its dangers. It is critical that both banks and regulators look beyond the mere fulfilment of mandatory thresholds.

Requiring disclosure of ratios has two effects. First, it forces banks to introduce the information technology needed to generate the necessary data, data that the banks should use to enhance their own safety and operations. Secondly, it provides analytical information to external analysts that cannot be generated from an examination of publicly disclosed financial statements. The new arrangements may well involve some losses in respect of this second concern. The reduction in the number of ratios subject to mandatory reporting requirements will reduce the level of transparency in the banking sector, although other elements of the CBR's reform agenda will enhance it.

The mandatory ratios that remain under the new instruction will provide information about capital adequacy, liquidity, asset concentration, and undue influence by owners and insiders. However, the new set of ratios does not cover certain key issues. These include:

- *Quality of capital.* Banks in difficult economic circumstances often accumulate large volumes of relatively illiquid assets, such as corporate equity and fixed assets. Under such circumstances, the bank may appear to have a good capital base, but its real ability to absorb losses is severely constrained. One solution might be to require banks to calculate a 'free capital adequacy ratio', where both the denominator and the numerator were reduced by the volume of illiquid assets.
- *Dynamic liquidity risks.* The liquidity ratios in Instruction No. 110 take a balance-sheet approach, based on ratios between different categories of asset and liability. However, liquidity can have three sources: liquidating liquid assets, increasing liabilities, and managing revenues and expenses. Liquidity can be sustained by ensuring that assets and liabilities generate cash flows in a balanced manner for each time period. The presence of any 'lumpiness' in the cash-flow can be assessed by a gap analysis. Assets and liabilities in appropriate time periods are netted. A number of methods can be used to reduce this dynamic profile to a single ratio, such as applying a time discount factor.
- *Liability concentrations.* Concentrations are a source of risk wherever they exist. The asset-side concentration risk is covered in the ratio limiting exposure to a single borrower.

96. There are at present exchange-traded derivative products and some over-the-counter derivatives, but volumes are very small. In addition, some rouble forwards are traded on the Chicago Market.

However, Russian banks are equally at risk from major depositors. A similar balance-sheet ratio (*i.e.* total exposure to depositors providing funds in excess of 5 per cent of capital) would provide information about the level of risk.

Table A2.1. Summary of prudential ratios

No	Name	Numerator	Denominator	Threshold
N1	Capital adequacy	Capital, according to new CBR regulation	Risk weighted [RW] assets (net of reserves), credit risk on contingent and derivative instruments, market risk measure, related party lending with risk weight 130%	> 11% if capital < €5mn > 10% if capital ≥ €5mn
N2	Instant liquidity	Assets realisable within a calendar day	Call (demand) liabilities	> 15%
N3	Current liquidity	30-day assets	30-day liabilities	> 50%
N4	Long-term liquidity	Assets with residual tenors > 365 days	Capital + Liabilities with residual maturities > 365 days	> 120%
N5	General liquidity	30-days assets	Total assets (net of accrued items) less reserves	> 20%
N6	Single exposure	RW credit exposure to one borrower (group of borrowers)	Capital	< 25%
N7	Large exposure	RW credit exposure to all borrowers (related groups) whose individual exposures exceed 5% capital	Capital	< 800%
N9.1	Owner exposure	RW exposure to entities with > 5% equity	Capital	< 50%
N10.1	Insider exposure	RW exposure to insiders (individuals with significant influence on bank decisions)	Capital	< 3%
N12	Equity held in other corporates	Sum of equity portfolio	Capital	≤ 25%

Conclusion

Instruction No. 110 represents a significant improvement in the regulatory regime for Russian banks. The innovations related to syndicated loans and compliance will profoundly affect the structure of banking. Nevertheless, contractions in the number of prudential ratios that must be reported may lead to reductions in disclosure and an inability for market observers to detect risk in commercial banks.

ANNEX 3. THE TRANSITION TO INTERNATIONAL ACCOUNTING STANDARDS

The full transition to International Financial Reporting Standards (IFRS) will, of necessity, be a lengthy and gradual process for both the financial and real sectors. The authorities expect the transition to be completed no sooner than 2008.⁹⁷ Abrupt change might actually reduce transparency, by making it all but impossible to compare current and historical data. In any case, the transition will require the adoption or amendment of several laws. There is still no law on consolidated accounting, although the government has agreed on a draft bill for consideration by the Federal Assembly. In addition, the accounting transition will require amendments to the laws on accounting, on the central bank, on banks and banking and on joint-stock companies. A good deal of secondary legislation, including numerous instructions and definitions, will have to be formulated and published. The pace and smoothness of the transition will therefore depend largely on the authorities' effectiveness in issuing the appropriate instructions, defining which standards will be mandatory, and specifying the interaction of tax and management accounts.

Re-training accountants will also be critical: there are still far too few accountants who understand international rules, especially outside Moscow and St Petersburg.⁹⁸ Russian accounting firms in early 2004 expressed concern at the CBR's recommendation that commercial banks choose audit firms with at least four specialists with internationally recognised qualifications for dealing with international accounting standards. The Russian profession feared that this would hand virtually all banking-audit business to a few large foreign firms.⁹⁹ It is important to stress that the retraining of Russian accountants involves preparing them to play a new role, not merely teaching them a new set of rules. This is because the RAS-IFRS transition involves, among other things, a shift from a rules-based system to a principles-based approach. Under Russian Accounting Standards (RAS), the question ever before the accountant is which rule he must apply in any given situation; under IFRS, the accountant's own judgement is important.

There is good reason to welcome the financial reporting shift, which has been delayed repeatedly since the late 1990s. RAS are particularly problematic with respect to banking. The main problem is that RAS accounts tend (like traditional Russian bank regulation) to emphasise form over substance. Thus, for example, a bank might transfer funds to an enterprise, on condition that the latter repay at a certain time with interest. The treatment of this transaction might be entirely different under the two sets of rules:

- If this standard transaction were formalised by a loan contract, RAS would treat it as a loan and a loan-loss provision would be established. If, however, the enterprise merely sold a promissory note to the bank, this would be treated as a security purchase under RAS rules. The loss provisions and disclosure regulations that applied would be different, although the economic significance of the two transactions would be identical.
- Under IFRS, the substance of the transaction would determine the issue and the transaction would probably be treated as a loan, irrespective of the documentation. It might be treated as

97. This is the date suggested by Economic Development and Trade Minister German Gref; Interfax, 5 February 2004.

98. See the discussion in McGee and Preobragenskaya (2004:1-2, 17-21).

99. *Kommersant*", 14 January 2004.

a security purchase under IFRS, but only if the promissory note could be traded in a liquid secondary market and the bank had purchased the note for trading purposes. Either way, the key point is that the accounting treatment should reflect the substance of the transaction.¹⁰⁰ In this respect, the move to IFRS and the new approach to prudential supervision embodied in Instruction No. 110 are mutually supportive (see Annex 2).

Other problems include difficulties in presenting consolidated accounts for complex entities and the vastly greater discretion RAS rules give regarding the marking of securities portfolios to market, loan classification and the formation of reserves.¹⁰¹ Such is the scope provided by RAS accounts for concealing losses in this way that many of the banks that failed after the 1998 financial collapse continued to show a profit on their RAS accounts, despite the fact that they could no longer service their obligations.¹⁰²

Unfortunately, the outlook for the transition to IFRS is still not entirely clear.¹⁰³

- Russia has indeed taken steps to bring RAS rules closer to IFRS but it has not adopted the full range of international standards, nor does it have immediate plans to do so.¹⁰⁴ This is not merely the result of a lack of reformist zeal: in some cases, there may be good reasons for not doing so or, at any rate, for not doing so in the near future. The question of which standards to adopt when is a complex one. However, it is also the case that the state bodies involved in the establishment of accounting standards have little interest in the wider aims that the reform is meant to achieve.¹⁰⁵
- The IFRS definitions of many concepts differ from the definitions found in the Russian Civil Code. This may create problems in interpretation of particular standards, but harmonising these definitions would require action by the Federal Assembly.
- The role of the state (chiefly the finance ministry) in defining accounting rules is likely to ensure that Russian standards continue to lag behind IFRS. The Russian standard on income tax, for example, is based on an old version of the international income tax standard. IFRS are continually changing, but Russia has no procedure for automatically implementing such changes.
- Some international standards have not been translated into Russian, and the translations that do exist are often substantially simplified and abbreviated texts.

In any case, RAS accounts will remain important, if only because they are likely to form the basis for tax accounts and to be required for other statutory purposes for some time to come. As Russian banks are quick to point out, this means that they will bear the costs of keeping RAS and IFRS accounts, as well as separate tax accounts.¹⁰⁶ In the long run, the accounting transition's major benefits may stem not from greater transparency but rather from the fact that IFRS should offer banks greater opportunities to manage

100. I am grateful to Richard Hainsworth for this illustration. See also Hainsworth (2002:14-15).

101. Matovnikov (2001); Hainsworth (2002).

102. Only 24 per cent of Russian banks officially recorded losses in 1998, despite the fact that the CBR recognised the sector as a whole to be bankrupt after the crisis. *Interfaks AiF*, 25 March 1999.

103. This paragraph draws on the analysis provided by McGee and Preobragenskaya (2004).

104. See, for example, the discussion of the standards on impairment, financial instruments or hyperinflation in McGee and Preobragenskaya (2004:9-10).

105. Gorbatova (2004).

106. Association of Russian Banks (2003).

their own finances more efficiently. IFRS accounts should give managers, particularly of larger banks, a much more accurate picture of the state of the business. IFRS also have the advantage of being more or less universally accepted, which will make interaction with foreign counterparties easier. Finally, by adopting IFRS, Russia will avoid the costs involved in trying to develop a new set of Russian standards.

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