BANKING SECTOR IN RUSSIA (1999-2008)

Dissertation submitted to Jawaharlal Nehru University in partial fulfillment of the requirements for the award of the degree of

MASTER OF PHILOSOPHY

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2009

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DECLARATION

I declare that the dissertation entitled **"BANKING SECTOR IN RUSSIA (1999-2008)"** submitted by me in partial fulfilment of the requirements for the award of the degree of **MASTER OF PHILOSOPHY** of Jawaharlal Nehru University is my own work. The dissertation has not been previously submitted for any other degree of this University or any other university.

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CERTIFICATE

We recommend that the dissertation may be placed before the examiners for evaluation.

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Dedicated to

My Grandmother, Parents and Brother

ACKNWOLEDGEMENT

First of all, I would like to thank my supervisor Dr. Tahir Asghar for his constant guidance in the course of writing the dissertation. Without his constant support, critical comments and suggestions it would have not been possible to complete the dissertation. I am also indebted to him for his timely reminding for my work, sharing his thoughts and reading materials.

I am also thankful to the Centre for Russian and Central Asian Studies, School of International Studies, JNU and all the faculty members who directly and indirectly shaped my understanding and personality, especially, Chairperson Prof. Anuradha M. Chinoy, Prof. Tulsi Ram, Prof Ajay Patnaik, Dr. Preeti Das, Dr. Arun Kumar Mohanty, Dr. Sanjay Kumar Pandey, Dr. Phool Badan, Dr. Nalini Mohapatra, Dr. Archana Upadhyaya and Dr. K.B. Usha. I am also thankful to the staff members of the centre particularly Handa, Vijay and Singhji.

My thanks are due to the staff members of JNU Central Library, Institute for Defence Studies and Analysis, New Delhi, Teen Murthy Library for providing sufficient reading material for pursuing this study.

I am indebted to my senior Abhay for his helping hand whenever I needed. My special thanks to Namita and Raj for their valuable and thought provoking suggestions.

I would also express thanks to Vimal for his timely suggestions and Lalji, Brahmhayya, Jitendra, Ramkishor, Amar, Suresh, Bhim, Mahashradha for their support. I am also thankful to all of my classmates without whom life would have been colorless.

I should be ever grateful to all my family members, particularly my father, mother and my grandmother who always stood behind me with love, affection and encouragement from the beginning. My special gratitude to my brother Sarabjeet, cousin Priyanka and Kiran for their support and encouragement.

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LIST OF ABBREVIATIONS

Agroprombank	Agro-industry bank
AKB	Aktsionerny Kommercheski Bank
AO	Aktsionernoe Obschestvo
ARKO	Agentstvo po Restrukturizatsii Kreditnikh Organizatsiy
C&S	Ceska & Sporitelna
CSOB	Ceskoslovenska Obchodni banka
GKO	Gosudarstvennaya kratkosrochnayaObligatsiya
GP	Gosudarstvennoe Predpriyatie
IANs	Interest Arrear Notes
IPB	Investicni a postovni banka
KB	Komercni banka
MFK	Mezhdanarodnaya finansovaya Kompaniya
OAO	Otkrytoe Aktsionernoe Obschestvc
OFZ	Obligatsii Federalnogo Zaima
OVVZ	Obligatsiya vnutrennogo valyutnogo Zaima
RAO	Rossiyskoye Aktsionernoe Obschestwo
RAS	Russian Accounting Standards
ROSCs	reports on Standards and Codes
RSFSR	Rossiyskaya Sovetskaya Federativnaya Sotsialisticheskaya Respublika
SBA	Stand-By- Agreement
SP	Sovmestnoe Predpriyatie
Vneshtorgbank	Foreign Trade Bank

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CHAPTER-1

INTRODUCTION

Overview

The banking sector of Russia after 1992 had to be recreated from scratch so as to satisfy the new requirements put forward by the emerging market economy.

Banks play very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking system. Although banks create no new wealth but their borrowing, lending and related activities facilitate the process of production, distribution, exchange and consumption of wealth. In this way they become very effective partners in the process of economic development. Today, modern banks are very useful for the utilization of the resources of the country. The banks are mobilizing the savings of the people for the investment purposes. The savings are encouraged and saving rate increases. If there would be no banks then a great portion of a capital of the country would remain idle.

A bank as a matter of fact is just like a heart in the economic structure and the Capital provided by it is like blood in it. As long as blood is in circulation the organs will remain sound and healthy. If the blood is not supplied to any organ then that part would become useless. So if the finance is not provided to Agriculture sector or industrial sector, these sectors will be destroyed. Loan facility provided by banks works as an incentive to the producer to increase the production. Banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. First of all, banking promotes savings. All manner of people, from the ordinary laborers and workers to the rich land owners and businessmen, can keep their money safely in banks and saving centers. Secondly, banking promotes investments. Banks easily invest the money they get in industry, agriculture and trade. They either invest it directly or advance loans to other investors. Thirdly, it is most through banks that foreign trade is carried on. Whether we export or import, it is through banks that money is transferred from one country to another. For example, bills of

exchange and letters of credit are the regular ways banks use to transfer money. Even the UN has the World Bank that is like a big deposit for all the members' countries. They can borrow from it according to their needs. But unwise borrowing and wasteful spending by countries leads to heavy debts and economic distress.

Keeping in view the above facts, this paper attempts to look at the banking sector of one of the major power of the world, i.e. Russia. The period of study is from 1999-2008. This period is of significance as it lies between two major financial crises seen by Russia. Post restructuring of Russia witnessed the financial crisis in 1998 and recent one in 2008. In the aftermath of 1998 crisis, one-fifth of Russia's banks had gone bankrupt by mid-2000. It was evident, then, that the banking sector needed a large amount of funds for its rehabilitation and to tackle the challenge of credit risks; market risks and risks of the loss of liquidity. To override the consequences of the 1998 financial crisis, the Bank of Russia took steps towards restructuring the banking system in order to improve the performance of commercial banks and increase their liquidity. As a consequence banking sector improved. In the recent period, 2008 the world has been suffering from a liquidity crisis. Russia is also suffering from crisis. So, it is of interest to see what went wrong.

Rational and Scope of the Study

With more than 1100 banking institutions, Russia provides an important base of rich test case for analyzing the responsible risk factors existing in Russian banking sector. So, it is important to analyze the reason for these risk factors and the impact that these might have on economic performance. Besides, the large number of bank failures during the last decade shows the fact that banking in Russia is still more risky than most developed countries. Therefore, examining the determinants of banking sector's risks is crucial for understanding the prospects of future economic growth of Russia. Little research has been done to see whether the behavior of Russian banking sector is congenial to other Russian sectors or institutions in case of distress.

Due to extreme fragmentation into many small banks with a few large banks in Russia, it is important to analyze the government's policy towards small and large banks separately and compare the performance of small Russian banks with that of large banks; besides, there is also need to compare the performance of foreign banks in Russia with the Russian banks. Therefore, it becomes very important to analyze the changing trend of Russia's banks as well as of foreign banks in Russia, and impact of all these banks on Russian economy.

Geographically, this study is confined to Russia. The proposed research will study various aspects of macroeconomic conditions and Russian banking sector's risk factors particularly focusing on credit risk, liquidity risk and market risk. This study will critically analyze the changing behavior of Russian banking sector and the impact of foreign and Russia's banks on non-banking sectors of Russia. Temporarily, the study covers the period from 1999 to 2008.

Objectives of the Study

- To study the structure and salient features of the Russian banking sector.
- To find out how the Russian banking sector affect the rest of the economy.
- To critically inquire the impact of risk factors of Russian banking sector i.e., Credit Risk, Liquidity Risk and Market Risk.
- To analyze Russian government economic policy towards Russian banking sector
- To explain the changing trends of Russian banks and foreign banks in Russia.

Hypotheses

- Russian banking sector has steady rapid growth due to favorable macroeconomic conditions, Growing consumer demands, consolidation of the banking structure, strengthening of legal and regulatory framework in Russian economy and stricter enforcement of the rules and regulations have created

favorable conditions that allowed the banking sector in Russia to expand and become efficient.

- The expanding Russian banking sector shows a positive correlation with growing demands of consumers and investors.
- Liquidity, market and credit risks in banking sector of Russia are the main factors responsible for destabilization of banks in Russia.

Research Methodology

Since, the proposed research focuses on the behavior of Russian banking sector and foreign banks in Russia, macroeconomic condition of Russia and risk factors i.e., credit risk, liquidity risk and market risk.

This study will be based on detailed data of Russian banking sector and foreign banks in Russia, and in this sense, this study will be mainly descriptive in nature.
Bank specific factors include credit growth, liquidity growth, and share of loans to individual and private institution in total loans, capital market growth. Macroeconomic variables are proxied by GDP growth.

This study uses a dataset which covers the banks operating in Russia over the period of 1999-2008. Data of macroeconomic growth published by the central bank of Russia are also included in this study and we will use them in the analysis to support our main results. The data are provided by the financial information agency Interfax and originate in the Central Bank of Russia (CBR). Data constitute an unbalanced panel because there were banks interesting and leaving the market due to mergers of failures. World Bank's published statistical report on Russian banks; Russian ministry of Trade and External affairs will contribute towards the set of primary data that this paper needs. There is no dearth of secondary data on Russian banking sector and articles of journals, books and newspaper will constitute the core of it.

CHAPTERISATION

The research work will be organized according to the following chapterisation:

Chapter 1: Introduction

Chapter 2: Banking System under Soviet Era

This chapter will explain the historical background of Russian banking sector since 1991. Russian banking system developments during the transition period to a market economy have been closely connected with overall economic conditions.

Chapter 3: Structure, Principal Goals and Performance of Russian Banking Sector

This chapter will study the structure of the Russian banking sector. Its aims and its performance during the period 1999-2008. This study will also explain about structural weakness, which has become visible during Russian stock market crisis in September, 2008.

Chapter 4. Risk of Russian Banking Sector Focusing on Credit Risk, Liquidity Risk and Market Risk

This chapter will critically analyze the risks especially credit risk, liquidity risk and market risk after 1998 financial crisis, what the Russian banks are facing.

Chapter 5: Conclusion:

Main findings of the whole work will constitute the concluding chapter.

CHAPTER-2

BANKING SYSTEM UNDER THE SOVIET ERA

Introduction

The banking sector is one of the important branches of the Russian economy. Prior to this 1861, the growth of private savings was limited only to a small class of urban merchants and craftsmen, since the majority of Russia's population was tied to the land and few personal freedoms.

The State Bank of the Russian Empire was founded in 1860 as Russia's entire banking system was overhauled. It was established when capitalism was gaining ground in the Russian Empire and it became the first "great reform," carried out Emperor Alexander II. The State Bank was a short-term commercial credit bank and its aim was "to boost trade turnovers and strengthen the monetary system". In 1862, there were only 140,000 deposit accounts totaling 8.5 million rubles in a country of 70 million people. After the abolition of serfdom in 1861, savings accounts became more widespread. Growth was particularly rapid in the 1880s, when the central offices at the Central Bank were supplemented by regional offices at local treasuries and telegraph stations. Savings offices opened in rural villages as well as urban centers, leading to a total of 4,000 branches and two million individual accounts in 1895. In the early 1880s the State Bank began to prepare a monetary reform, which was launched in 1895 and ended in 1898 with the introduction of gold monometallism in Russia. In the course of the reform the State Bank was granted the right to issue currency.

The banking system of the Soviet period was a rudimentary mechanism for state control of the economy. The government owned and managed the banking system. The State Bank (Go-sudarstvennyy bank--Gosbank) was the central bank and the only commercial bank. In its capacity as a central bank, Gosbank handled all significant banking transactions, including the issuance and control of currency and credit, the management of gold reserves, and the oversight of transactions among enterprises. Enterprises were issued money and credits in accordance with the government's planned allocation of

wages and its management strategy for other expenses. During the First World War gold reserves of the State Bank shrank from 1,604 million rubles as of June 16, 1914, to 1,101 million rubles as of October 8, 1917. The pre-revolutionary history of the State Bank ended on October 25 (November 7), 1917, when its Soviet history began.

In Vladimir Lenin's view, banks were an important framework for the building of a socialist society. He believed the ready-made big banks of capitalism could be converted into an effective apparatus for state control of the economy. However, banking activities ground to a halt in the chaos of the years immediately following the revolution. All commercial banks closed down in October 1917. Their staff received salaries but was instructed not to perform any banking functions in the hope that economic paralysis would bring down the Bolshevik regime. . Nevertheless, by the end of the year, the Bolsheviks had succeeded in nationalizing all commercial banks, sending armed detachments to occupy their offices in Petrograd. While business accounts were confiscated, private savings accounts were respected. Commissar of Finance V. Menzhinsky ordered the re-establishment of the Department of Savings Offices. However, his efforts to maintain the private savings system failed during the period of Revolution from 1918 to 1921. Throughout those years, farm and consumer goods were requisitioned, nearly all money was withdrawn from the economy, and the exchange of goods operated on a barter system.

When the New Economic Policy (NEP) was launched, the All-Russian Central Executive Committee (VTsIK) and the Council of People's Commissars (SNK), on October 3 and 10, 1921, respectively, passed resolutions re-establishing the bank under the name of the State Bank of the RSFSR(the Russian Soviet Federative Socialist Republic). On November 16, 1921, it began to conduct operations and in 1923 it was transformed into the State Bank of the USSR.

As the banking system was re-organised in February 1928, most short-term credit operations began to be concentrated in the State Bank. It also took control of many branches of joint-stock banks, which began to play an auxiliary role in crediting the economy. Long-term lending was conducted mainly by the Bank for the Long-Term

Crediting of Industry and Power Engineering (BDK) specially created for this purpose, the Central Utilities and Housing Bank (Tsekombank) and partly the Central Agricultural Bank (TsSKhbank).

In May 1932 the functions of the State Bank and those of the long-term investment banks (Prombank, Selkhozbank, Vsekobank and Tsekombank) were finally delineated. In 1963, all the state savings banks were brought under the control of the State Bank. In July 1987 as a result of the reorganisation of the credit system new specialised banks were founded and the State Bank began to perform the functions of the country's main bank. Two other banks also existed prior to 1987. The Construction Bank (Stroybank) provided investment credits to enterprises, and the Foreign Trade Bank (Vneshtorgbank) handled financial transactions pertaining to trade.

In 1987 and 1988, the Gorbachev regime separated commercial banking operations from Gosbank and replaced the two specialized banks with three banks to provide credit to designated sectors of the economy: the Agro-Industrial Bank (Agroprombank), the Industry and Construction Bank (Promstroy-bank), and the Social Investment Bank (Zhilsotsbank), which managed credits for the social welfare sector. The Soviet economy had no other forms of finance such as stocks and bonds. Through the 1988 law on cooperatives, the government allowed the creation of 'Zero Banks' that were formed from private capital. Many firms created 'Pocket Banks' that acted primarily as account agents for related companies.

Before the disintegration of USSR, Soviet Union operated with a monobank system consisting of a State Bank (Gosbank) that operated both as a central bank and a commercial bank. With the October 1917 revolution the Bolsheviks nationalised the banks, but made no attempt to restrict inflation. The market economy was demolished, inflation soared, and money became virtually valueless. Lenin stressed that the big banks represent the potential state apparatus, which we need for putting Socialism into practice. One State Bank with branches in every rural district, in every factory-that is already of nine-tenths of the Socialist apparatus.

According to this premise the banks had to be nationalised and merged into one Central Bank. For this reason, on the second day of taking power the Soviet Government took the offices of the State Bank and commissars were appointed as the heads of many branches of the State Bank, which later was renamed the People's Bank of the Russian Federative Socialist Republic (later it was renamed the State Bank of the USSR) (Zoulfia 2002).

Banking was declared to be a State monopoly, all private joint-stock banks and banking houses were merged in the State Bank. Several credit institutions were created but the State Bank not only preserved but also increased its role as the predominant credit institution and as a bank of banks. Soviet banks were restricted to the minimum functions of a banking system. They did not undertake any kind of investment activities in stocks, bonds, sales of securities and commodities. It was not the aim of Soviet banks to get profit from their credit operations. Instead of this, they had to carry out economic and political directives of the Soviet Government. Soviet banks had no role in the appraisal of risk, either in the production of commodities, or with respect to enterprises which produced them. Management of enterprises experienced no economic or market risks as all risk related decisions were taken by those responsible for the economic plans. In this context, a system of banks existed to exercise financial control over enterprises. Credit was allocated to enterprises and channeled through the banks which were responsible for the expenditure of money in accordance with the plan allocated to enterprises. A major distinction may be made between industrialization under capitalism and in the state socialist societies: in the former, monetarisation of economies was part of the movement from feudalism to capitalism - to the development of a market-type society, in the latter, demonetarisation took place.

Hence 'demonetarisation' of the economies of post-communist countries has been one of the main, though neglected, tasks of the transition process (Lane 2002). But the centrally controlled economy was changing even before the 1980s in the USSR and particularly so in the other state socialist economies of Eastern Europe. One of the most important ideological developments under Khrushchev was that, with the movement to communism, there would be a development of 'commodity-money' relations (rather than as hitherto of

'product-exchange'). It is possible that greater monetarisation could have occurred, with banks being given a greater role in risk management in the context of a more decentralized economy of 'finance socialism'. The changes which took place in Russia, in the period of reforms under Gorbachev, did not raise significantly the role of the banks in the hierarchy of economic control (Lane 2002).

Under Gorbachev, proposals were made to reform the banking system. Consequently, in 1988 and 1989, the State banks were reorganised into a central bank (Gosbank USSR) which controlled the management of money and credit and oversaw a system of unified monetary policy; it supervised and determined the level of credit operating in the other banks. There were five specialist banks - Vneshekonbank (Foreign Trade), Promstroibank (Industry and Building), Agroprombank (Agro-industry), Zhilsotsbank (Communal Services) and Sberbank (Savings Bank). New non-state banks were also allowed to be formed. The thrust of Gorbachev's perestroika policy was not to develop banks as mediators between savings and investment (or determinants of investments). His concern was to weaken the system of central planning and control (including financial control) and to move to a market system in which the major State enterprises were able to divert their surpluses into investment (if they wished). Steps were not taken during this period which would have led to the formation of an autonomous banking sector. The formation of 'new' banks were part of the establishment of 'cooperative' businesses. These concerns, which were outside the economic plan, needed credit and gave an impetus to the formation of private banks, which initially operated without any legal basis.

The first non-state bank emerged spontaneously in the summer of 1988 and, by the end of 1989, 150 non-state banks had been founded. The 'new' banks evolved in a spontaneous manner. In the late 1980s, the old system was on its way out; Policy encouraged the formation of business outside the State sector. To further new business, the government allowed the printing of money and an increase in bank credit.More than 80 years the Communist Party through the Government, Labour Unions, committees, commissions and State Bank controlled all areas of public and private life in the Soviet Union.

2.1 The Structure of the Soviet Banking System

Gosbank (literally, "State Bank") has traditionally been the core of the Soviet Banking system. In addition to Gosbank, three other financial institutions were the Soviet monobank Sberbank ("Savings Bank"), Stroibank ("investment Bank") and Vneshtorgbank ("Foreign Trade Bank"). Soviet monobank Sperbank was the sole bank for household savings deposits, which earned a positive but very low rate of interest. Stroibank was responsible for disbursing funds to enterprises for long run investment.And Vneshtorgbank handled all transactions involving imports and exports (Kennet, Lieberman 1992).

In 1988, the government created a two-tier banking system. The central banking functions were vested with Gosbank, while commercial banking functions were performed by five specialized institutions i.e; Sberbank-savings; Vneshtorgbank- foreign trade; Agroprombank – agriculture lending; and Zhilsotsbank- housing.Through the 1988 law on cooperatives, the government allowed the creation of 'zero banks' that were formed from private capital.

In this chapter an attempt is made to review the status of banking system, performance and functions of soviet banking system. As the banking system was influenced by Lenin's view it demands a look into his views on the role of banking system. In the years following, we will see an eventual inclination of soviet banking sector towards his views. This chapter is divided into // sections. Section // will discuss about

2.2 Lenin's Views on the Role

Lenin envisioned a single state bank, supported by a state foreign exchange monopoly, as the "keleton of a socialist society" and the core of a socialist administrative apparatus controlling the economy (Garvy 1977). All of the elements of Lenin's much-quoted passage on the role of banks in building socialism can be traced to the beginning and the middle of the nineteenth century, to Saint- Simon and Marx. But it is likely that his advocacy in 1917 of using the banking system as a tool for the socialist transformation of society was more directly related to the discussion in the pre-World War I social-

democratic literature concerning the role of banks in forging powerful industrial combines and their control over industry. Lenin's specific prescription for using banks as an administrative as well as an economic tool was derived from the contemporary theories of some radical and socialist writers of Western Europe, including Hobson (1902), Helphand, better known as "Parvus" (1910), and Hilferding (1910), with whose works he became familiar during his long years of exile. He used their analyses of the role of banks in advanced industrial countries, expanded by studies of more recent developments, in his book on imperialism, and made the concepts of "financial capital," "monopoly capitalism" and "economic imperialism" his own. Thus, in 1907 he wrote:

> Scattered capitalists are transformed into a single collective capitalist. When carrying the current accounts of a few capitalists, the banks, as it were, transact a purely technical and exclusively auxiliary operation. When, however, these operations grow to enormous dimensions we find that a handful of monopolists control all the operations, both commercial and industrial, of capitalist society. They can, by means of their banking connections, by running current accounts and transacting other financial operations, first ascertain exactly the position of the various capitalists, then control them, influence them by restricting or enlarging, facilitating or hindering their credits, and finally they can entirely determine their fate, determine their income, deprive them of capital, or, on the other hand, permit them to increase their capital rapidly and to enormous proportions, etc.

Lenin advocated the creation of a single government bank as a means of assuring control over industry, but also because he believed that a nationalized banking system could be easily reshaped into the core of the socialist state's administrative apparatus. In a passage much quoted by Soviet authors, he wrote a few days before the October Revolution:

> Without big banks, socialism would be impossible. The big banks are the "state apparatus" which we need to bring about socialism, and which we take ready-made from capitalism. A single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus.

There will be country-wide bookkeeping, country-wide accounting of the production and distribution of goods; this will be, so to speak, something in the nature of the skeleton of socialist society (Gravy 1977).

An identical view was expressed by Lenin after the October Revolution. "Banking policy must not stop with the nationalization of banks, but must work slowly but decisively toward the transformation of banks into a single accounting apparatus for the regulation of the organized socialist economic life of the country as a whole." Lenin's notion of the role of banks in building socialism and in directing the economy during the transitional period hardly goes beyond the theme developed by Saint-Simon, Marx, Hobson, Hilferding, and Parvus. Interestingly enough all discussed the potential use of the commercial banking system, rather than of the central bank, in building socialism. Similarly, Lenin noted that the control which commercial banks had achieved over individual industrial firms resulted in concentration of production in large operating units. He ascribed the banks' ability to exercise this control largely to industry's dependence on them for obtaining additional equity capital as well as credit. Lenin saw their potential for central control and direction of dispersed industries in a country where regional and local units of the government's administrative apparatus were inadequate to deal with economic problems. He was impressed with the technical functions performed by the extensive branch networks dominating the scene in Germany, the United Kingdom, France, and indeed, Russia itself, rather than with the possibility of using monetary and credit policy as a tool for restructuring the economy and achieving adequate growth and stability. As events turned out after the Bolshevik seizure of power, the monetary and banking system disintegrated under the impact of the civil war and the accompanying inflation. A state bank as envisaged by Lenin, complete with credit monopoly and complex control functions, did not materialize until almost fifteen years later, with the first Five-Year Plan well under way. When it did, the heritage from another epoch was unmistakable an epoch when enlightened bureaucrats under an authoritarian regime had tried to use state-directed credit and Treasury resources to lift Russia from centuries of economic backwardness. Sharapov would have easily recognized his "universal bank."

2.3 Evolution of Soviet Banking system since 1917

On the first day of the Bolshevik coup, October 25, 1917 (old calendar), an armed detachment of workers and soldiers, under direct orders from Lenin, occupied the main office of the State Bank in Petrograd. The Bolsheviks were determined not to repeat the mistakes of the Paris Commune, which had respected the Banque de France and left its gold stock and supply of unissued notes inviolate. The Bolsheviks encountered resistance and sabotage, not only from State Bank officials but also from employees who refused to cooperate with the new officials appointed by Lenin's government. On the day following the Bolshevik seizure of power all commercial banks closed down (Garvy 1972).

Their staffs received salaries for three months in advance, with the understanding that they would abstain from performing their duties as long as a Soviet government was in power, joining the concerted action of the employees of the State Bank and all other government financial institutions and ministries in refusing to serve the new regime. This boycott was fully effective.

The few operations that commercial banks did undertake in the weeks following the October Revolution were directed solely toward protecting their assets while contributing to the general paralysis of economic life that, Lenin's opponents hoped, would bring down the new regime. The new authorities were slow in making full use of the central bank. This was due partly to their lack of knowledge and experience, and partly to the fact that their immediate objective was merely to obtain currency from its vaults to meet the most pressing needs. Manifestly, the effective boycott by the bulk of bank employees made the use of the banking system as "the skeleton of socialist society" a practical impossibility.

However, during the months that followed, the total disorganization of all banking operations was gradually overcome and by the end of 1917 the cash department of the State Bank was functioning again and some discount and lending operations were taking place. In the middle of December 1917, the State Bank, as an agency of the new political

power structure, was given control over commercial banks, simultaneously with the establishment of "workers' and peasants' control" over all private firms, the precise scope of which was to be determined later by agreements with individual banking institutions. Within a few weeks, however, armed detachments led by representatives of the Bolshevik-controlled local Soviet occupied the head offices of the commercial banks in Petrograd. On December 27, 1917 (supplemented by a decree issued on January 26, 1918), the Soviet government nationalized all commercial banks without compensation of domestic or foreign stockholders by canceling all their shares. The commercial banks were merged into the State Bank, whose name was changed to People's Bank (Norodny Bank) of the Russian Socialist Republic. The nationalization of mortgage banks had preceded that of commercial banks.

This earlier act was the logical consequence of the nationalization of all land, with mortgaging of land declared illegal. The central bank of cooperatives, the Moscow Narodny Bank, was originally spared from the wholesale nationalization of banks. Organized in 1912 by the cooperative movement, which by that time had attained considerable importance, it had thousands of farm cooperatives as shareowners. For this reason, even though the bank as well as the cooperative movement were controlled by socialist parties other than the Bolsheviks, Lenin delayed nationalization for over a year, seeking a compromise. Only when the government failed to achieve control through suasion was the bank nationalized and merged with the People's Bank, the predecessor of the State Bank.

At the same time farm credit cooperatives were placed under government control. In 1918, following unification of all public budgets into a single national ("unified") budget, the People's Bank became the sole depository of government funds and was put in charge of all fiscal operations. Deposit transfers, through advice, draft, or check, became obligatory for the socialized and cooperative sectors of the economy. These two measures laid the foundations for the subsequent separation of payments circuits. Thus, some of the basic features of the present credit system emerged within a year of the October Revolution. Soviet monetary and banking experience between the October Revolution

and the credit reforms of 1930-1932 may be divided into the two periods 1917 to 1924 and 1924 to 1932. The first period saw the rapid disintegration of the old monetary and banking system and the subsequent long but successful struggle to introduce a stable Soviet currency. These years were characterized by unprecedented hyper-inflation fueled not only by a flood of currency issued by the Treasury but also by the chaotic state of public finances, the breakdown of the economy, the virtual cessation of foreign trade, and the fragmentation of the country as a result of the civil war. Much of the trade, particularly between farmers and the urban population, took place on a barter basis. Business transactions were typically based on valuation other than the face value of the circulating medium. Considerable quantities of goods were requisitioned by the armies and other military groups fighting in the civil war and by the related civilian authorities (or paid for in currency issued by them, or in old Tsarist rubles). At the end of the period (1924), industrial production was still less than half, and agricultural output, not much more than two-thirds, of the prewar (1913) level. Various types of direct controls were applied to cope with the pervasive scarcities that arose with the destruction of the market mechanism during the civil war and the superinflation that deprived money of all its standard functions.

During the period known as War Communism, an overall scarcity of consumer goods led to demonetization of the economy, and financial relations with foreign countries ceased. The subsequent reintegration of the national territory required central direction in setting priorities and in allocating material resources under conditions of overall scarcities and a chronic shortage of foreign exchange. Lenin's earlier view that banks should become the backbone of the socialist administration underwent a number of drastic changes not unrelated to the gradual disintegration of the economy. The focus of what constituted top priority for building socialism shifted from a centralized system of accounting and control, which the single bank could have easily provided, to the complex problem of rebuilding the Russian economy on the principles of directive planning. The Supreme Council of the National Economy, the trade unions, and the soviets were successively identified as the carriers of economic transformation responsible for assuring that the decisions reached at the center of government be implemented throughout the whole

country, down to the remotest corner. This reversal in policy was complete at the time of the introduction of the New Economic Policy (NEP) in 1921. By this time, a unified monetary system had ceased to exist and the country was in the grip of a wild inflation. In January of 1920-against a background of civil war, with the area controlled by the central government considerably reduced and transportation and communications almost completely disrupted-the People's (Narodny) Bank, the only banking institution still in existence, was liquidated. Its main functions were transferred to a department of the People's Commissariat (Ministry) of Finance. The economic collapse caused by the civil war was only partly responsible for the demise of the People's Bank. Equally important was the belief in the imminence of a socialist society, reflecting the influence of the extreme left both inside and outside the Communist Party.

The People's Commissar of Finance, C. S. Sokolnikov, was quoted as saying that "finance should not exist in a socialist community." Indeed, Marx himself seems to have believed that a socialist society could dispense with money (little, if anything was said about credit), and that vouchers or tokens evidencing the amount of socially useful labor performed were all that the toiling population would require to obtain consumption goods. However, it soon became evident that a new economy could not be built and that the government could not function without a stable monetary unit and credit system. A return to more conventional banking and credit practices was signaled by the creation, in October 1921, of a new State Bank of the Russian Socialist Republic, placed under the Commissariat of Finance. By the end of the year, the State Bank had begun operations in several of the main cities and its network of branches rapidly expanded in the following years.

The monetary policy that gradually emerged toward the end of this period aimed at creating a stable currency to replace the Treasury Notes (Sovznak-Soviet tokens). Issue of the latter increased by 11 to 15 percent per month in the first half of 1921 and by 50 to 70 percent a month in the corresponding period of 1922, the high point of the hyperinflation. The monetary reform of early 1924 that resulted in the creation of a new currency system began with the introduction of the new chervonets currency in October

1922, with a statutory cover of 28 percent in precious metals. For a time it produced a "bi-paper standard" until the old currency was completely retired. The complexities of the previous practice of linking business and some other payments to a variety of indexes and the wide use of a computed "commodity ruble" were only gradually overcome. The gold-backed currency ultimately became the new money of the Soviet state when the currency reform was completed. While its real purchasing power declined in subsequent years, no further currency reforms were undertaken until the end of World War II.

2.4 Major Reforms in The Soviet Era

Reforms formed a major package in the evolution of banking system. Keeping this in view, the reform periods can be divided into // parts. They are as follows:

- **a) Monetary reform of 1924**
- **b) Credit reform of 1932**
- **c) Economic reform of 1965**
- **d) Evolution of modern banking system and;**
- **e) Gorbachov reform**

a) Monetary reform of 1924

The monetary reform of 1924 was accomplished by an effort to balance the unified budget (for the fiscal year 1924-1925); it made possible the reestablishment of a banking and credit system. While the monetary reform terminated hyperinflation by the introduction of a "stable ruble," it did not remove the basic causes of inflationary pressures. Prices remained, however, fairly stable between 1924 and 1928, even though currency in circulation almost tripled; the improvement in the availability of consumer goods was apparently great enough to offset this increase. But between October 1, 1928 and June 1. 1932, the volume of currency in circulation almost tripled again, and consumer prices rose sharply. Inflationary forces received renewed impetus from the drive toward forced industrialization, shortages in consumer goods production, and excessive issuance of credit. Rationing of food, introduced in 1928 for the urban

population, was made more comprehensive in 1931; it was not abolished until 1936 (Garvy 1977). The share of private stores in total retail trade, which at the time of the monetary reform still exceeded that of State and cooperative stores combined (57.7 percent in 1923-1924), declined, but was still 5.6 percent in 1930. For a variety of reasons, the official retail price index became less and less representative and, indeed, its publication was discontinued at the beginning of 1931, not to be resumed until 1956.

The creation of a stable gold-backed parallel currency in 1922 permitted the organization, in the same year, of the first state commercial bank for granting long-term investment loans as well as short-term credit—the Russian Trade and Industrial Bank, known as Prombank. A new bank to service consumer cooperatives had been created already at the end of 1921 (the Pokobank) which was later (November 1922) enlarged (under the name of Vsekobank) to serve all types of cooperative organizations, including farm cooperatives. 1922 also saw the introduction of a free market for consumer goods and services under the New Economic Policy (NEP). It demonstrated that financial incentives could increase output, but also signaled potential political dangers to the regime. Related developments in the financial field involved an attempt to reintroduce a multichannel system for the extension of credit while maintaining a tight overall control by the resuscitated State Bank.

During the NEP period, L. Kamenev, at that time head of the government (Council of People's Commissars), assigned to credit the role that Lenin had hoped banks would play in the transition period. He described "centralized credit" as "this commanding high which we have created practically out of nothing" and as "the decisive factor in the regulation of the economy, the factor which [introduces decisive corrections and is capable both of causing and preventing crises."

In 1923, after the creation of the Federation following the end of the civil war, the State Bank of the Russian Republic was renamed "State Bank of the USSR" (Gosudarstvennyi Bank, abbreviated as Gosbank) and became the bank of issue. By 1925, it had retired almost all other currencies previously in circulation, including regional and

prerevolutionary issues. During this second period of Soviet monetary experience, from 1924 up to the credit reforms of 1930-1932, a system of specialized banks was created. The State Bank, however, was not able to control their credit activities, and a good deal of competition between its own lending and that of the other banks developed. The competing commercial and special-purpose banks were created by the government in the legal form of joint-stock companies. A Bank for Foreign Trade and two banks for agriculture were also organized, and some elements of the pre-Revolutionary credit system were revitalized, including the savings bank system, credit unions, municipal (communal) banks, and various types of cooperative banks for agriculture, craftsmen, and small entrepreneurs. Several additional institutions to provide credit for producers' and consumers' cooperatives were created during the twenties, but all were liquidated by 1930, at the time of the farm collectivization drive. No cooperative credit organizations have survived. Before it emerged as the single banking institution of the country, the State Bank had begun to perform certain bank functions vis-á-vis other banks. In particular, it was assigned the role of controlling credit policies of all other banking institutions. This control was achieved mainly through administrative means rather than the monetary policy measures employed by central banks in non-socialist countries. Credit planning became the main instrument of pursuing overall credit objectives. As early as 1923, the State Bank had begun to elaborate overall credit plans.

The first plan to receive the formal sanction of the government covered the initial quarter of 1925. Collection of all government revenue and its disbursement were transferred to the State Bank in 1925, when the network of local offices of the Ministry of Finance was abolished, thus completing a process initiated in 1918. In the same year the accounts of all local governments were also transferred to the State Bank. The central role of the State Bank was enhanced by the issuance of new laws in the middle of 1927, which delineated the activities of various banks and assigned all short-term lending to the State Bank. Their main purpose was to delineate the type of short- and long-term credit, each banking institution was to extend (so that an enterprise would not borrow from more than one bank), and to centralize resources, reporting, and control.

b) The Credit Reform of 1930-1932

Abolition of inter-enterprise credit in 1930 was a final step toward complete control by the planning authorities over allocation of the means of production and inventories and toward the reduction of credit to a purely implementary role. Prohibition of inter-enterprise lending left the State Bank as the only source of short-term credit, except for construction and foreign trade. The various measures initiated in 1927 laid the groundwork for a series of sweeping changes which began with a Credit Reform (decree of January 30, 1930) and was essentially completed by a reorganization of the State Bank on the basis of a decree issued on May 25, 1932.[29] Also, in 1932, various banks engaged in long-term financing were reorganized into four such banks with well delineated areas of activity and deprived of the remaining responsibilities in the area of short-term credit.

These various changes and the reconstruction of the balance sheet of the State Bank in 1932 are referred to in the Soviet Union collectively as the Credit Reform of 1930—1932. Although these reforms required a significant reorganization of the banking system to be effective, the structural changes that were made subsequently dealt mainly with delineating the spheres of activity of the specialized banks, particularly those which acted as conduits for long-term investment funds. Other subsequent changes were mostly of a procedural and organizational nature. They involved, among other things, merging the specialized banks for long-term financing into a single Investment Bank in 1959 and incorporating the savings bank system into the State Bank in 1961. Otherwise, the banking structure remained unchanged, with the State Bank (Gosbank) occupying the key position, and the Investment Bank (Stroibank) and the Bank for Foreign Trade (Vneshtorgbank) fulfilling specialized, far narrower functions. Various changes in payments instruments, in the details of the deposit transfer mechanism, and in credit procedures were also made after 1932, but the main features of the Soviet banking and credit system have remained basically unchanged to the present day. This standard system has been adopted by other "people's democracies" in Eastern Europe and other areas where communist regimes have become established since the end of the Second World War (Garvy 1977).

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c) The Economic Reform of 1965

The economic reforms initiated in September 1965 by a resolution adopted by the highest body of the Communist Party (Plenum of the Central Committee) can be characterized as a half-hearted attempt to deal with some of the most obvious shortcomings of the command economy without changing its basic character. They were conceived as a set of interrelated measures to improve the performance of the "economic steering mechanism" rather than as a basic revision of the Soviet system of resource allocation and the whole economic organization that implements it. From the inception of the Reform, Soviet authorities have tended to minimize the significance of the departures from the old methods. Indeed, they have constantly stressed that their purpose is to improve planning, not to work toward introducing a socialist market economy-the goal pursued in Yugoslavia and later, in a more limited way, in Hungary. Still, the 1965 Reform does represent the first change of any significance in the management of the Soviet economy since the launching of the first Five-Year Plan in 1928. It enlarged the activities of the State Bank by shifting part of long-term financing of industry to credit and by enlarging the use of credit in capital formation by kolkhozes. Otherwise, it left the structure and basic mechanism of the banking and credit system as they had evolved as a result of the changes introduced in 1930-1932 (Garvy 1977).

Prior to the government's action, there had been considerable public discussion by Soviet academicians, administrators, and enterprise managers of ways to improve the operations of the economy. Proposals by Professor Liberman and other economists in the early sixties regarding the improvement of key mechanisms in the Soviet economy had produced an impressive array of arguments in favor of changes that would open, to a limited extent, the centrally directed economy to market forces. The various steps gradually taken since the fall of 1965 were originally presented as a sweeping reform "to improve management of industry, to perfect planning, and to reinforce economic stimulation." Its aim was to improve the performance of the economy by reducing the range of detailed instructions from the center-without, however, giving the enterprise manager enough authority to operate the enterprise as an independent, profit

maximizing unit. To a certain extent, the Reform shifted the responsibility for short-run profit maximization from the central planner to the enterprise manager ("director"). It replaced the excessive number of plan targets to be achieved or surpassed by a mere nine success ("directive") indicators, among which total sales, profits, and the profitability ratio occupy a predominant position. The physical output of the principal product, the wage fund, payments into the budget, the value of centrally planned investments, new capacity to be added and goals for the introduction of new techniques, processes and products are the remaining planning indicators of the enterprise plan. Under the former system the gearing of all rewards to the fulfillment of goals specified mainly or exclusively in physical terms failed in providing incentives to maximize profits and to recognize adequately consumer preferences in the determination of the type of goods to be produced.

Narrowing the number of success indicators made it possible for individual enterprises to concentrate their efforts on meeting or exceeding these targets in order to qualify for additional financial rewards, such as retention of a greater share of profits. Maximization of profits is not the ultimate goal of Soviet planning. It serves, rather, as a means of achieving (or exceeding) plan targets of an individual enterprise with regard to productivity and efficient use of various inputs. The principle of profit maximization does not require, or depend upon, ownership: profit and profitability have long been central in the economic calculus in the Soviet Union, even though in economic plans they appeared as just one of many targets. The Reform introduced as additional indicators of enterprise performance a set of ratios measuring the return on (invested and working) capital and profits expressed as a percentage of total production costs, both called "profitability" with several accounting variants used. The introduction of a capital use charge required a revision of the entire price structure.

The reasons for the 1965 Reform were numerous and complex, and stemmed mainly from the performance of the economy itself. For years, Western critics, as well as some Soviet economists, pointed to various shortcomings in the Soviet economy's performance,

and in the early sixties there was widespread domestic concern about the key economic indicators showing less progress than during the fifties. However, there is little doubt that the immediate cause of the Reform lay, rather, in the radically changed situation in the consumer goods market. There a rising per capita real income in the early sixties faced a consumer goods output that had reached a level high enough to satisfy most basic consumer demands. After decades of chronic overall shortages, consumers began to buy discriminatingly and, in some cases, to withhold purchases, confident that more satisfactory goods would ultimately appear on store shelves.

For the first time, the consumer could choose, reflect, and postpone, at least in the area of certain important periodic purchases, such as clothing and household goods. The consumers' refusal to buy shoddy or outmoded goods was one of the immediate influences that precipitated the Reform. By postponing their purchases, they caused a piling up of goods in retail channels-while savings soared. Reports in the Soviet press amply documented this situation, succinctly summarized in an article in a leading literary monthly that made a case for greater reliance on the market mechanism. To convert consumer choice into limited feedbacks, the authorities began experimenting in 1962 with a system whereby production would be guided by actual orders from retail stores rather than by planners' command. The new system made greater allowance for consumer choice without giving recognition to consumer sovereignty.

Greater emphasis on consumer choice pointed to the need for reforms via several different avenues. For example, the pressure to increase the production of consumer goods by achieving greater efficiency and flexibility in planning and better use of fixed capital investment was one of them. Finally, maximization of benefits from foreign trade required a more rational price system for optimizing the use of domestic resources in producing for export. Removing distortions required the restructuring of domestic prices and integration of foreign trade with the domestic economy. In this area, the Soviet Reform stopped far short of the fundamental changes introduced in Hungary and the more limited reforms in Poland and Czechoslovakia, which were undertaken to make the domestic producer directly interested in the profitability of exports.

The basic characteristics of the Soviet economy were left untouched by the Reform-state ownership of the means of production, central planning of economic activity, administrative allocation of inputs other than labor, and administrative setting of prices have continued as before. In its all-important state sector, it has remained a one-seller, one-buyer economy. The planning authorities still control the relationship between enterprises and the various state organizations that supply raw materials and certain intermediate goods and direct the distribution of finished products. Contracts merely formalize these relationships and set details; monetary penalties still play a very modest role in enforcing fulfillment of obligations undertaken.

d) Evolution of Market-Oriented Banking Sector

The first steps that prepared the establishment of a market-oriented banking sector in the former Soviet Union were taken as elements of perestroika policies of the second half of the 1980s. Before that, the single-tier banking system, dominated by Gosbank Gosudarstvenny bank/State Bank) in the Soviet state owned and centrally planned economy, essentially played a passive role. The banks carried out payment transactions that were to accompany-and thus verify-the execution of orders and directives pertaining to the real economy. In the context of arbitrarily determined prices, enterprise profits were redistributed by the state or used otherwise according to the central plan, and credits granted to firms by the central bank in effect constituted automatic transfers and were not really expected to be paid back. Bankruptcy was practically unknown in the centrally planned economy. Money, except that paid out to workers and employees, was largely constrained to fulfilling bookkeeping functions. Gosbank was supported by a special purpose bank, the Sberkassa (State Workers Savings Bank) (Lane, 2002).

Until the end of the 1980s, private property rights with regard to means of production were generally outlawed and banking skills were all but nonexistent. Given the central planners, lack of information on the real productive capabilities and efficiency of many enterprises subordinated to their instructions, these enterprises were in a position to demand and receive from the state more inputs than they really needed to fulfill the

central plan, which perpetuated wasteful modes of production (soft planning). Owing to the general rigidity and inefficiency of the system, central planning could not have survived without a robust and supple underground or informal economy. However, given that the informal economy was mostly illegal, such basically market-oriented activities had to be continuously disguised (Barisitz 2004).

The USSR Governmental Decree on the Reorganization of the Banking System (1987) formally created a two-tier banking system. Gosbank was renamed "Central Bank of the USSR" and tasks which resembled commercial banking activities were separated from the central bank and transferred to various newly created specialized state-owned institutions: Promstroibank (which granted investment credits to the industry, construction, transport and communications sectors), Agroprombank (which served kolkhozes, sovkhozes and agroindustrial complexes), Zhilsotsbank (which served residential construction, light industry and trade). Vneshekonombank was established to deal with foreign creditors of the Soviet state. The Sberkassa (with its approximately 70,000 branches and outlets throughout the USSR) was consolidated into Sberbank (Sberegatelny Bank/Savings Bank). Sberbank collected household deposits and granted loans to the government largely as a contribution to budget finance. The Soviet central bank was thus left with the function of carrying out monetary policy and banking supervision, while at the same time it was still in charge of the central credit plan (Laurila 1996).

The Law on Cooperatives and subsequent regulations of the USSR central bank permitted the setting up of private commercial and cooperative banks, most of which were established by state-owned enterprises and organizations. The following years witnessed the rapid weakening of Soviet central and state authority. Elements of central planning started to disintegrate. In December 1990 the Russian Soviet Republic enacted its own Central Bank Law, declaring the Russian office of Gosbank the Central Bank of Russia (CBR) and subjecting it to Russian republican jurisdiction. This effectively turned the Soviet monetary authority into an umbrella organization of central banks of the Soviet republics. The same year the Russian Law on Banks and Banking Activity was passed

and Vneshtorgbank was created to service foreign trade transactions of the Russian Soviet republic. Despite the fact that the country was as yet far from featuring basic market-oriented institutions, the total number of operating credit institutions on Russian territory grew from 6 at end-1988 to 1,360 at end-1991. This development was promoted by the initial virtual absence of effective commercial banking regulations (IMF, World Bank, OECD, EBRD 1991).

After the collapse of the USSR and the demise of central planning, the CBR formally took over the remaining functions of former Gosbank in the Russian Federation. Licensing and prudential regulations remained under the sole jurisdiction of the CBR. The boom in new banks continued, promoted by a very liberal licensing policy (in particular low charter capital requirements, which e.g. in 1992 amounted to USD 2,00,000) and a generally lax regulatory environment with poor enforcement.

e) The Gorbachev Reform

Before the dissolution of the Soviet Union in late 1991, several important changes were made in the Soviet banking system. While these reforms moved the system closer to Western-style banking, they did not move it very far. The most important elements of the banking reforms, which began in earnest in 1987, were as follows:

(1) Private banking was legalized as part of the 1988 "Law on Cooperatives." Banks could be organized as joint-stock companies (with stock owned by enterprises, local governments, or social organizations) or as cooperatives. Enterprises were now permitted to maintain surplus cash, and the new banks were free to compete for household and enterprise deposits and to make long- and short-term loans. At the time of the dissolution of the USSR, there were several hundred of these banks in existence.

(2) Commercial bank operations (allocating credit, accepting deposits) were stripped from Gosbank and transferred to three new specialized banks (Agroprombank, Promstroibank, and Zhilsotsbank) each handling deposits, lending, and payments services in a different sector of the economy. The intention was to convert each of these banks

into a joint stock company, although by late 1991, this had only been accomplished for Agroprombank, the agricultural-sector bank. Sperbank (Savings Bank) continued to accept household deposits, although now it had to compete with private sector banks and was forced to raise interest rates. And enterprises were given more freedom to deal in foreign currency, reducing the power of the foreign trade bank (which had been given the new name, "Vneshekonombank").

(3) Gosbank began its transformation into a Western-style central bank, establishing reserve requirements, capitalization requirements, and lending regulations for the nascent private banking sector.

These steps fell far short of what the most radical reformers thought necessary. In particular, the Gosbank monopoly on enterprise loans and deposits was simply replaced with three new monopoly banks, each responsible for its own sector of the economy. None of the three new banks were permitted to compete for customers or clients with the others, and Sperbank, with its 70,000 branch offices, retained a virtual monopoly on household savings deposits, since its only competitor was the tiny commercial banking sector. Finally, monetary policy remained essentially passive, since Gosbank was still forced to print up cash to finance wage payments in State enterprises (Kennet, Lieberman 1992).

The gradual dissolution of the Soviet Union led to a virtual collapse of Gosbank by the end of 1991. Increasingly, individual republics (most importantly, the RFSR) ordered enterprises within their borders to turn over cash revenue to them, and then used it to expand the role and size of their *own* governments. Since the central Soviet government refused to shrink itself out of existence, Gosbank was forced to accelerate cash-printing to pay the wages of workers in enterprises and agencies still controlled by the center. In the first 11 months of 1991, the quantity of rubles in circulation increased from 132 billion to 234 billion. By late 1991, the only constraints on cash growth were physical: the printing presses which were capable of printing notes of specific denominations only (the largest being a 200-ruble note) were running 24-hours a day. Shortages of consumer

goods intensified, lines at State stores grew even longer, and the inflation rate reached roughly 3% per week by late 1991.

Planning Functions of the State Bank of Soviet Russia

The State Bank's basic responsibilities were adjusting the supply of money to the "real" transaction needs of the economy as determined by the economic plan and preventing expenditures outside planned purposes. Both economic growth and economic stability could be endangered by any diversion of resources outside the planned channels. In order to avoid such dangers, the State Bank aimed systematically at keeping both enterprises and households as illiquid as possible and strived to ensure that all scheduled transactions were carried out with minimum monetary means. Thus, the bank's tasks required that it exercise both planning and controlling functions during Soviet era (Spulber 1962).

The State Bank's planning embraced currency needs and credit expansion. Currency needs were determined by wage-bill requirements and pattern of wage-earners' expenditures. The currency requirements were projected in a set of monthly and quarterly currency plans which aimed at bringing into balance receipts of currency and disbursements of currency. Thus, the currency plans dealt with gross flows of currency to, and from, the socialist sector, excluding transactions among households. The State Bank's All-Union currency plan was drawn up on the basis of the observed trends in currency turnover in the country as a whole and on the plans of each of the bank's offices, branches, and agencies; these in turn were based on general trends in their respective republics, regions, or districts and on the quarterly currency plans submitted to them by each state enterprise pertaining to its sphere of operation.

In order to keep the quantity of currency at a minimum and to permit the enforcement of tight controls, each enterprise used to be ordered to hold as little currency as possible, and each socialized shop was required to deposit its daily receipts. The impact of such factors as the time element in income formation, redistribution of income through transactions among persons, and propensities to save and consume could be ascertained both through

the variation in the fulfillment of the currency plans and through correlation of other data grouped in the closely related balance of income and expenditures of the population. As we know, Changes in the distribution of income affects the velocity of currency balances, the pattern of effective demand for state goods, and the consumption-saving ratio. Therefore, attempt of the State Bank of Soviet Russia was to keep currency accounts in balance.

Closely connected with the currency plans were the credit plans. Each credit plan aimed at balancing, in each planning period, estimated "credit resources" and scheduled credit needs arising from the planned transactions concerning material goods. The plans were drawn quarterly by the State Bank on the basis of forecast receipts and expenditures of each of its offices, branches, and agencies, and of each of their respective customers. After approval by the Council of Ministers, the plan was broken down by republic, regional, and district bank offices, which in turn established "limits" of the credits to be granted to their clients for the end of each given plan period.

The State Bank expanded loans to the extent of its reserves and of the "idle" resources at its disposal. The latter were defined as (1) current budgetary surplus; (2) previously accumulated budgetary surpluses held by the bank for the treasury; and (3) portions of all other deposits not currently in active use. The State Bank estimated deposits not in current use on the basis of the minimum balance on hand at the end of an operational planning period. Variations in the minimum balances of enterprises were estimated by the State Bank from the plans of the enterprises. Consequently, any error in the output plans had monetary effects, since it would result in an overestimate of the idle resources at the disposal of the State Bank.

The State Bank treated credit as essentially a revolving fund. As we know that it creates new deposits on the basis of its estimated idle resources. In the Soviet Union, no reserves were required; the idle resources set the ceiling of credit to be created by the State Bank. The bank loans, traditionally provided only in response to current expenditure needs, had

been expanded as a result of decentralization of certain investment decisions, the shift to various credit-financed investments, and the expanded role of interest. But since the late 1960's the idea of broadening the rights and discretionary power of the divisions and agencies of the State Bank in their relations with the enterprises and the idea of abandoning detailed regulation of credit operations have been increasingly stressed in specialized literature. The State Bank operated on the basis of an old assumption, the fallaciousness of which is well known; namely, that money requirements and capital requirements are identical.

Professor D. H. Robertson reminds us, the money created does not sit and wait "tied around the neck of the goods but goes off on a round of visits of its own." In other words, if the plans of enterprises were entirely consistent with each other and with the total of resources, giving the enterprises just enough credit to carry out these plans would be consistent with stability. But the plans are not fully consistent, and credits are not used for the specified purpose for which they are extended but for a set of both planned and unplanned transactions. Therefore, the policy of lending on "real bills" in no way ensures that the quantity of money thus created matches the actual transaction requirements of the economy, though the credit plan may perfectly equate the two sides of its balance.

2.5 The State Bank's Controlling Functions

The State Bank used to ensure that, within the framework established by the plan, its main objectives were carried through without unplanned increases in costs, wage bill, or currency holdings of either wage earners or peasants. In order to fulfill this task, the State Bank was charged with the control of the ways in which each enterprise fulfilled the plan and was instructed to make systematic efforts to minimize the quantity of money needed to support the prescribed transactions in the economy (Spulber 1962).

The State Bank's offices were supposed to exercise a detailed control over the financial activity of each of the enterprises belonging to their respective spheres of operation. The segregation of settlement and current accounts, and of currency and credit flows, the specificity of each account and of each operation were all helpful devices for the establishment of a comprehensive financial control, or as the Russians call it "control by the ruble". The bank was supposed to treat enterprises which carried out their planned obligations leniently and delinquent enterprises severely.

The enormous burden of surveying details used to force the bank to resort to what were officially described as formalistic controls and led to a sparing application of sanctions. Since 1954, when the bank was strongly admonished for its formalism and leniency, the relative importance in the total volume of inter-enterprise transactions of payments by letter of credit, special account, or checks -by no means exclusively reserved for penalized enterprises- had fallen to around 3 per cent per year, a considerable decline since 1950.

In order to ensure economic stability, the State Bank imposed "financial discipline" on enterprises by the controls. The bank disciplined itself by the cumbersome practices of "mobilizing idle resources" and then matching its credits to them, granting each loan in response to "real goods" movements, etc. Inflation, i.e., increases in "unplanned liquidities" which had an adverse effect on the plan, was a danger; its chief causes in the Soviet economy were faulty planning and faulty plan implementation especially in respect to volume of wages and volume of minimum working capital requirements and bank credits.

Other things being equal, increases in the volume of wages immediately affected the liquidity of households; increases in working capital and bank credit affected the liquidity of enterprises and ultimately also that of households, increases in the wage fund and shortages in consumers' goods output pushed the free market prices upward and led to an increased spread between them and the state retail prices. Prices of raw materials and intermediate goods within the state sector, though sluggish, reacted to the upward price push of

consumers' goods via cost-wage increases, i.e., through pressures of planned profit margins. Adroit manipulation of turnover taxes, i.e., reduction of actual consumer purchasing power and eventual increases in deduction from profits when enterprises showed excess liquidities, kept the inflationary pressures in check. If and when liquidities became heavily concentrated outside the regular state-controlled channels the state used to resort to monetary refunding. This, however, was used only as a last resort to keep people's confidence in currency.

2.6 Performance of State Bank of USSR

When the New Economic Policy (NEP) was launched, the All-Russian Central Executive Committee (VTsIK) and the Council of People's Commissars (SNK), on October 3 and 10, 1921, respectively, passed resolutions re-establishing the bank under the name of the State Bank of the RSFSR. On November 16, 1921, it began to conduct operations and in 1923 it was transformed into the State Bank of the USSR.

The Statute of the State Bank of the RSFSR, passed by VTsIK on October 13, 1921, said that it was an economic organization established "to assist by credit and other banking operations the development of industry, agriculture and goods turnover and also the concentration of monetary turnovers and the implementation of other measures designed to establish proper money circulation". The bank had the right to extend loans to industrial and commercial enterprises based on different forms of ownership, farms and self-employed handicraftsmen "only if they were solvent and their financing was economically justified". The State Bank was a part of the People's Commissariat of Finance (Narkomfin), directly accountable to the People's Commissar (Minister) of Finance.

In November 1921 the State Bank was granted the exclusive right to conduct operations with foreign currency and valuables. It also set the official price of precious metals and the official exchange rate, regulating private trade in gold, silver and foreign currency on stock exchanges and cheques and bills of exchange drawn in foreign currency, which were permitted in 1922. Two re-denominations conducted in 1922 and 1923 increased

the face value of Soviet paper money which Narkomfin issued at that time to cover the budget deficit. During the first re-denomination the new ruble of the 1922 issue exchanged for 10,000 rubles of all issues that were in circulation in the country; during the second re-denomination the new ruble of the 1923 issue exchanged for 100 rubles of the 1922 issue (Bank of Russia 2009).

On October 11, 1922, the State Bank was granted the right to issue the chervonets (banknote) and became the issuing centre. The issue of the chervonets marked the beginning of the monetary reform that ended spiraling post-war inflation. In 1922-1924 both the ruble and the chervonets were in circulation. The chervonets was backed by gold: it was equivalent to 7.74232 grams of fine gold, equaling the tsarist Russia's 10-ruble coin. In 1923 Russia began to mint gold chervonets coins, which were mostly used in foreign trade. In March 1924 the monetary reform was completed and the new ruble, which was used as change and equaled one-tenth of the chervonets, exchanged for 50,000 rubles of the 1923 issue or 50 million rubles of the earlier issues.

During the period of the new economic policy (NEP) the following types of bank credits were used: the discounting of bills of exchange, demand loans from special current accounts covered by bills of exchange and time loans against bills of exchange. In addition, three years after its founding, the bank began to practice direct target crediting. In October 1924 the State Bank drew up its first consolidated credit plan comprising all branches. As a result of the reform of the cash structure of the State Treasury, conducted in 1925, the cash holdings of the State Bank and Narkomfin were merged.

Soviet Russia's first commercial banks, including sectoral joint-stock banks (specialized banks) and mutual loan societies, appeared in 1922. These banks were to extend short- or long-term loans to individual sectors of the economy. In 1924 the Committee on Banks was set up under the State Bank's Board to co-ordinate their activities. In the latter half of the 1920s the functions and activities of the State Bank changed dramatically. The change was mainly the result of the accelerated rates of industrialization, which required vast capital investment in the basic industries within a short period of time.

It was impossible to industrialize the USSR by traditional methods, that is, by accumulating financial resources inside the country and using foreign loans. The population lacked the required savings, while foreign loans could not be obtained for economic (the world was in the grip of an economic crisis) and political reasons. As a result industrialization in the USSR was financed by money emission. Throughout the entire period of phasing out the NEP the Soviet authorities tried to find the simplest means by which the state could distribute funds between the various sectors of the economy.

In June 1927 as a result of tighter regulation of the short-term capital movement the State Bank was vested with the responsibility of exercising immediate day-to-day control over the entire credit system, while the Narkomfin retained its function of general regulation. The State Bank was to supervise the activities of other credit institutions in compliance with government credit policy directives. Specialized banks were required to keep their spare funds in and borrow from the State Bank only and the latter was granted the right to be represented in their boards and auditing units. In addition, the State Bank increased its share of the specialized banks' equity capital.

As the banking system was re-organized in February 1928, most short-term credit operations began to be concentrated in the State Bank. It also took control of many branches of joint-stock banks, which began to play an auxiliary role in crediting the economy. Long-term lending was conducted mainly by the Bank for the Long-Term Crediting of Industry and Power Engineering (BDK) specially created for this purpose, the Central Utilities and Housing Bank (Tsekombank) and partly the Central Agricultural Bank (TsSKhbank).

In August 1928 the Central Bank was assigned the task of cash budgeting and that made it possible to concentrate all the cash operations of the socialist economy in the State Bank. In June 1929 the first Statute of the State Bank was adopted, which declared the State Bank an authority regulating money circulation and short-term lending in accordance with the general economic development plan of the USSR.

In the late 1920s and early 1930s the USSR carried out a series of reforms aimed at creating an effective mechanism of centrally planned regulation of the material and financial aspects of the reproduction process. Accordingly, a credit reform was carried through in 1930-1932, which resulted in the creation of a mechanism of centrally planned regulation of the monetary and credit resource flows. In January 1930 as a result of the abolition of mutual commercial credit all direct short-term lending began to be conducted in the State Bank. All specialized banks turned into long-term investment banks and all their branches were closed. Specialized banks were required to conduct all operations through State Bank branches. In January 1931 the acceptance form of non-cash settlements through the State Bank was introduced. In March 1931 the State Bank's functions as the only short-term credit bank and settlement and cash centre of the Soviet economy were established.

In June 1931 working capital of enterprises was divided into their own capital and borrowed capital, and the main principles of short-term bank crediting were laid down. When enterprises became owners of working capital, it became possible to establish the entities of bank crediting. State enterprises now received short-term loans only to finance en route values, advance payments for seasonal production reserves, the accumulation of seasonal reserves of raw materials, fuel, production and auxiliary materials, temporary increases in investment in unfinished construction projects, seasonal accumulation of finished goods and products and other temporary needs related to the production and circulation of commodities. In May 1932 the functions of the State Bank and those of the long-term investment banks (Prombank, Selkhozbank, Vsekobank and Tsekombank) were finally delineated.

As a result of the credit reform the State Bank lost the last elements of a commercial bank and became a typical Soviet state bank whose main functions were to extend planned loans to the economy, manage money circulation and settlements, do the cash budgeting and effect international settlements. The structure of the credit system that was established at that time would remain in place for 55 years practically unchanged. Later on all changes in the activities of the State Bank were limited to the introduction of new forms of planned credit to the economy and bank settlements and also new methods of

controlling the spending of funds on wages and salaries (80% of the entire cash turnover) and the collection of proceeds from trade. In February 1930 all transactions to sell gold and foreign currency to private individuals for chervonets at a fixed rate were banned, the Soviet currency was withdrawn from foreign exchanges and a quoting commission was set up under the State Bank's Board to set the exchange rates of foreign currencies.

In 1933 the State Bank implemented a series of measures to accelerate settlements, improve accounting, reporting and paperwork and enhance internal banking control. The State Bank balance sheet was restructured on a departmental basis to become comparable with the credit plan. The offsetting of inter-affiliate turnovers was decentralised, while the centre continued to exercise general control. In 1939 the State Bank began to collect cash. During the Second World War (1941-1945) it issued cash to cover the budget deficit, increasing the money supply fourfold. To normalise money circulation a confiscatory monetary reform was conducted in 1947, during which old money was exchanged for new at the rate of 10 to 1, cash accounts in the savings banks were re-evaluated and all state loans, except the 1947 loan, were convented. In March 1950 the gold content of the ruble was set at 0.222168 grams of fine gold. In December 1949 the second Statute of the State Bank was adopted.

In April 1959 an overhaul of 1959 the credit system resulted in the transfer of some operations conducted by the Selkhozbank, Tsekombank and municipal banks to the State Bank. In 1960 the State Bank began to draw up plans to credit long-term investment. In May 1961 the ruble was re-denominated and devalued. One new ruble exchanged for 10 old rubles. At the same time the gold content of the ruble was only increased four times to equal 0.987412 grams of fine gold. In October 1960 the State Bank adopted its third Statute and in 1963 all the state savings banks were brought under its control. In 1965-1969 the economic reform brought about some changes in the activities of the State Bank, which were connected with lending and settlements, money circulation planning and regulation, financing capital investments and organising the savings system. Credits on material assets turnover and wage costs and credits on ordinary loan accounts became the main means of crediting industry.

In July 1987 as a result of the reorganisation of the credit system new specialised banks were founded (Vneshekonombank SSSR, Promstroibank SSSR, Zhilsotsbank SSSR and Sberbank SSSR) and the State Bank began to perform the functions of the country's main bank. It was assigned the task of elaborating the consolidated credit plan and planning the distribution of funds and credit investments among all banks.In September 1988 the fourth Statute of the State Bank of the USSR was approved, declaring the State Bank the country's main bank and the only issuing centre and organiser of credit and settlement relations in the economy.

In March 1989 the transfer of the specialised banks to full cost-accounting and self-financing required the State Bank to provide them with target figures on the volume of credit resources, the amount of household savings taken on deposit, and the volume of foreign-currency receipts and payments on banking operations. In January 1990 the State Bank was given control over the Savings Bank of the USSR. On July 13, 1990, the State Bank of the RSFSR, accountable to the Supreme Soviet of the RSFSR, was created on the basis of the Russian Republic Bank of the State Bank of the USSR. On December 2, 1990, the Supreme Soviet of the RSFSR passed the Law on the Central Bank of the RSFSR (Bank of Russia), which stipulated that the Bank of Russia was a legal entity and the main bank of the RSFSR and that it was accountable to the Supreme Soviet of the RSFSR. The law specified the functions of the bank in organising money circulation, monetary regulation, economic activity and the regulation of joint-stock and co-operative banks.

In December 1990 the Law on the State Bank of the USSR and the Law on Banks and Banking were passed. Under these laws the State Bank of the USSR and the national banks that were being established at that time on the basis of the republic divisions of the State Bank were to build a single system of central banks based on a single monetary unit, the ruble, and fulfilling the functions of a reserve system. In June 1991 the Statute of the Central Bank of the RSFSR (Bank of Russia), accountable to the Supreme Soviet of the RSFSR, was approved. The period between July 1990 and December 1991 was a time of conflict between the Russian State Bank and the State Bank of the USSR. In November 1991, owing to the establishment of the Commonwealth of Independent States and the

disbandment of Soviet Union structures, the Supreme Soviet of the RSFSR proclaimed the Central Bank of the RSFSR the only body of monetary and foreign exchange regulation in the RSFSR. It was entrusted with the functions of the State Bank of the USSR in issuing money and setting the exchange rate of the ruble. The Central Bank of the RSFSR was instructed to assume, before January 1, 1992, full control of the assets, technical facilities and other resources of the State Bank of the USSR and all its institutions, enterprises and organisations. On December 20, 1991, the State Bank of the USSR was dissolved and all its assets, liabilities and property in the RSFSR were transferred to the Central Bank of the RSFSR (Bank of Russia 2009).

CHAPTER- 3
RUSSIAN BANKING SYSTEM

INTRODUCTION

3.1 Banking Sector in the 1990s

In the 1990s, banking sector has been one of the fastest changing sector of the Russian economy. On December 20, 1991, the State Bank of the USSR was disbanded and all its assets, liabilities and property in the RSFSR were transferred to the Central Bank of the RSFSR (Bank of Russia), which several months later was renamed the Central Bank of the Russian Federation (Bank of Russia 2009). Federal law was passed for the establishment and regulation of this banking and it underlines the functions.

3.2 Russian Federation Federal Law

Banking legislation is a branch of law that represents a system of normative acts regulating banking activities. The legal regulation of banking activities is implemented by the Constitution of the Russian Federation, the Civil Code of the Russian Federation, which provides the basis for the legal relations under loan and credit agreements and bank deposit and account agreements and the relations that rise in connection with the effectuation of settlements, the Federal Law on the Central Bank of the Russian Federation, Federal Law on Banks and Banking Activities and other federal laws and Bank of Russia regulations.

In accordance with point g of Article 71 of the Constitution of the Russian Federation, the competence of the Russian Federation comprises, among other things, financial, foreign exchange, credit and customs regulation, currency issue and the main aspects of the pricing policy. This provision signifies that the legal regulation of banking activities may be effected at the federal level only.

Part 2 of Article 75 of the Constitution of the Russian Federation lays down the principle of independence of the Bank of Russia from other state bodies when it fulfils its principal function of protecting the ruble and ensuring its stability (Bank of Russia 2009).

Federal Law No. 86-FZ, dated July 10, 2002, "On the Central Bank of the Russian Federation (Bank of Russia)" (hereinafter referred to as the Bank of Russia Law), spelled out the principle of independence of the Bank of Russia, stipulating that the Central Bank of the Russian Federation fulfilled the functions and powers established by the Constitution of the Russian Federation and Bank of Russia Law independently from other federal bodies of state power, the bodies of state power of the constituent entities of the Russian Federation and local self-government.

The Bank of Russia Law established the legal status of the Bank of Russia, the size of its authorised capital and the procedure for forming the National Banking Board and its principal functions and the functions of the bodies of management, settled the relations between the Bank of Russia and the bodies of state power and local self-government and between the Bank of Russia and credit institutions, set out the principles of organising non-cash settlements and cash turnover, established the principles of implementing monetary policy and its major instruments, specified the operations and transactions conducted by the Bank of Russia, banking regulation and supervision powers and formulated the principles of managing the Bank of Russia and its reporting and audit.

Article 4 of the Bank of Russia Law specified the functions fulfilled by the Bank of Russia. Article 7 of the Bank of Russia Law stipulates that on issues within its competence under this Federal Law and other federal laws, the Bank of Russia issues in the form of ordinances, regulations and instructions normative acts binding upon the federal bodies of state power, the bodies of state power of the constituent entities of the Russian Federation and local self-government and all legal entities and private individuals.

Another key federal law relating to banking activities is the Federal Law on Banks and Banking Activities, which defines such terms as "a credit institution", "a bank", "a non-bank credit institution", "a banking group", etc.

This Law describes the components of the Russian banking system, specifies the banking operations and other transactions and the operations conducted by credit institutions on the securities market and sets up the procedure for registering credit institutions, licensing banking activities and opening branches and representative offices of credit institutions. It also sets out the principles of relationship between credit institutions and their customers and the state, establishes the grounds for the revocation of banking licence, formulates the principles of ensuring stability of credit institutions, establishes the banking secrecy regime and anti-monopoly restrictions for credit institutions and lays down the principles of organising the savings business in Russia.

The passage of Federal Law No. 40-FZ, dated February 25, 1999, 'On Insolvency (Bankruptcy) of Credit Institutions" (hereinafter referred to as the Bank Insolvency Law), was a major step forward in setting up an effective, up-to-date and internationally accepted procedure for declaring credit institutions insolvent (bankrupt).

The Bank Insolvency Law establishes the procedure and conditions for implementing measures to prevent insolvency (bankruptcy) of credit institutions and specifies the grounds and procedures for declaring credit institutions insolvent (bankrupt) and subsequently liquidating them.

The Bank Insolvency Law pays special attention to the bankruptcy-prevention measures implemented before the revocation of banking licence. These are:

- the financial rehabilitation of a credit institution;
- the appointment of a provisional administration to a credit institution;
- the re-organisation of a credit institution.

The Anti-money Laundering Law regulated by Federal Law No. 115-FZ, dated August 7, 2001, "On Countering the Legalisation (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism" sets the criteria for the value of operations subject to mandatory control, specifies these operations and determines what organisations, credit institutions among them, conducting operations with money and other property must inform the authorised agency about these operations.

To increase public confidence in the banking system, stimulate growth in household savings and reduce risks assumed by banks when building up a long-term resource base, Russia passed Federal Law No. 177-FZ, dated December 23, 2003, "On Insurance of Household Deposits with Russian Banks".

The logical next step in building the deposit insurance system in Russia was the passage of Federal Law No. 96-FZ, dated July 29, 2004, "On Bank of Russia Payments on Household Deposits with Bankrupt Banks Uncovered by the Compulsory Deposit Insurance System".

As a result of the measures taken to organise the deposit insurance system, the financial standing of the banks that do not participate in this system may become destabilised because of the outflow of deposits to the banks participating in this system and the reduction of customer and investor confidence in the non-participating banks.

To implement the single state foreign exchange policy and ensure stability of the ruble and the domestic foreign exchange market as the factors of progress in national economy and international economic co-operation, Russia adopted Law No. 173-FZ, dated December 10, 2003, "On Foreign Exchange Regulation and Foreign Exchange Control", which replaced the 1992 law with the same name.

In December 2003, the Federal Law "On Insurance of Personal Bank Deposits in the Russian Federation" was adopted. The law stipulated the legal, financial and organisational framework for the mandatory personal bank deposits insurance system,

and also the powers, procedure for the establishment and operation of an institution implementing mandatory deposit insurance functions and set the procedure for paying deposit compensation.

The adoption of Federal Law No. 218-FZ, dated December 30, 2004, "On Credit Histories" was of special significance for arranging credit relations and building a modern economy in general. This Law is designed to help build a system for the disclosure of information on borrowers' credibility in respect to their obligations to creditors.

In April 2005, the Russian Government and Bank of Russia adopted the Banking Sector Development Strategy for the Period up to 2008, a document which set as the main objective of banking sector development in the medium term (2005-2008) the enhancement of the banking sector's stability and efficiency.

On 13 October 2008, President Medvedev signed Federal Law No. 173-FZ "On Additional Measures of Support for the Financial System of the Russian Federation" (the "Financial Support Law") and Federal Law No. 171-FZ amending Article 46 of Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)" (The amendments to "CBR Law"). Both laws were entered into effect on 14 October 2008. The new legislation aims to provide additional state support to Russian companies and banks whose financial standing has been adversely affected by the turmoil on the global financial markets (Baker & Mc.Kenzie 2008).

Under the new laws:

a) The Central Bank of the Russian Federation (the "CBR") and Vnesheconombank will advance up to RUR 950 billion as subordinated funding to Russian banks. Under it, it is planned to provide subordinated funding to Russian banks for the total amount up to RUR 950 billion. Subordinated funding shall be distributed among the banks as follows: Sberbank -up to RUR 500 billion,VTB-up to RUR 200 billion, Russian Agricultural Bank-up to RUR 25 billion and other banks-up

to RUR 225 billion. Subordinated loans to Sberbank shall be provided by the CBR. It is planned that the other banks shall receive subordinated loans from Vnesheconombank. The funding for subordinated loans to be made by Vnesheconombank is to come from the National Wealth Fund by way of deposit. The subordinated loans are to be granted to the banks for a term until 31 December 2019. Subordinated loans shall be provided to banks which meet, inter alia, the following criteria:

- the bank should have a minimum credit rating level as determined by Vnesheconombank; and
- the bank should manage to attract a subordinated loan from a third party or increase its charter capital after 1 October 2008.

The total amount of the subordinated loans provided by Vnesheconombank to each Russian bank can not exceed 15 per cent. of the relevant bank's capital as of 1 October 2008.The interest rate on the subordinated loans shall be 8 per cent per annum Subordinated funding from Vnesheconombank can also be provided through the purchase of domestic subordinated bonds issued by the relevant Russian bank or Eurobonds issued to fund a subordinated loan to such bank.

b) The CBR is authorized to extend short term loans to eligible Russian banks on an unsecured basis. Financial Support Law also authorizes the CBR to enter into agreements with Russian banks to partially compensate them for any losses incurred by them as a result of lending to other banks whose banking licenses would have been revoked after the adoption of the Financial Support Law.

This measure aims to restore trust among the banks and boost the efficiency of funds allocation within the banking system. In addition, the CBR is authorized by the amendments to the CBR law to provide short-term (up to six months) loans to Russian banks on an unsecured basis. The eligibility criteria for banks, including minimum credit rating requirements, shall be set forth by the Board of Directors of the CBR. Before the

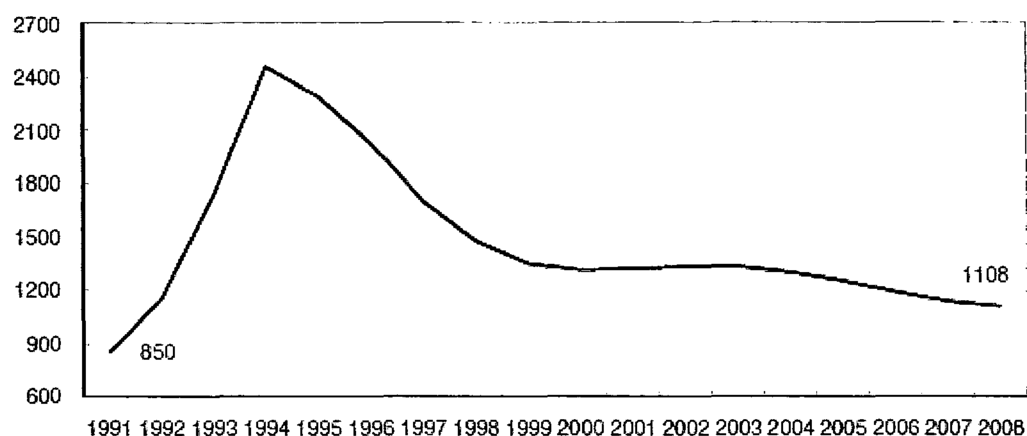
introduction of these amendments the CBR was only lending to banks on a secured basis. While commenting on the above amendment, a CBR representative has emphasized that unsecured lending is an "extraordinary" measure with high risk potential for the CBR.Therefore, the eligibility criteria for the banks including capital requirements and credit rating will be stricter.

c) Other Financial Support Measures

In addition to the above, other measures are also being taken by the Russian Government in order to enhance liquidity in the banking sector and support the stock market. One of such measures is holding regular auctions for the allocation of budgetary funds to bank deposits. Besides, the CBR has temporarily lowered the rate of mandatory bank reserves. The rate of mandatory reserves has been lowered from 8.5% to 0.5% in relation to foreign currency obligations to foreign banks, from 5.5% to 0.5% in relation to the ruble denominated obligations to individuals, and from 6% to 0.5% in relation to other obligations of banks in any currency. The prevent bank runs, State Duma also increased the level for the protection of private deposits from RUR 400,000 to RUR 700,000.These amendments were introduced by the Federal Law No. 174-FZ which also entered into effect on 14 October 2008.

Until the end of the Soviet era there were no private banks, and no competition within the public sector. The banking sector did not intermediate savings and investment on the basis of price signals in a manner conducive to an efficient allocation of capital. The situation changed dramatically during the initial transition period, from 1992, as the central bank issued a huge number of banking licenses (Figure- 3.1) (OECD Economic Survey: Russian Federation 2009).

Figure- 3.1, Trend of Number of Banks



Source: Central Bank of Russia.

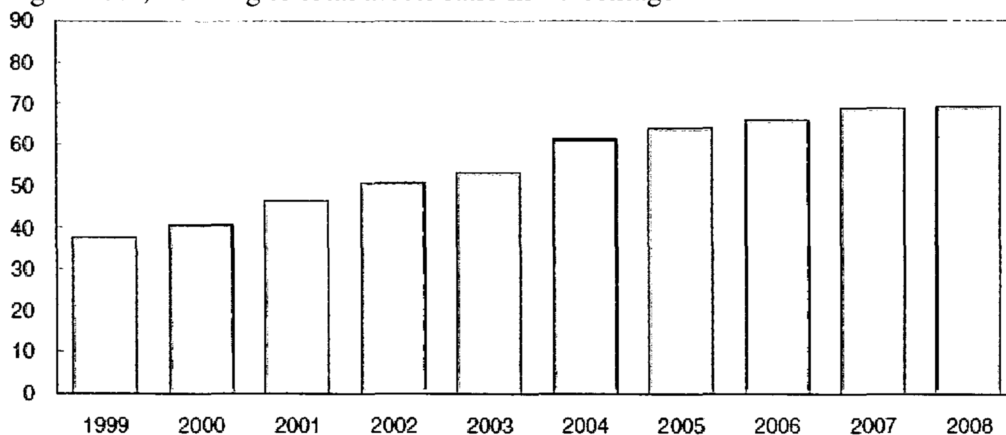
http://dx.doi.org/10.1787/650250822214

There were several specific reasons for establishing or acquiring a bank during the early years of transition. Banks were allowed to deal in foreign exchange, and could hold correspondent accounts with foreign banks. This meant that owning a bank facilitated capital flight (net private capital outflows were equivalent to more than 5% of GDP a year on average in the 1990s) and money laundering. Banks could be used as corporate treasuries for groups of non-financial enterprises. This was attractive given the lack of trust in unrelated parties, which in turn was in large part a function of the low level of confidence in the rule of law and the protection of property rights. Banks also provided a vehicle for securities speculation. In addition, given that minimum capital for a bank was set as low as USD 1,00,000.

In the first year of transition, commercial banking was very profitable. At the end of 1994, the total capitalization of the commercial banking sector estimated at about 4 per cent of GDP and total value of commercial bank credit amounted to approximately 20 per cent of GDP. During 1992-1995, to maintain stability of the banking system, the Bank of Russia set up a system of supervision and inspection of commercial banks and a system of foreign exchange regulation and foreign exchange control. The banking sector played only a limited role in intermediating savings and investment in the 1990s. Insofar as they

were lenders, banks largely funnelled loans to related companies at rates of interest that had more to do with tax optimisation than true cost of capital. Lending, however, was relatively limited, amounting to little more than a third of bank assets in 1999 (Figure-3.2) and the ratio of bank assets to GDP remained very low.

Figure- 3.2, Lending to total assets ratio in Percentage



1. Loans, deposits and other funds placed with organisations, individuals and credit institutions.
Source: OECD calculations based on Central Bank of Russia

Bank profits were highly reliant on securities transactions. In particular, during the period of fixed exchange rates from 1995 through the onset of the financial crisis in August 1998, banks were able to borrow dollars and buy government treasury bills (GKOs), earning substantial interest margins.

Between 1989 and 1996, the banks' business environment deteriorated because of unstable macroeconomic conditions, Risk management and prudential supervision were weak, accounting standards for banks were below international standards, and ownership of banks was opaque, while screening for fit and proper ownership of banks was largely non-existent. Lending to smaller companies was especially underdeveloped, while consumer and mortgage lending remained embryonic. Consequently, the profitability of the corporate sector was weak and banks had difficulties identifying reliable and profitable borrowers.

During 1993-98, when Russian government introduced 'short-term bonds' known as the GKO's, many banks used their resources including state funds for procuring the GKO's which yielded high interest rates and hence high returns on money. In February 1996, foreign investors were allowed to buy GKO's in primary markets. The Russian stock market rose by 142 per cent in 1996 and 184 per cent during the first eight months of 1997. According to reports, many banks invested about one third of their assets in the GKO's. But when the Russian government declared a moratorium on the encashment of the GKO's in august 1998, many banks including a few large private banks became insolvent. And Russia suffered a collapse in private sector confidence.

During the 1998 Russian financial crisis, private accounts at the SBS-Agro and MENATEP banks, Inkombank, Promstroibank, Most Bank, and Moscow Business Bank were frozen. Depositors at these banks were given the opportunity to transfer their money to the Sberbank at the rate of 9.33 rubles/$.

3.3 Structure of the Russian Banking Sector

The history of Russia's banking system goes back to August 1998 when the first commercial bank was registered. The formation of non-governmental financial and credit structures reached a peak in late 1991 following the commercialization of state banks and the emergence of private ones.

On March 1, 2001, the aggregate assets belonging to credit institutions amounted to 309.3 billion rubles, or 12.2% of the country's banking sector. On October 1, 2001, 1,322 credit organizations were in operation in Russia. The largest of them are based in Moscow and St. Petersburg (Russia Today 2002).

Russia's banking system has a two-tier structure. The first tier is represented by state-owned banks and banks where the state has a blocking package of stock or more. The second tier is represented by private commercial banks where the state's package of stock is either below the blocking package or non-existent. The state owes banks by virtue of

participation in their assets by the Central Bank, other state agencies and companies, local governments and economic structures founded by them. In October 2001 the state held stock in 679 banks, with a controlling block in 62 banks and a blocking package in 80. Most of them are small banks, which have no tangible impact on the formation of the market, and the state's presence in them is nominal rather than determining their operations.

The share of the banks where more than half of the assets belong to the state accounts for less than two percent of the country's credit establishments. However, they include several leading banks, such as Sberbank and Vneshtorg bank. Such banks play a fairly significant role on the market of banking services. These banks account for 35% of the assets of the entire banking system, 34% of aggregate equity capital and 41% of the credits granted to non-banking borrowers. The Bank of Russia (the Central Bank of the Russian Federation) forms the basis of Russia's banking system. It is the nation's only bank issuing banknotes and overseeing and regulating the work of commercial banks on the basis of a law on banks and banking activity. The Bank of Russia holds the controlling stock of the country's two leading banks-Sberbank and Vneshtorg bank. Through these banks it controls some 30% of the assets of the whole banking system. Nearly three fourths of the populations' deposits-close to 400 billion rubles are in Sberbank.

Another leading bank is USSR Vneshekonombank. This financial agent of the government is responsible for the servicing of the foreign debt of the former Soviet Union.

Russian banks abroad occupy a special place in Russia's banking system. They are Eurobank (Paris), Moscow Narodny Bank, Ltd (London), Ost-West Handelsbank (Frankfurt), East-West United Bank (Luxemburg) and Donau-Bank (Vienna). The stock of the latter three banks has been bought out of the Bank of Russia and now belongs to Vneshtorgbank. But since the Bank of Russia holds controlling interest at Vneshtorgbank the Russian banks abroad retain their "state status". Another group of banks controlled by

state structures includes banks belonging to regional administrations. The top twenty credit and financial establishments of that sort are represented by the Bank of Moscow and Bashcreditbank. They service the budget of Moscow and the Republic of Bashkortostan respectively.

The second group of Russian banks includes credit and financial structures with zero or insignificant state participation: commercial banks servicing separate industries, the banks of major companies, banking structures forming the financial basis of powerful holdings representing diversified businesses and small and medium-sized banks catering to individual enterprises.

A few examples of industrial banks: Gazprombank which belongs to the Gazprom joint-stock company, Konversbank which caters to the Atomic Energy Ministry and related enterprises and Rosselkhozbank financing the agro-industrial complex.

Major holdings have the financial backing of MENATEP-SPB (it services the Rosprom holding and the YUKOS oil company), ROSBANK (the Interros holding is its leading client), Alfa-Bank (it caters to the Alfa-Group), and MDM-Bank servicing the MDM Group. Most of them are major multi-purpose banks with a widely diversified credit portfolio.

In recent years several major private banks have attracted growing amounts of money from various organizations and enterprises and expanded the scope of lending. For example, non-financial organizations have more than trebled their deposits in Alfa-Bank since the start of the year 2000. The corresponding figure for Rosbank has trebled, and for Trust and Investment Bank it has gone up more than seven times. Medium-sized and small banks are playing a dwindling role in the Russian economy. Their number has dropped significantly since the mid-90s. Enterprises are finding it less profitable to set up their own banks, and they prefer to turn to leading commercial banks. The automobile concern in Togliatti, for example, has its own bank-AvtoVAZbank.

Bank associations have been playing a growing role in Russia's banking system in recent years. They are set up to heighten the efficiency of financial and credit institutions and organize cooperation between them. They also lobby the interests of the banking community at various levels of government. The leading associations include the Association of Russian Banks, the Association of the Banks of Central Russia and Inter-Bank Financial House.

The Russian banking system includes five functional groups of banks to cater to various businesses: credit banks, banks of settlements, market banks, "bankers' banks," and retail banks. Although this is a fairly relative configuration, each group has its own distinguishing features as far as the structure of its capital and activities are concerned. The share of commercial credits in the assets of credit banks accounts for more than 60%, with customers' money in liabilities amounting to more than 50%. This group is represented by such relatively large banks as Promsvyazbank, Promtorgbank, Bashkreditbank, Baltiisky Bank and Vozrozhdeniye. Settlement and cash services are the main job of banks of settlements. Their assets are dominated by correspondent account balance in the Central Bank and major foreign banks (more than 50%). Their liabilities are dominated by their clients' account balance (more than 70%). Examples of banks of settlements include Surgutneftegazbank, Khanty-Mansiisk Bank, Metallurgical Commercial Bank in Cherepovets (the bank of settlements of the Severstal joint-stock company) and Krasbank. As a rule, such banks cater to one customer or a small group of industrialists.

Speculative operations on securities markets form the basis of market banks, with credits accounting for only a negligible part of their business. Liabilities are dominated by their own capital. These banks include the International Financial Company, Russo-German Trading Bank, Roseksimbank, Sovfintrade and National Reserve Bank.

The main element of the assets and liabilities of "bankers' banks" is operations on the inter-bank market and cash operations with correspondent accounts. Many of them are foreign branch banks: Iktisat Bank (Moscow), Credit Suisse First Boston (Moscow), BNP

Dresdner Bank and others. Some purely Russian banks, such as Globeks and Vis-à-vis also gravitate to this group.Retail banks have a diversified structure of assets. Basically, they are multi-purpose banks capable of providing a wide spectrum of services on the financial market. They include, for example, Avangard, Industrial-Construction Bank in St. Petersburg and Menatep. Governmental and non-governmental agencies control the work of Russian banks. On the government side the Central Bank bears the brunt of the overseeing function. The finance ministry, the interior ministry, the FSB and other institutions of state authority too are involved in control over the banking system within the framework of relevant legislation. Audit and consulting firms are among the non-governmental agencies of control over banking activities (RussiaToday 2002).

3.4 Principal Goal

In April 2005, the Russian Government and Bank of Russia adopted the Banking Sector Development Strategy for the Period up to 2008, a document which set as the main objective of banking sector development in the medium term (2005-2008) the enhancement of the banking sector's stability and efficiency (Bank of Russia 2009).

The principal goals of banking sector development are as follows:

- increasing the protection of interests of depositors and other creditors of banks;
- enhancing the effectiveness of the banking sector's activity in accumulating household and enterprise sector funds and transforming them into loans and investments;
- making Russian credit institutions more competitive;
- preventing the use of credit institutions in dishonest commercial practices and illegal activities, especially the financing of terrorism and money laundering;
- promoting the development of the competitive environment and ensuring the transparency of credit institutions;
- building up investor, creditor and depositor confidence in the banking sector.

The banking sector reform was formulated to help implement Russia's medium-term social and economic development programme (2005-2008), especially its objective to end the raw materials bias of the Russian economy by rapidly diversifying it and utilizing its competitive advantages. At the next stage (2009-2015), the Russian Government and Bank of Russia will attach priority to effectively positioning the Russian banking sector on international financial markets (Bank of Russia 2009).

3.5 Banking Sector Reforms since 1991 till 1998

The Russian banking system has developed from the centralized system of the Soviet period into a two-tier system, including a central bank and commercial banks. The Russian Central Bank (RCB) assumed the functions of Gosbank in November 1991, and Gosbank was eliminated when the Soviet Union dissolved one month later. In its first years of existence, the RCB functioned under the guidelines of the 1977 Soviet constitution and after passing Russian laws in 1990, bank became an instrument of the Russian parliament, whose members manipulated bank policy to help favored enterprises.

Russia's 1993 constitution gave the RCB more autonomy. However, the president has substantial influence on bank policies through his power to appoint the bank chairman, who in turn wields extensive authority over bank operations and policy. (The nomination is subject to the approval of the State Duma). Viktor Gerashchenko, a former Gosbank chairman, was the first chairman of the RCB. In late 1994, he resigned under pressure from President Yeltsin after the so-called Black Tuesday plunge of the ruble's value on exchange markets.

The Law on the Central Bank, enacted in April 1995, provides the statutory authority for the RCB. Under the law, the RCB is responsible for controlling the country's money supply, monitoring transactions among banks, implementing the federal budget and servicing Russia's foreign debt, monitoring the foreign-exchange rate of the ruble, implementing Russian exchange-rate policies, maintaining foreign currency reserves and gold reserves, licensing commercial banks, and regulating and supervising commercial banks.

The RCB has had the greatest impact on Russia's economy through its role in monetary policy. The RCB controls the money supply by lending funds to commercial banks and by establishing their reserve requirements. For several years after its establishment, the RCB issued direct credits to enterprises and to the agricultural sector at subsidized rates. Such credits were directed via commercial banks to politically influential sectors: agriculture, the industrial and energy enterprises of the northern regions, the energy sector in general, and other large, state-run enterprises.

In the early years, the RCB also financed state budget deficits by issuing credits to cover Government expenditures. The availability of such credits played a central role in the high inflation that the Russian economy endured between 1991 and 1994. In 1995 new legislation and regulations reduced this type of credit by prohibiting the use of credit to finance state budget deficits. Such restrictions have been heavily influenced by requirements of the IMF to maintain strict fiscal and monetary standards to be eligible for international financial assistance.

Initially, the RCB's regulation of commercial banks also was lax because the banking sector grew rapidly as the centralized economy collapsed and because Russia had no experience in establishing a market-based system. In the early and mid-1990s, the failure of regulation led to a plethora of new commercial banks, most of which were of dubious quality.

In the mid-1990s, the World Bank assisted the Russian government in establishing a core of large banks, called international standard banks, that met the standards of the Bank for International Settlements (BIS).

3.5a Banking Sector after 1998 Financial Crisis

The 1998 financial crisis had several crippling effects on banks. The quadrupling of the Rouble-Dollar exchange rate in a short period was devastating for banks reliant on borrowing abroad to fund purchases of Rouble securities, while on the asset side, the government defaulted on its domestic bonds, and went on to impose on holders of the

defaulted debt a restructuring involving deep discounts. At the same time, the sharp recession pushed up non-performing loans, and bond and equity prices collapsed. Many banks, including some of the largest private ones, failed. There was a flight of deposits to the public banks (especially Sberbank, the largest bank in the system), which benefited from a government guarantee by December 1999, Sberbank alone accounted for some 80% of household deposits.

3.5b Restructuring

The Russian financial crisis in August 1998 caused a great deal of damage to the banking sector. In the second half of 1998, there was a drastic change in bank asset and liability structure. Bank equity capital declined sharply and the capital- to-net-assets ratio decreased from 20% at the beginning of November 1998. Banks financial condition worsened and all commercial banks except Sberbank, went into the red. Household deposits were either frozen or withdrawn and transferred to Sberbank. Firm's demand deposits also fell. A large amount of debt to non-residents remained on bank balance sheets. Payments on short-term government securities were frozen indefinitely. Bank lending to firms decreased by 41 % in August 1998 alone. As a result of the rapid decrease of assets and increase of bad loans, the banking sector came on the stage of bankruptcy. One-fifth of Russia's bank had gone bankrupt by mid-2000 (Mizobata 2002).

State control over the financial system in Russia was strengthened. The first stabilization measure taken by the Central Bank of Russia was ensuring safety of residents' deposits. Household at six troubled banks designated by the CBR or frozen. Secondly, the CBR lowered reserve requirements and used the freed funds for the repayment of arrears. Thirdly, the CBR extended loans to commercial banks in need of liquidity. Besides, the CBR classified banks into four types.

I. Banks with a sound financial position;
II. Banks experiencing some financial difficulties;
III. Banks in serious financial trouble; and
IV. Banks hurt most heavily by the crisis.

Banks were also devided into those that needed government support and those that could manage without it (Mizobata 2002).

There were four fundamental policies related to the post-crisis restructuring of the banking of the banking sector.

I. The CBR encouraged mergers among large banks to create new independent holding banks, for example, ONEKSIMbank, Menatep and Rosebank.
II. The CBR fined or withdrew the licences of banks that could not match reserve requirements. The law on the bankruptcy of credit organizations of 25 February 1999 was the legal basis for bank sector restructuring.
III. The government strengthened its control of the banking system through stabilization loans, restrictions on capital flight and other measures. For example, the government took capital participation in some banks. The state-owned Sberbank and Vneshtorgbank (The foreign Trade Bank) expanded the scope of their operations to the commercial banking field.

Besides, Russian Development Bank (RDB) was established which aimed to stimulate investment in the real sector. The concept of this bank was approved in 1999, with its capital being set at 375 million rubles. Besides this, the concept of a state agricultural bank (Rosselkhozbank) was finally approved by the government at the end of 1999 as a result of intense lobbing by the Lower House and the Ministry of Agriculture. This new bank, established with capital of 327 million rubles, took over the assets of the former agricultural commercial bank (SBS-Agro), which used to be the government's agent for disbursing agricultural loans. Government set up another financial institution ARCO in March 1999 with the objective of creating an efficient banking system. ARCO was a non-profit public corporation owned by the Federal Property Fund and the CBR.

According to the Law on the Restructuring of Credit Organisations of July 1999, the main functions of ARCO were supervision of troubled banks, acquisition of bank assets based on restructuring schemes and participation in the liquidation process. ARCO controlled commercial banks through the provision of financing and management. And

the CBR used to supervise ARCO. The CBR extended loans to ARCO, with bank shares serving as collateral (Tekeeva 1999).

IV. Foreign Banks were encouraged to expand their operations. The CBR pegged maximum limit of Russian bank shares at 12 per cent of bank capital. And the limit was expected to be relaxed as the share of bank capital owned by foreigners exceeded 10 per cent at a beginning of 2000. The share of foreign capital was less than 4.5 per cent in 1996-98 and 5.3 per cent in October-December 1998. Besides, the CBR published the instruction which permitted the transfer of individuals' money to foreign banks (less than 75 thousand dollars) (Kommersant-Daily 2001).

One-fifth of russia's banks had gone bankrupt by mid-2000. It was evident, then that the banking sector needed a large amount of funds for its rehabilitation and to tackle the challenges of credit risks; market risks and risks of loss of liquidity. To override the consequences of the 1998 financial crisis, the Bank of Russia took steps towards restructuring the banking system in order to improve the performance of commercial banks and increase their liquidity.

The first stabilization measure taken by the CBR was ensuring the safety of resident's deposits. The CBR also encouraged mergers among large banks to create new independent holding banks. Through stabilization loans, restrictions on capital flight and other measures, the government strengthened its control of the banking system.

Foreign banks were encouraged to expand their operations. All such reforms and anti-crisis measures gave a new shape to banking sectors in Russia. By the end of 2004 state banks owned 41% of the banking sector in terms of the volume of assets (incl. Sberbank 28%, Vneshtorgbank 6%, Gazprombank 5% and Vneshekonombank 2%). The share of the remaining 1,295 banks reached a total of 59% of the market. The latter are dominated by banks owned by large financial and industrial groups, such as Alfa-Bank (Alfa), Rosbank (Interros), Sobinbank, Petrokommertsbank and URALSIB (LUKOIL), MDM-Bank (MDM), Trust & Investment Bank and Menatep.

The Russian banking system is regionally concentrated. If we see table- 3.1, on 1 September, 2005, about 60% of operating credit institutions are situated in the Central Federal District of Russia, whereas 50% of all credit institutions are located in the city of Moscow. The territorial distribution of credit institutions generally shows the economic success of the respective areas.

Table-3.1, Regional distribution of credit institutions in Russia (as at 1 September 2005)

	Credit Institutions	**Share of the total number (%)**	**Operating branches**	**Share of branches (%)**	**Total**	**Share of the total sum (%)**
Russian Federation	1,270	100.0	3,283	100.0	4,553	100.0
Central District	724	57.0	728	22.2	1,452	31.9
Moscow	639	50.3	135	4.1	774	17.0
North-West District	84	6.6	374	11.4	458	10.0
St. Petersburg	42	3.3	129	3.9	171	3.8
South District	128	10.1	470	14.3	598	13.1
Volga District	150	11.8	662	20.2	812	17.8
The Urals	67	5.3	385	11.7	452	9.9
Siberia	74	5.8	446	13.6	520	11.4
Far-East	43	3.4	218	6.6	261	5.7

*Source: Bank of Russia

And at the end of 2005, there were 1,258 banks in Russia. Although the number of banks was decreasing considerably, the banking sector development remained fast. Within a year i.e., from October 2004 till October 2005, banks assets increased 36 per cent, the total volume of credit granted to the private sector grew 47 per cent and household loans nearly doubled. The number of banks had only decreased to about 1,250 at the end of 2007, nearly 60 per cent of which failed to meet the minimum capitalization requirement.

Due to the balanced monetary and exchange rate policies pursued by the Bank of Russia, the country's international reserves have grown and there have been no sharp fluctuations in the exchange rate (Pollisinski 2006) . The efforts made by the Bank of Russia with regard to the payment system were designed to increase its reliability and efficiency for financial and economic stability. To make the Russian payment system more transparent,

the Bank of Russia introduced reports on payments by credit institutions and its own regional branches, which took into account international experience, methodology and practice of surveillance over payment systems.

In 2003, the Bank of Russia launched a project designed to improve banking supervision and prudential reporting by introducing international financial reporting standards (IFRS).

The banking sector reform was made to help implement Russia's medium-term social and economic development programme (2005-2008), especially its objective to end the raw materials bias of the Russian economy by rapidly diversifying it and utilising its competitive advantages. At the next stage (2009-2015), the Russian Government and Bank of Russia will attach priority to effectively positioning the Russian banking sector on international financial markets (Bank of Russia 2009).

3.6 Banking Sector Reforms since 1999

The banking sector in Russia was in dire need of reform after the 1998 financial crisis this was because of at least three reasons. First, the ability to sustain the positive economic gains made in the last few years depend, to a large extent, on a well functioning banking sector. The existing system was inadequate to support economic growth as very little of its activity consists of financial intermediation Komulainen et al (2003), Rautava (1996), Ruhl (2001), Tompson (1997)]. Since banking sector helps improving economic growth by mobilizing savings and making this available to meet the demand for investment. Second, it was expected that reform would prevent a repeat of the 1998 banking crisis and avoid contagion by keeping the problems of Russian banks from igniting global financial turmoil. Third, Russia's desire to join the World Trade Organization (WTO) points out to the urgency of reform as the banking and financial sector has to conform to WTO obligations.

After the 1998 financial crisis, the average annual growth rates since 2000 have been about 7 per cent in Russia. The situation in the Russian banks has improved markedly.

At the end of Putin's second term in office, a stable macroeconomic environment and responsible fiscal policies have created favourable conditions for financial development. Under banking sector reform, the Bank team proposed an Action Plan to be followed during 2000. The Plan was built on the lessons learned from the experience since the crisis began in 1998 and at the same time, building the necessary understandings to allow development of a longer-term strategic approach to bank restructuring in Russia.

The Action Plan was organized into three strategic areas: (1) continued consolidation of the banking sector; (2) creation of a small number of viable core banks; and (3) establishment of a competitive and transparent environment for banking. The agenda for 2000 was full of high expectation and had an urgency of concerted efforts on the part of the authorities to implement. The objective behind this action plan was to accelerate the restructuring of banking system to achieve desired level of financial growth.

Under banking sector reform, deposit insurance scheme in 2003 was introduced. The following table shows the recent important reforms in Russia's banking sector:

Table 3.2 Reforms After 1998

Year	Reform
1998	Federal Law, "on Mortgages"
2003	Fit and proper standards for bank owners, and greater scrutiny of sources of bank-capital;
	Improved enforcement of bank's rights over pledged collateral;
	limited reporting- requirements based on international standards(IFRS);
	Law on mortgage back securities.
2004	Introduction of deposit insurance system (admission of individual banks conditional in compliance with a set of 12 prudential standards);
	Minimum capital requirements for newly created banks (waved for existing banks until 2010).
2005	Law on 'Credit Histories' and introduction of credit bureaux;
	Mortgage legislation including on securities.
2006	Complete elimination of capital account controls.

In 2006, the banking sector expanded its net credit to non-financial enterprises by about RUB 1 trillion i.e., about 46 per cent in terms of 2005 GDP. Russian banking sector moved some distance towards an improved framework like separate banking supervision. Bank credit was increased to meet the financing requirements of medium sized enterprises. Average maturities of bank liabilities also lengthened, including in international funding, such as syndicated loans, allowing banks to lengthen terms on their assets while limiting maturity mismatches. This encouraging trend was primarily the result of expectations of macroeconomic stability, as evident in a much reduced inflation rate. Banks could extend credit maturity and hence push back exercising the option of calling a loan. And similarly, increasing trend was also prevailing in the case of mortgage market. Maximum maturities lengthened to 30 years while competition was beginning to bring rates down. Growth was stronger in Russia's regions than in Moscow. This had been fuelling a construction boom, which showed 16 per cent growth in 2007. Equally remarkable was the shift of the banking system out of dollars. Slightly over one fifth of total bank credit to the private sector was still in foreign currency in 2007, though this share continues to decline (Berglof, Lehmann 2009).

Table- 3.3, Key indicators of bank credit to the non-financial corporate sector

	2001	2002	2003	2004	2005	2006	2007
Share of corp. credit in roubles at maturities							
above one year	18.0	21.9	28.3	32.1	37.0	38.7	45.2
above three years	5.9	4.9	5.3	7.0	10.2	13.3	18.8
Share of foreign currency credit to							
enterprises	30.6	34.5	33.0	27.6	29.3	24.6	22.5
households	17.9	18.5	17.9	15.1	15.1	15.0	13.0

Source: CBR

Russia's credit boom was due to a set of reforms aimed at both the broad context of contract enforcement, and at the integrity of the financial sector as such. Problems in the sector were again underlined by the illiquidity problems that returned to parts of the banking system in the fall of 2007, a range of measures were adopted by the CBR and the government to secure the liquidity of the sector but inflation was taking place at an

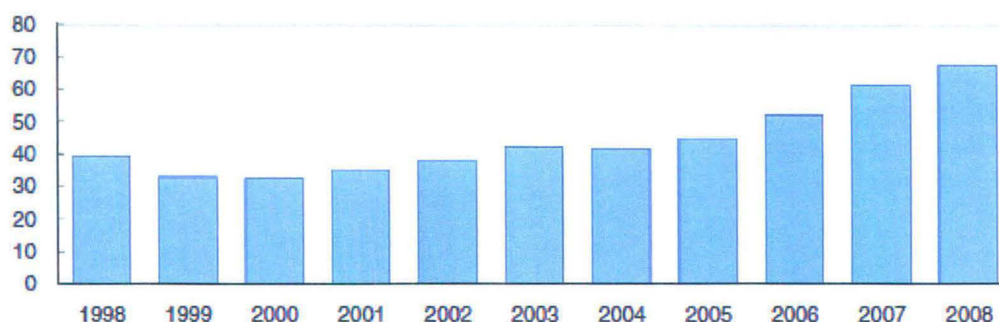
increasing rate. The period of illiquidity in Russia's banking sector since the summer of 2007 enhanced challenges to further reforms in the sector.

3.6a Bank Sector Recovery

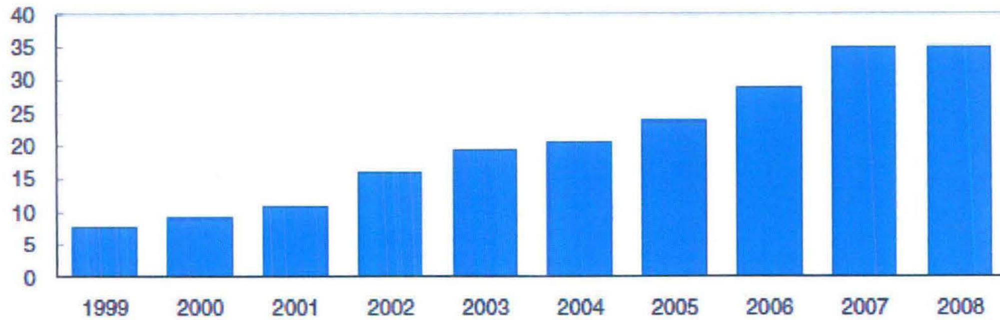
After the 1998 financial crisis, it is said that 1999 was the year when banks adopted to the new conditions in the Russian banking system.

Total capital of commercial banks increased by 2.8 times in the first quarter of 2000, compared to the bottom of March 1999. The reasons for this were the net capital increase and the withdral of problem bank licenses. The share of problem banks in total assets and in personal deposits respectively decreased from 45.5 per cent to 20 per cent and from 13.9 per cent to 7 per cent in 1999 and during 1999, share of stable bank rose from 65.4 per cent to 76.5 per cent. In particular, with the oil price rising from the lows of under USD 10 a barrel in 1998 to the high-twenties in 2000, the fortunes of the important energy sector took a sharp turn for the better. Against this favourable macroeconomic background, bank assets, deposits, capital, profits, and market capitalisation all increased (Figure-3.3).

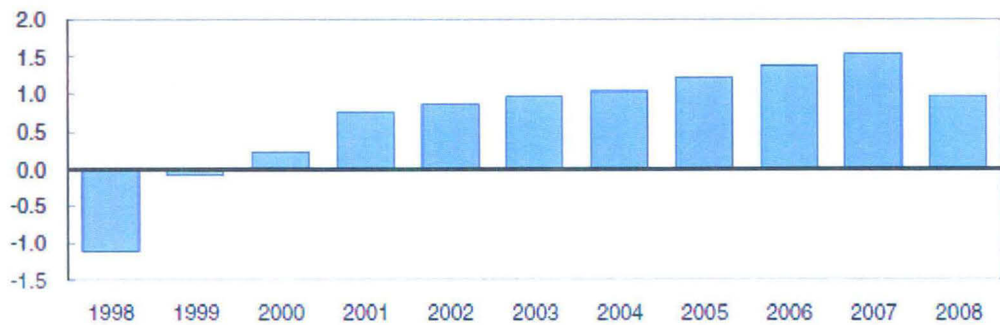
Figure- 3.3. Post-crisis recovery of the banking system
A. Banks assets (percentage of GDP)



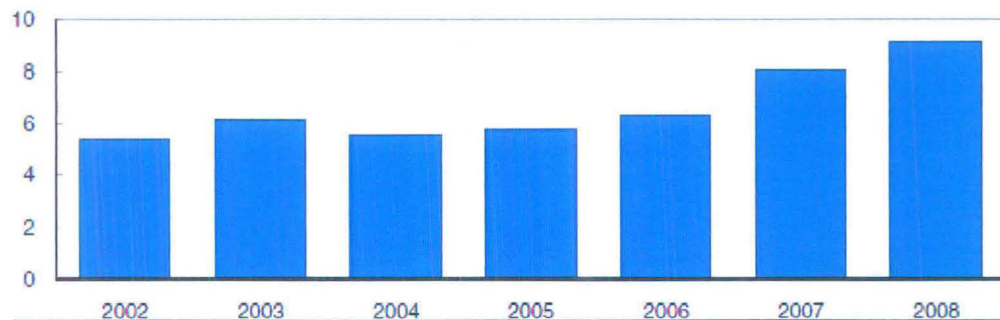
B. Deposits (percentage of GDP)[1]



C.Profits(+)/losses(-) (percentage of GDP)



D. Equity capital (percentage of GDP)[2]

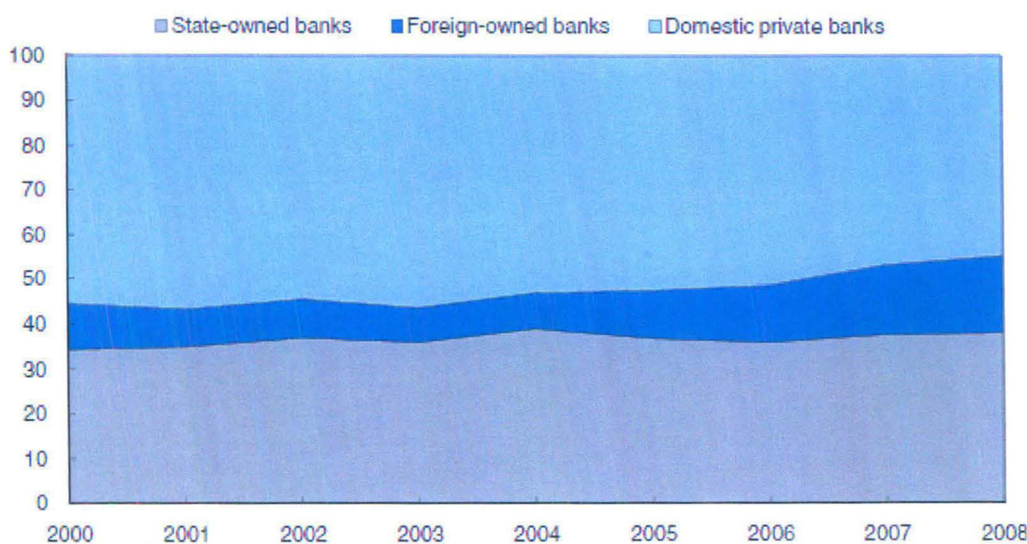


1. Deposits of individuals, individual entrepreneurs and organisations (financial and non-financial). A methodological change in 2002 makes earlier data not directly comparable.
2. Data are available only from 2002 for equity capital.

Source: OECD calculations based on Central Bank of Russia and Federal Service for State Statistics.
http://dx.doi.org/10.1787/650271678132

In support of the improved macroeconomic conditions, a number of structural reforms were also underway at this time. In the wake of the crisis numerous changes were made to the banking laws to streamline bank bankruptcy, permit earlier resolution of failing banks, and tighten regulation on fit and proper ownership of banks. Also, in 2001 an anti-money laundering agency was launched and in the following year Russia was removed from the Financial Action Task Force blacklist. In 2002 the CBR released a strategy for the banking sector covering the period through 2008. Among the most important elements of that strategy were the proposals to: require banks to submit financial statements under International Financial Reporting Standards (IFRS) (see part-1, Appendix); introduce deposit insurance for household deposits (see part-2, Appendices); and improve the effectiveness of prudential supervision. The introduction of a deposit insurance scheme was itself intended to be an important step in improving supervision, as banks wanting to join the scheme were effectively subjected to a relicensing. All groups of banks experienced rapid growth in assets and deposits after the 1998 financial crisis and there was little change in the market share of state-owned banks, domestic private banks, and foreign banks (Figure- 3.4)

Figure- 3.4. **Ownership structure of the banking system**
Share in total assets



Source: Interfax.

http://dx.doi.org/10.1787/650276548588

Sberbank's share of household deposits fell from 80% to under 60% between late-1998 and 2002. At the same time, Sberbank expanded its share of other deposit and loan segments, as did VTB. The government divested itself of holdings in hundreds of banks, but maintained its much smaller number of majority stakes, and injected equity capital into the major state-owned banks. The post-crisis recovery period witnessed a gradual but fairly steady consolidation of the sector. After the initial wave of bank failures in the wake of the 1998 crisis, there were very few bank bankruptcies or license withdrawals for reasons of capital insufficiency (OECD Economic Surveys: Russian Federation 2009).

Initially, consolidation happened largely *via* the acquisition of regional banks by Moscow based private banks trying to build national branch networks. Later, the main contributor to consolidation was the removal of licenses from (generally small) banks for money laundering offences. During the period 1999-2004 the number of banks fell from 1 476 to 1 299. While the growth and strengthening of the banking sector were almost continuous from 1999 onward, there was one significant hiccup in the summer of 2004, when a liquidity crisis claimed a few medium-sized banks and caused a short-lived run on deposits. It did, however, underline the limitations of the CBR's instruments to support liquidity, and highlighted the importance of leveling the playing field between private and state-owned banks as regards deposit guarantees.

3.7 Performance of Russian Banks

Since 1999 Russian economy has been rapidly developing and the growth domestic product in 2006 was 6.7 per cent. The banking sector's growth outpaced growth in GDP. The capital base of Russian credit institutions increased from 0.6 trillion rubles as of January 1, 2003 to 2.3 trillion rubles as of June 1, 2007. The dominance of state-owned banks remains very high. Simultaneously, we see a rapid decrease in Russian banks. Since January 2004 to September 2007, almost two hundred credit institutions ceased to exist, mostly on money-laundering charges. Russian banking sector is one of the most profitable sectors of economy. Since 1999 till 2007, the return on bank assets has amounted to 2.5%-3.5%, and the return on equity has consistently exceeded 20%. Profit

of Russia's top 30 banks grew by 24.3% in January-August 2007, to RUR252bn ($10.08bn, or €7.15bn). This is the main reason for growing competition in the sector as well as for increasing number of mergers and acquisitions. Russia's economic growth and high profitability of Russian banks attract foreign capital into the banking sector. By September 1, 2007, there were 58 credit organizations in which foreign capital accounted for 100 percent of authorized capital, and 22 credit organizations in which foreigners controlled more than 50 percent. The leading automobile brands are establishing their own Russian banking or finance subsidiaries. In June 2007, Toyota received a license, becoming the first foreign carmaker with a permit to establish its own financial operations in Russia.

Some Russian bankers feel threatened by the intervention of foreign capital, others are looking for cooperation with foreign banks. We also know that foreign banks in Russia play a very positive role for the sector as a whole. They offer a wider specter of affordable banking services in terms of credits and deposit programs and this certainly leads to reducing credits' rates of interest (Lopukhim 2008).

The banking sector shows signs of becoming a genuinely service-oriented business. The total value of loans to non-financial enterprises and households showed very extensive growth (till 2007). In 2004 the ratio of outstanding credit to businesses and households to GDP amounted to 19.5% or 1.8 trillion rubles in absolute terms, by the middle of 2007 this ratio reached 30% and exceeded 9 trillion rubles. Credits issued by Russian lending organizations to various enterprises and organizations, banks and private individuals in Rubles and foreign currency, including loans to foreign states, rose by 24.8% from January-July 2007 to R10.968 trillion on August 1, 2007. The share of credits, issued to enterprises and organizations for under year and more, grew to 50.1% of the overall volume of credits issued to them and distributed by due dates, as compared to 48.8% on July 1, 2007. The growth rate of the retail market segment is significantly higher than the corporate one, especially in terms of loans. The volume of mortgage loans represent about 10% of all retail loans. The ratio of household deposits to GDP as of January 1, 2005 was 11.9 per cent, by the end of 2007 it reached 15% of GDP. It was substantially

influenced by the emergence of a deposit insurance system. Now all household deposits under 4,00,000 rubles are covered by state insurance. The main problem of Russian banks is a shortage of equity capital. Assets are growing much faster than equity funds. Till 2007, many Russian banks were already reaching the critical amount of equity capital as a percentage of assets, 10%-11%. The percentage of banks with capital adequacy ratio of over 14 percent dropped by 2.9 percent to 55.4 percent; the number of banks with capital adequacy of between 12 and 14 percent declined 6.7 percent to 15.9 percent, while the percentage of banks with capital adequacy of 10 to 12 percent went up 9.6 percent. "Apparently, the decrease in the percentage of banks with a high liquidity ratio was connected with the withdrawal of funds by banks from correspondent accounts and from their deposits in the Central Bank. Capital adequacy ratio reflects the amount of risk-free assets, including deposits in the Central Bank. Many Russian banks are trying to solve the problem. They are actively searching for the new sources of financing for the next stage of their growth. They are seeking to attract international investors, either through IPOs or as strategic partners. It was also reflected in the success of IPOs in 2007, launched by the leaders of the Russian banking market-Sberbank and VTB – for the total amount around 16.8 bn USD.

On January 1, 2007, Russia's Stabilisation Fund held RUR2.346tn ($93.92bn, or € 66.52bn at the current exchange rate). By September 30, it grew by RUR1.245tn to RUR3.519tn ($140.87bn, or €99.77bn) in rouble equivalent. In this situation a financial crisis was unlikely in Russia in 2007. October 2007, there was some shortage of disposable funds in the banking system together with a degree of mistrust between financial institutions.

3.8 Macroeconomic Conditions and Monetary Policy

Since the severe financial and economic crisis of August 1998, banks in Russia have recovered a lot. To create favorable conditions for sustainable economic growth, Russia's bank pursued a monetary policy aimed at consistently reducing inflation and maintaining the stability of the national currency 'ruble'.

In terms of GDP, the past eight years have seen the Russian economy grow at an annual rate of over 7%. Economic growth, increasing export revenue, fiscal surpluses, the structural reforms of earlier in the decade and developments in international financial markets have all served to enhance the extraordinarily rapid growth in recent years in the Russian financial sector. Government external debt reduced from 158 billion dollars as of the end of 1998 to about 45 billion dollars beginning of 2007.Despite this recent brisk growth, the Russian banking sector remains relatively small. Managing money supply stands out as the dominant monetary policy tool rather than the interest rate. The Central Bank claims to aim at a transfer to a free float and inflation targeting using the interest rate in the medium term. Development over the past years supports this reform option, but the 2008 crisis could impede financial market maturity leaving the Central Bank dependent on money supply as its main tool. The Russian trade surplus has been substantial over the last years leading to significant inflow of foreign currency. Large foreign currency earnings tend to erode domestic competiveness on domestic and global markets through upward pressure on the exchange rate. If foreign earnings are spent, windfall profits also tend to heat up the economy leading to inflationary pressures that both erode the domestic value of export earnings and put further strain on tradables' competitive position.

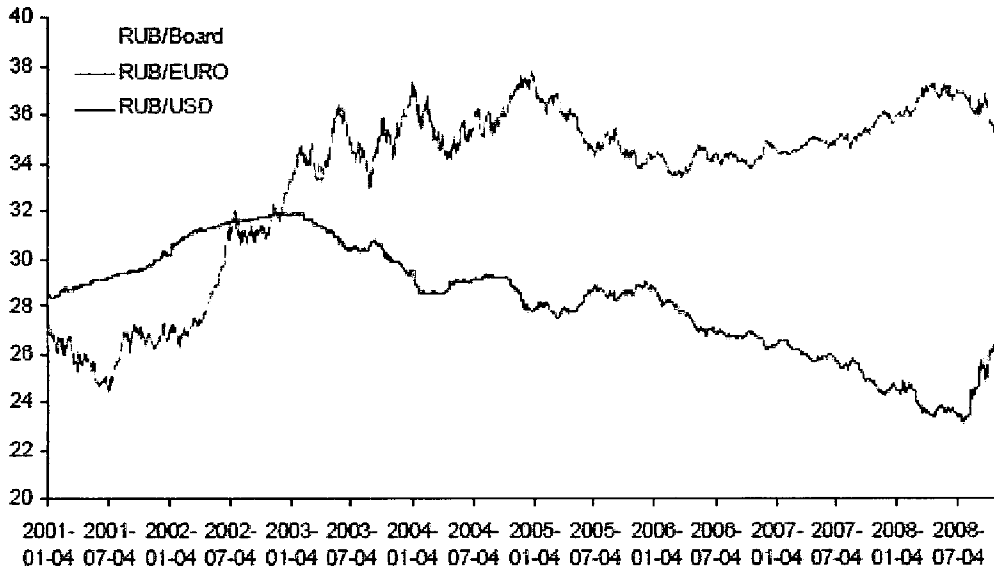
Pre- and post-1998 Russian monetary policies have been made the subject of several studies. Vdovichenko and Voronina (2004) estimate decision rules for monetary policy based on the Taylor and McCallum rules for the years 2000-2003. The authors concluded that the interest rate has played a minor role in monetary policy as opposed to managing base money supply. The study furthermore concludes that inflation, output and the real exchange rate are the CBR's target variables, with the latter dominating the former two. Esanov et al. (2004) achieve similar results identifying also a structural break in the data in 1995 with the introduction of an exchange rate peg. Ivanova (2007) estimates the equilibrium real exchange rate for Russia based on a trade balance approach and thus provides an assessment of on-going real exchange rate targeting. She finds that the Russian real exchange rate was undervalued by 45-85 % in 2006 depending on the choice of price deflator when calculating the real exchange rate.

Ivanova attributes this undervaluation to the Central Bank of the Russian Federation's (CBR) policy of balancing inflation and exchange rate concerns. However, the real ruble undervaluation found by Ivanova provides apparent testimony to the success of real exchange rate targeting by the CBR. As a new financial crisis is underway, the effect of the interest rate on money demand appears weak. On this accord, liquidity has been withdrawn from the market by issuing bonds and raising banks' reserve requirements. In theory, a country practicing capital controls can counter foreign exchange interventions by issuing bonds for the equivalent amount leaving money supply unchanged. However after a ban on almost all capital controls imposed in 2006, the CBR has been left with even more limited opportunity to conduct such sterilizing operations. Since then increasing emphasis in CBR policy documents has been given to conversion to a free float in order to allow for full-fledged inflation targeting (Fjærtoft 2008).

In 2007 the following goal was stated for the CBR's exchange rate policy: "Its (CBR's..) exchange rate policy will aim to mitigate abrupt fluctuations in the exchange rate that are not caused by fundamental economic factors and take into account the necessity of curbing inflation and keeping domestic producer prices competitive." (Bank of Russia 2007). The CBR sets daily exchange rates that are intended to function as benchmarks for price formation. In periods of upward pressure to the exchange rate this involves issuing rubles to satisfy ruble demand due to oversupply of foreign currency. These open market operations extend domestic money supply with accompanying inflationary effects.

Since 2003 the ruble has steadily appreciated vis-à-vis the dollar, and on average official exchange rates have decreased by 0.4 % a month in the period 2003-2007 but starting in 2006 official exchange rates increased on average by 0.1 % each month. As visible from Figure- 3.5, in 2008, and especially from its third quarter and on recent exchange rate, trends have changed – both in relation to the dollar and the euro. In total the ruble has appreciated 17 % in relation to the dollar and depreciated almost 40 % in relation to the euro in the period 2001-2008 based on yearly averages.

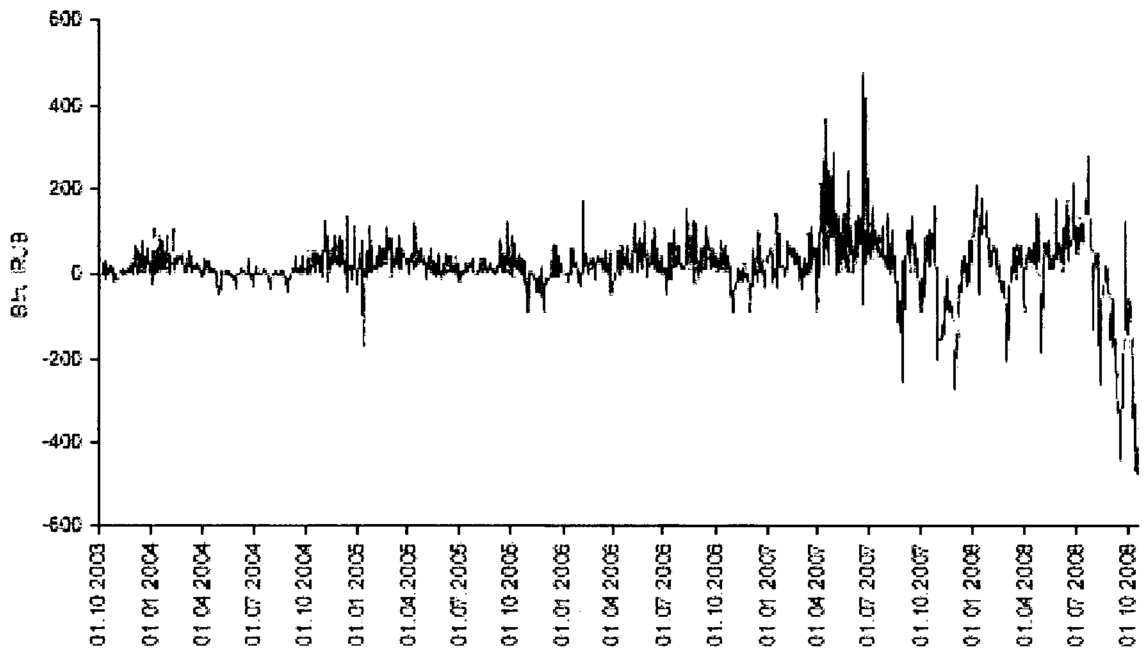
Figure- 3.5, Central Bank Exchange Rates 2001-2008



Source: CBR.RU

As Figure- 3.6 shows Net Added Liquidity by the CBR has been predominantly positive and also particularly pronounced in the first half of 2007 and 2008; both of which being periods of an oil price rally.

Figure- 3.6, Net Added Liquidity 2003-2008, Daily Data



*Source: CBR.RU

Managing money supply stands out as the dominant instrument of monetary policy, at least in the period 2000-2005. The CBR focuses on expanding money supply proportionally to money demand growth which is described to be a function of GDP growth and velocity of money. In its policy documents the CBR (2007 & 2008) highlights the goal of moderating inflation and in 2007 the Bank aimed to achieve a year-on-year inflation of 6-7 % in 2008. The trade-off between exchange rate manipulation and inflation arises along two channels:

- **Demand substitution in favor of domestic goods and services.** Exchange rate manipulation, geared at the ruble being valued below is ceteris paribus equilibrium level alters relative prices and increases domestic and foreign demand for domestic goods and services. Assuming some relation between output and capacity utilization, and capacity utilization and prices, increased capacity utilization following an increase in demand will trigger a rise in capacity prices that feeds into the price of output.

- **Expansion in money supply.** When purchasing foreign exchange with rubles, the CBR expands the supply of rubles in the domestic money market. This reduces the ruble's real value measured in goods due to increasing prices.

Russian demand growth has been recognized as a strong and major contributor to economic growth over the past years (e.g. OECD 2004 & BOFIT 2008). Managing demand growth is therefore important in managing inflation.

Money market equilibrium requires real money supply to equal money demand. As mathematical illustration of a typical approach to developed money markets one can suggest the following simplistic equation:

$$\frac{M}{P} = D_M(Y,r); D'_Y > 0 \vee D'_r < 0 \qquad (1)$$

The right-hand side of the equation (1) represents real money supply where M is nominal money supply and P is the price level. The left hand side, money demand, is function of income Y (real GDP) and the real interest rate r representing the opportunity cost of holding money.

Outside this equation (1), an increase in M, reduces the nominal interest rate in the domestic money market (price of money) increasing money demand and reinstating equality of supply and demand. A decrease in r also has a positive influence on money demand through its effect on investment demand and consequently Y.

The exchange equation says that nominal income over a certain period of time must move on par with the amount of money in the economy multiplied by the average times a unit of money is spent over the period of time (velocity of money). The idea is that an increase in income will increase the amount of money demanded for additional purchases. If money growth exceeds the growth of real income, this will lead to an increase in prices.

$$MV = PY \rightarrow M^{*}_{S/D} = PY/V \qquad (2)$$

Where V is the velocity of money, and M^* is the nominal value of money satisfying supply and demand. V is assumed to the reciprocal of the desired ratio of money to income. In short this means that if economic agents increase their demand for money at a given level of income, V will decrease.

Now differentiating equation (2), we get

$$dP/p = dM/M - \left[dV/V + dY/Y\right] \qquad (3)$$

This equation says that changes in prices are a function of changes in the money stock less of changes to velocity and real income. Thus money growth has to be managed so

that the economy has the liquidity is needs without fostering inflation. To this end the CBR has practiced money programs stipulating scenario-based growth in M2.

There are several reasons why Russian monetary policy is formulated to a larger degree within the framework of equations (2) and (3). One reason that is also highlighted by the CBR is the interest rate's relatively modest effect on domestic money demand (Fjærtoft 2008).

Following the collapse of the Soviet Union, the Russian economy became highly dollarized. Oomes (2003) provides estimates of currency dollarization in the Russian economy reaching 80 % of total currency during the 1990's. The 1998 devaluation of the ruble wept out the population's savings, leaving little faith in the countries financial institutions and hence limited use of ruble denominated deposits and thus also limited scope for issuing ruble denominated credit.

The Russian mortgage market has increased its share in the consumer credit market in recent years (from 3.6 % of total consumer credits in 2005 to 15.6 % in 2007 (Bank of Russia 2008)), nonetheless mortgage's share of GDP remains low. In 2006 total mortgages amounted to 0.3 % of GDP while in 2007 the share has risen to 1%.

Although the CBR (2007) comments on the progress of de-dollarization, Russia's prevailing exchange rate regime hinders using the interest rate as a dominant policy instrument for containing inflation. If anything, the interest rate can be used for exchange rate targeting and in 2004, the CBR proposed that the most important role of the Bank's interest rate was to counter additional in- and outflows of capital arising on the basis of emerging balance-of-payments trends (Bank of Russia 2004).

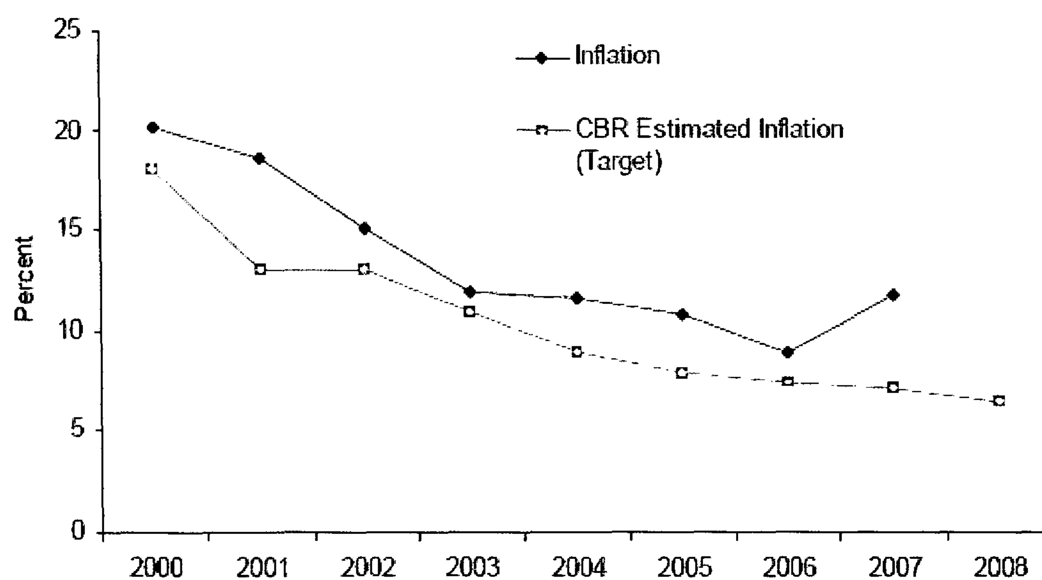
Common to both models is a positive relation between liquidity, output and prices. Liquidity expansion increases demand, which positively affects output. However, to the extent that an economy is resource constrained (e.g. steep input supply curve), increased demand following an expansion in M, will to a larger degree result in nominal price

effects rather than an increase in Y. It follows that the more constrained the economy is, the larger the price effects relative to output effects of an increase in M. As the Russian economy appears increasingly capacity constrained, monetary expansion can be expected to have increasing inflationary effects (WB 2008).

3.8a Inflation and Money Growth

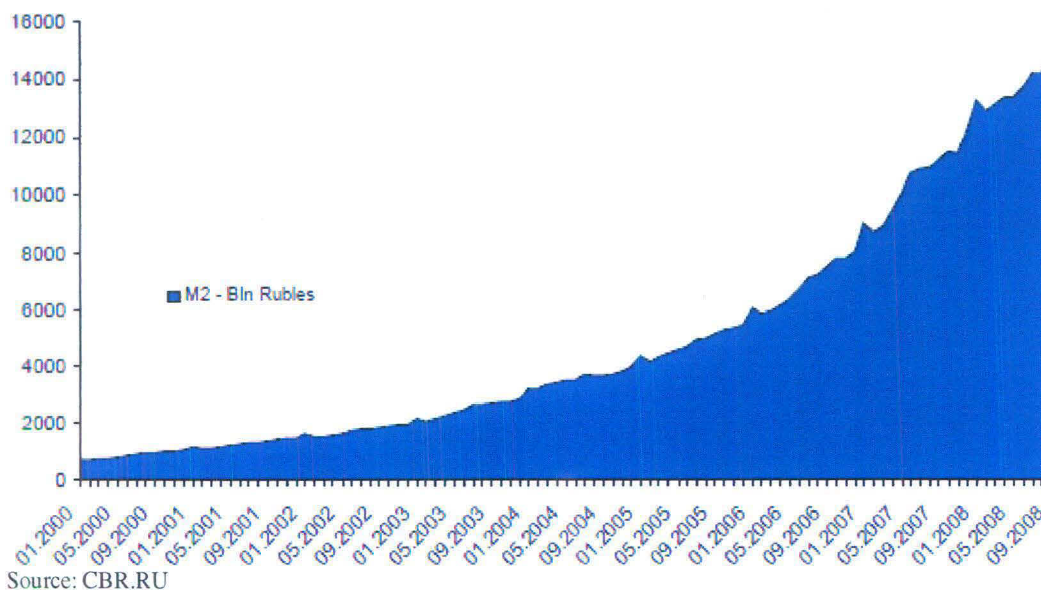
Russian inflation has declined year on year since 2000 with the exception of 2007, when inflation rose to 11 %. As can be seen from Figure– 3.7, inflation has consistently been higher than CBR inflation targets. While the 2008 target stood at 6-7 % in mid 2007, inflation in 2008 is now expected to exceed 12 % (Fjærtoft 2008).

Figure- 3.7, Inflation, Actual Targets YoY December 2000-2007



Source: GKS.RU, CBR.RU

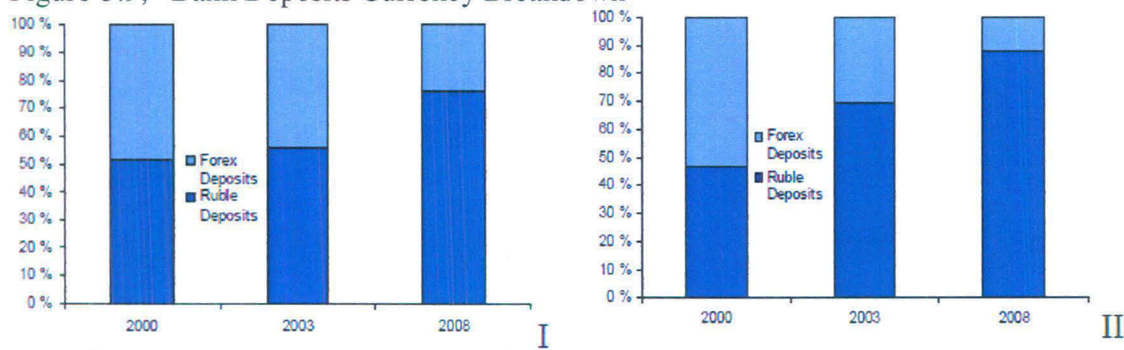
Figure- 3.8, Nominal Money Supply M2



Source: CBR.RU

Russian M2 has grown approximately 40 % each year since 2000. During this period annual inflation has averaged 13 % and real GDP growth has averaged approximately 7 %.

Figure-3.9, Bank Deposits Currency Breakdown

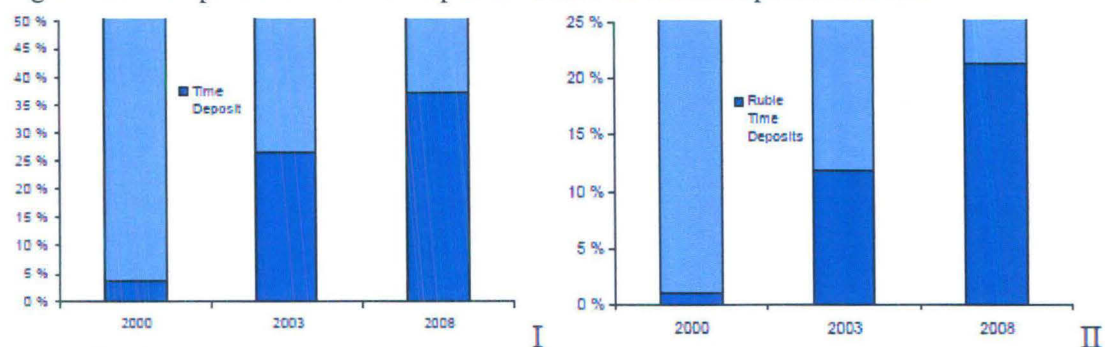


Source: CBR.RU

Following the theoretical foundation behind equation (2) decreasing velocity should reflect an increasing demand for money for all levels of income. This means that economic agents in Russia need more money than they used to. If the propensity to save is increasing M2 demand will increase more than the income raise. De-dollarization adds momentum to this effect. This Figure- 3.9 provides an illustration of how the ruble has gained foothold in relation to foreign currency has a preferred deposit currency.

Figure- 3.10 shows time deposits have increased their share of total deposits significantly from less than 5 % of total deposits in 2000 to more than 35 % in 2008.19 Furthermore ruble time deposits have shown an equally impressive increase in their share of M2.

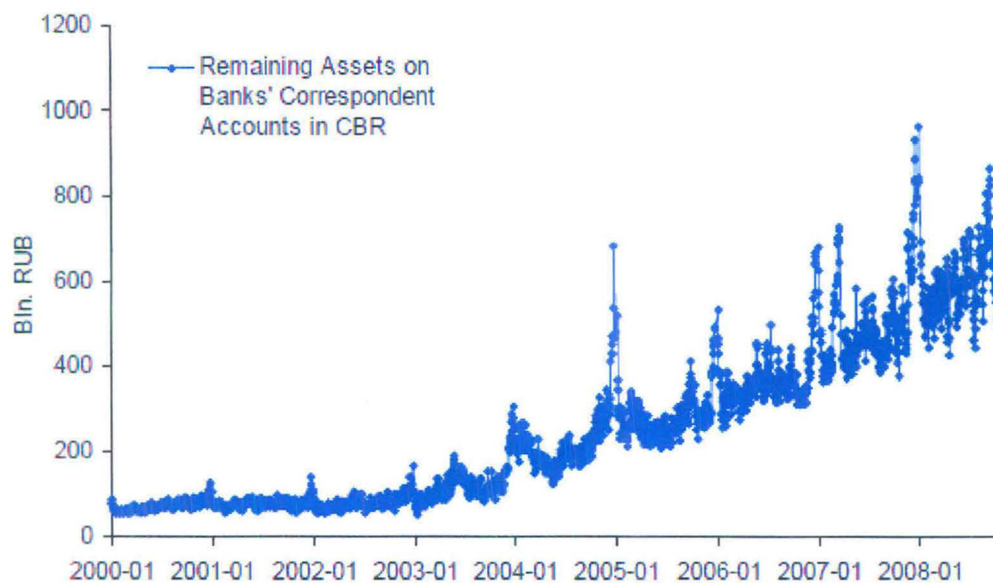
Figure- 3.10 Population's Time Deposits' Share of Total Deposits and M2



Source: CBR.RU

While only roughly half of Russian deposits where held in rubles in 2000, this share had increased to more than 75 % at the outset of 2008. In the beginning of 2008, almost 90 % of time deposits where ruble denominated as opposed to 46 % in 2000.

Figure- 3.11, Banks' Deposits in CBR

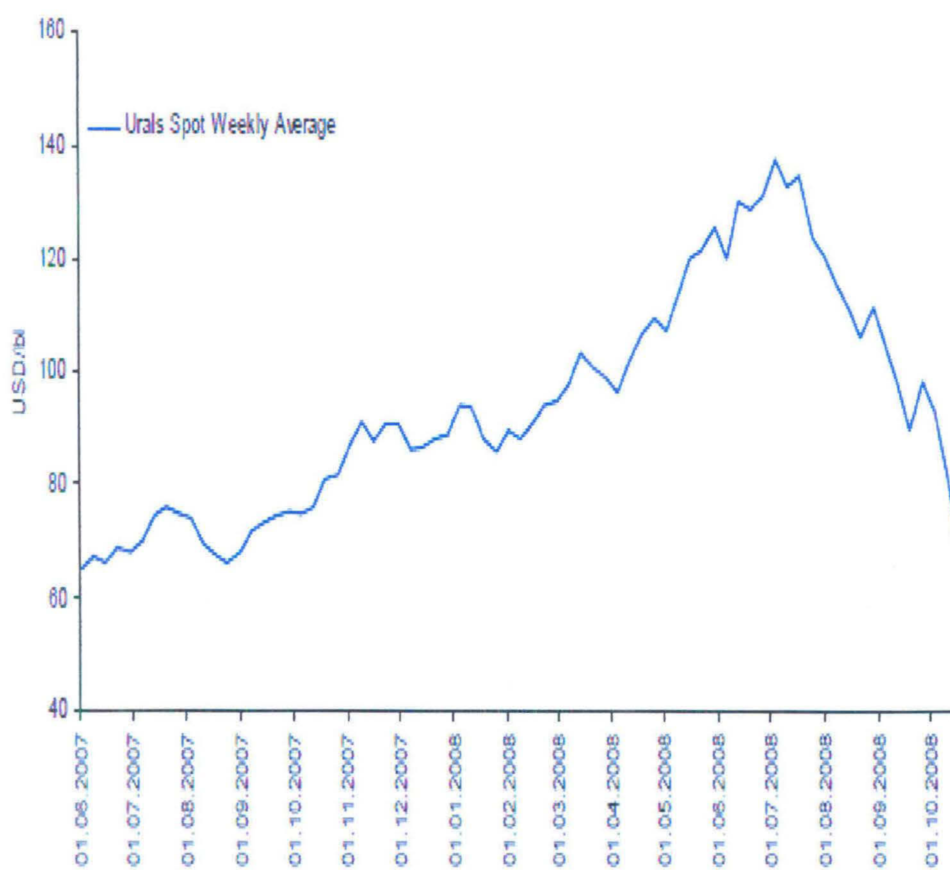


Source: CBR.RU

3.9 Recent developments

The Russian stock market collapsed in May 2008, after a three year rally that had brought the Russian RTS Index up 275 % starting 2005. Although the Russian Trading System (RTS) broke 800 points at closing time November 1 up 3, 8 % from the day before. Last time the RTS stood at 800 was in August 2005, meaning that after a period of strong growth the Russian market is back to start.

Figure- 3.12 , Urals Spot Price June 2007- October 2008



Source: EIA

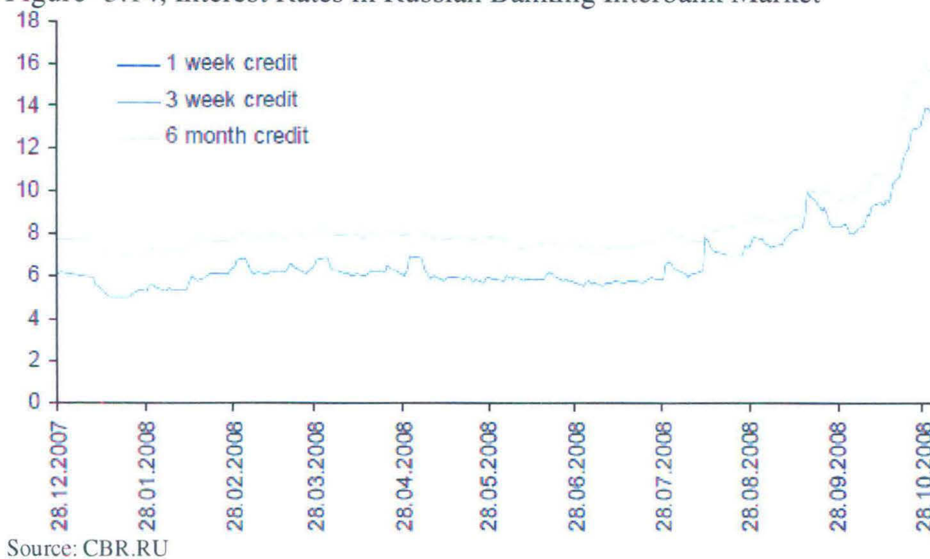
Figure- 3.13, Russian Trading System (RTS) Closing Index

Source: RTS.RU

The first reports of faltering liquidity in the Russian interbank market appeared in late 2007. In February 2008, the CBR reportedly acknowledged a credit crunch on the interbank market, promising to give the task of maintaining liquidity priority.

Figure – 3.14 shows that interest rates on the Russian interbank market roughly doubled from August to November 1 2008.

Figure- 3.14, Interest Rates in Russian Banking Interbank Market



Source: CBR.RU

3.9a Run on the Ruble

The failing Russian stock market reflects a trend that became evident across world markets as the financial crisis unfolded. Investors withdrew from assets deemed insecure and broke for save assets such as government bonds in familiar currencies such as the dollar. This action has brought about an abrupt strengthening of the dollar, despite market fundamentals (sustained budget deficit) pointing the opposite direction.

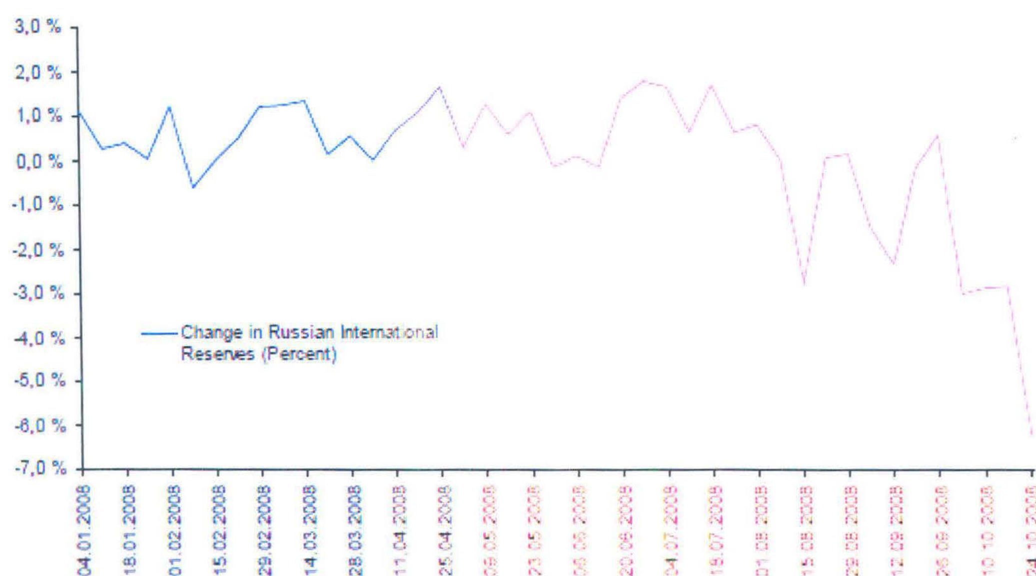
Glancing at Figure- 3.15 , the ruble's dynamics vis-à-vis its main trading currencies show a strikingly different trend post August 2008. The ruble has been weakened considerably vis-à-vis the dollar falling four rubles from 23.1 on July 15 to 27.5 RUB/USD on October 28. The previous strengthening of the ruble can be assumed to have largely been caused by price driven increases in foreign trade revenue in addition to a weakening USD. CBR has intervened heavily in the foreign exchange market in defense of the ruble.

Since their maximum value of $ 597.5 billion on August 8, Russian international reserves had shrunk by near $ 113 billion by October 24. A one-week decrease of $ 31billion from October 17 to October 24 raised significant interest in the press.

Figure- 3.15, Ruble Exchange Rates

Source: CBR.RU

Figure- 3.16, Weekly Changes in Russian Foreign Reserves Measured in USD



Source: CBR.RU

As the ruble seemed sure to continue loosing value, banks seemingly spent the liquidity acquired in liquidity actions to buy foreign currency, thus playing against the ruble. On August 20 $ 500 billion was suggested as the limit after which the CBR would cease open-market operations and succumb to the will of market. The CBR however has shown a stronger commitment to managing the ruble as reserves now most likely stand more than $ 20 billion from this limit. Open-market operations alone seem however not to have been sufficient and in a bid toward off the speculative attack, the CBR has taken to regulatory measures. First the maximum value of currency swaps was reduced from RUB 150 to 10 billion, later minimum interest rates of the liquidity auctions were raised by a percentage point.

3.9b Income Effect and Faith in the Ruble

The 1998 devaluation eradicated the purchasing power of the population's ruble endowments. A new 1998 devaluation would be detrimental to domestic demand and have a serious impact on the economies ability to recover from the crisis.

3.9c Government Bailout

In October 2008 the CBR has conducted four liquidity auctions totaling RUB 1.4 trillion. On November 6, an additional auction was announced for the sum of RUB 150 billion. Although during the first four auctions only 630 billion were issued, the mechanism caused some challenges vis-à-vis the managed float. In mid October the State Duma passed a government bailout package including real sector support, extra-ordinary loans to the banking sector, additional private deposit securitization by the state (from RUB 200 000 to 700 000) and direct support to key banking institutions. In early November the government announced a second wave of action to address real sector challenges more directly. The bailout started with a $ 50 billion transfer to Vneshekonombank to refinance foreign debt. This sum was quickly deemed insufficient, however Vneshekonombank estimated the need for foreign debt financing at $ 120 billion by the end of 2009. Later, Rusal, the world's second largest aluminum producer controlled largely by the oligarch Oleg Deripaska, received a $ 4.5 billion loan to cover foreign liabilities. Vneshekonombank was also to administer a RUB 225 billion support package for the banking sector.

The four banks Sberbank, VTB, Gazprombank and Selkhozbank were initially defined as market bearing and found eligible for extraordinary loans exceeding RUB 700 billion. The government intervened in the stock market, buying first companies with a state-owned majority and later moving into shares of private companies. The first interventions took place on October 22 after a RUB 175 billion transfer from the National Welfare Fund to Vneshekonombank for stock market operations was approved by the State Duma. Later, First Deputy Prime Minister Igor Shuvalov confirmed that the government was also considering acquiring stakes in private companies as a means of supporting real sector firms.

3.10 Consequences of Monetary Policy

The room for maneuver in Russian monetary policy has largely been dictated by the prevailing exchange rate regime. In particular Russia has, in common with all fixed

exchange rate regimes, been prohibited from using the interest rate to influence inflation rates. Large foreign currency purchases in defense of the ruble have expanded money supply being a possible cause of inflation persistently in excess of targets. The CBR has accentuated factors typical of a transaction approach to money demand and M2 targeting stands out as the dominant target variable for inflation control.

The upward pressure to the ruble should subside if not be reversed. If the current account levels out, the CBR will be relieved of having to issue liquidity in defense of the ruble. Thus monetary policy could be allowed to focus on managing inflation alone. Net-liquidity additions should subside and the 2006-2008 100 % annual growth in cumulated added liquidity should fall to a mean growth more in line with equation (3).

The financial crisis has put significant downward pressure to the ruble. Large private sector debt makes an immediate transfer to a free float hard because of the strong downward movements of the ruble if oil prices are not sufficient to support current imports, the CBR will have to follow through with its mid-term goal of a free float. If not, presently abundant foreign reserves risk swift depletion. Whether the CBR opts to float or allows devaluation, a nominal depreciation will spark inflation through more expensive imports and import substitution correcting the real exchange rate.

The income effect from reduced oil and gas revenues, a cut-off of foreign capital inflow and more expensive imports is potentially grave. A negative demand shock might therefore prove a greater worry than inflation. Rising import prices will have negative effects on the economy's supply side as imports are also inputs to domestic production. Combined with weakening demand this could have serious implications for economic growth in coming years and the CBR could face both accelerated inflation and faltering demand.

As the economy starts to contract, fiscal elbow room is a greater blessing than curse. The government has already put to use its rainy-day reserves. If the current account goes negative, these funds will have to continue to be spent rather than accumulated. To the

extent that Russian growth over the past years has been driven by the demand side through increased public expenditure, money market supply shocks coming from the CBR's defense of the ruble and ample supply of investment credit, the Russian economy seems to be ahead of a serious slump.

The financial crisis has at least two potential effects on the development of the financial market pulling in separate directions. De-dollarization, growth in the mortgage market and increased savings suggest a commencing shift in the adequate approach to money demand in line with equation (1). Thus the prerequisites might be coming in place for the interest rate to take the place of money targeting as the dominant tool of monetary policy.

On the one hand increased ruble savings has been built on the back of reclining inflation and expected ruble appreciation. The financial crisis could potentially lead to lost faith in domestic currency and financial markets, halting or reversing recent development in Ruble saving. Credit scarcity will likely limit mortgage market growth. Thus, the financial crisis might lead to setback in the development of a foundation for mature capital markets and Russian monetary policy will have to continue to concentrate on money targeting. Uncertainties related to measuring money aggregates and estimating future velocity make this an imprecise science and the CBR is likely to be less efficient in its inflation targeting behavior.

On the other hand, lamed international credit markets will possibly increase demand for Russian credit (apparently, for now the Russian government has been attempting to satisfy this demand). The financial crisis could in this way hypothetically aid a switch from predominantly foreign to increased ruble denominated credit in the Russian market. A larger share of ruble denominated credit will increase the interest rate's demand effects, making it a more potent tool of monetary policy.

The financial crisis has altered the prerequisites for Russian monetary policy. It remains to be seen if the crisis constitutes a temporary setback or leads to a reversal of past achievements. The improved investment climate and the stable economic situation also

contributed to net private capital inflow. In order to restrict money supply growth, the Central Bank raised interest rates on commercial banks' deposits with the Central Bank several times in 2006 and 2007 (Fjærtoft 2008).

CHAPTER – 4
LIQUIDITY RISK, CREDIT RISK AND MARKET RISK IN THE RUSSIAN BANKING SECTOR

4.1 Introduction

Bank is by nature a business of balancing risks. Being one of the fastest-growing sectors in the economy, Russian banking is also one of the riskiest. The changing environment in which banks find themselves presents major opportunities for banks, but also entails complex, variable risks that challenge traditional approaches to bank management.

4.2 Credit Risk, Liquidity Risk and Market Risk

Credit, liquidity and market risks are components of financial risk. Financial risk is a probability of actual return being less than expected return i.e; an unfavorable condition for financial institution. Financial risk is associated with the use of debt financing by firms or companies. Since the presence of debt involves the legal or mandatory obligation to make specified payments at specified time periods, there is a risk that the earnings of the firm may not be sufficient to meet these obligations towards the creditors. Financial risk is usually measured by the debt/equity ratio of the firm; the higher this ratio, the greater the variability of return and higher the financial risk.

4.2a Credit Risk

Credit risk is defined as the chance that a debtor or finance instrument issuer will not be able to pay interest or repay the principal according to the terms specified in a credit agreement, which can in turn cause cash flow problems and affect a bank's liquidity.

4.2b Liquidity Risk

An asset that can be bought and sold quickly, and without significant price concession and transaction cost is said to be liquid. Liquidity risk refers to inability of banks and financial institutions to meet the liabilities towards depositors when they want to withdraw their deposits. The greater the uncertainty about time element, price concession, and transaction cost, the greater the liquidity risk.

4.2c Market Risk

Market risk is defined as the volatility of income or market value due to fluctuations in underlying market factors such as currency, interest rates, or credit spreads. For commercial banks, the market risk of the stable liquidity investment portfolio arises from mismatches between the risk profile of the assets and their funding. In other words, market risk is the risk that a bank may experience loss due to unfavorable movements in market prices. Exposure to such risk may arise as a result of the bank taking deliberate speculative positions (proprietary trading) or may ensue from the bank's market-making (dealer) activities. Both the stable liquidity investment and proprietary trading portfolios are subject to market risk. Market risk results from the volatility of positions taken in the four fundamental economic markets: interest-sensitive debt securities, equities, currencies, and commodities.

4.3 Credit Risk in Russian banking sector

Credit risk in Russian banking sector is due to the rapid credit growth. Increase in the loans to total assets ratio (see Table-4.1) suggests that the growth of lending has been higher than the growth in total assets, implying a gradual shift towards riskier operations of banks. Domestic banks have significantly higher lending ratios than foreign banks, whereas regional banks tend to lend more than Moscow-based ones. It has been seen in Russia that banks belonging to the deposit insurance system lend more. The share of nonperforming loans (NPL) has indeed increased during the last few years.

When considering banks by ownership, state-controlled banks exhibit significantly higher ratio of nonperforming loans than others in Russia. The recent increase in NPL share is caused mainly by private banks. On the other hand, foreign banks have the lowest level of NPLs, which reflects better credit risk management in Russian economy. The share of nonperforming loans (NPL) has indeed increased during the last few years. When considering banks by ownership, state-controlled banks exhibit significantly higher ratio of nonperforming loans than others in Russia. The recent increase in NPL share is

caused mainly by private banks. On the other hand, foreign banks have the lowest level of NPLs, which reflects better credit risk management in Russian economy.

The ratio of NPLs is increasing with bank's size which points out that large banks are able to sustain larger proportion of NPLs. The difference between small and big banks is decreasing gradually. Shrinking of this gap is the result of both increase in the NPLs ratio of small banks and decrease in the big ones. There are significant differences in the amount of NPLs by location as well. Even though regional banks still tend to have larger ratio of NPLs. Apart from this, the banks that are part of the deposit insurance system have in general higher nonperforming loans ratios than those banks that are not part of deposit insurance system. This is the consequence of higher lending by those banks that are the part of deposit insurance system.

Maximum large credit risk is a regulation ratio that measures proportion of the total amount of large credit risks in the bank's equity capital. It increases over time and tends to be higher for the state-controlled banks and for the regional banks. This could be an indicator of these having close connections with big state-controlled or regional companies. Maximum large credit risk ratio is also higher for larger banks with some exceptional largest banks. Moreover, it is significantly lower for the banks outside the deposit insurance system which once again indicates that banks that are part of the system are able to get engaged in relatively more risky activities.

Table- 4.1, Loans to assets ratio by bank ownership, location, size and participation in the deposit insurance scheme

LOANS TO ASSETS RATIO		1999	2000	2001	2002	2003	2004	2005	2006	2007
TOTAL SAMPLE	obs.	1469	1326	1313	1238	1331	1326	1238	856	1015
	med	0.481	0.428	0.485	0.521	0.535	0.555	0.582	0.614	0.627
OWNERSHIP GROUPS										
Private	obs.	1420	1275	1259	1183	1269	1261	1170	795	946
	med	0.481	0.431	0.491	0.524	0.538	0.556	0.584	0.616	0.628
State-controlled	obs.	30	30	32	30	33	32	32	29	32
	med	0.431	0.418	0.474	0.520	0.531	0.591	0.594	0.633	0.669
Foreign	obs.	19	21	22	25	29	33	36	32	37
	med	0.428	0.276	0.257	0.294	0.414	0.309	0.368	0.500	0.495
medians significantly different		no	yes	yes	yes	yes	yes	no	no	yes
REGION										
Moscow-based banks	obs.	567	571	586	615	646	663	620	357	469
	med	0.425	0.401	0.451	0.493	0.496	0.506	0.515	0.550	0.561
Regional banks	obs.	588	593	595	598	685	663	618	499	546
	med	0.462	0.437	0.505	0.541	0.564	0.596	0.635	0.651	0.659
medians significantly different		yes	yes	yes	yes	yes	yes	yes	yes	yes
SIZE CATEGORIES										
Small	obs.	489	442	437	412	443	442	412	285	338
	med	0.503	0.436	0.499	0.496	0.487	0.516	0.554	0.598	0.552
Medium-sized	obs.	490	442	438	413	444	442	413	285	338
	med	0.486	0.459	0.479	0.522	0.555	0.578	0.585	0.62	0.631
Large	obs.	487	439	435	410	441	439	410	283	336
	med	0.443	0.395	0.478	0.538	0.545	0.568	0.596	0.622	0.671
The Big 3	obs.	3	3	3	3	3	3	3	3	3
	med	0.332	0.363	0.472	0.530	0.437	0.577	0.590	0.495	0.486
medians significantly different		yes	yes	no	no	yes	yes	no	no	yes
DEPOSIT INSURANCE SCHEME										
Included in DIS	obs.					801	801	802	649	632
	med					0.556	0.583	0.610	0.631	0.654
Not included in DIS	obs.					419	525	436	207	172
	med					0.490	0.497	0.503	0.516	0.595
medians significantly different						yes	yes	yes	yes	yes

Note: all the indicators are calculated at the end of the first quarter of each year.

Source: Risk taking by Russian banks: Do location, ownership and size matter? Bofit discussion papers, 21 • 2008, Zuzana fungáčová and laura solanko http://www.bof.fi/bofit

Table – 4.2, Nonperforming loans to total loans by bank ownership, location, size and participation the deposite insurance scheme

NONPERFORMING LOANS		1999	2000	2001	2002	2003	2004	2005	2006	2007
TOTAL SAMPLE	obs.	1423	1275	1265	1181	1280	1277	1226	853	1009
	med	0.019	0.008	0.004	0.003	0.003	0.003	0.005	0.009	0.007
OWNERSHIP GROUPS										
Private	obs.	1374	1226	1214	1128	1220	1214	1159	792	940
	med	0.019	0.008	0.004	0.003	0.003	0.003	0.005	0.009	0.007
State-controlled	obs.	30	30	31	30	33	32	32	29	32
	med	0.022	0.014	0.005	0.014	0.009	0.008	0.008	0.010	0.008
Foreign	obs.	19	19	20	23	27	31	35	32	37
	med	0.000	0.000	0.000	0.002	0.000	0.000	0.000	0.003	0.001
medians significantly different		no	yes	no	yes	yes	yes	yes	no	yes
REGION										
Moscow-based banks	obs.	537	541	559	575	612	630	608	356	464
	med	0.001	0.000	0.000	0.000	0.001	0.001	0.002	0.009	0.006
Regional banks	obs.	575	574	578	582	658	647	618	497	545
	med	0.040	0.018	0.009	0.006	0.006	0.006	0.008	0.009	0.008
medians significantly different		yes	yes	yes	yes	yes	yes	yes	no	yes
SIZE CATEGORIES										
Small	obs.	454	408	403	367	406	406	403	282	333
	med	0.036	0.012	0.008	0.000	0.002	0.001	0.003	0.008	0.005
Medium-sized	obs.	482	432	428	404	436	433	410	285	337
	med	0.011	0.008	0.003	0.003	0.004	0.003	0.004	0.007	0.005
Large	obs.	484	432	431	407	435	435	410	283	336
	med	0.020	0.007	0.003	0.004	0.005	0.005	0.007	0.010	0.009
The Big 3	obs.	3	3	3	3	3	3	3	3	3
	med	0.149	0.046	0.023	0.027	0.019	0.017	0.015	0.012	0.012
medians significantly different		yes	no	no	yes	yes	yes	yes	yes	yes
DEPOSIT INSURANCE										
Included in DI	obs.					797	798	802	647	630
	med					0.005	0.005	0.007	0.008	0.009
Not included in DI	obs.					403	419	424	205	172
	med					0.001	0.001	0.002	0.010	0.005
medians significantly different						yes	yes	yes	no	yes

Note: all the indicators are calculated at the end of the first quarter of each year.
Source : Risk taking by Russian banks: Do location, ownership and size matter? Bofit discussion papers, 21 • 2008, Zuzana fungáčová and laura solanko
http://www.bof.fi/bofit

4.4 Liquidity Risk in Russian banking sector

The Russian banking sector's liquidity as measured by the ratio of liquid to total assets has decreased slightly in recent years, but its level, reported in Table- 4.3 is still comparable to the other transition countries as well as to the quality level recommended by Grier (2001). An analysis of the regulatory ratios of quick and current liquidity confirms that they have remained basically unchanged. Foreign banks and Moscow-based

banks exhibit the highest level of liquidity during the whole period under review. One possible explanation for this phenomenon is that Moscow-based banks are on average less engaged in traditional banking operations (collecting retail deposits and channeling them into corporate loans) than regional banks. Furthermore, Moscow-based banks tend to be more active in interbank money markets and therefore have a larger proportion of their assets in a highly liquid form.

This difference in bank operations is reflected in the increasing gap in the liquidity indicator between Moscow and regional banks. From the point of view of foreign banks, their operations on the emerging market may be considered more risky and this could lead them to the decision to hold more liquid assets. It is, however, important to note that the difference in liquidity between foreign banks on the one hand and state-controlled and private banks on the other has decreased recently. Unlike the divisions by region and ownership, the distribution of banks by size does not indicate any significant differences in liquidity for banks of various sizes. Moreover, in line with the other credit risk indicators, the banks included in the deposit insurance scheme hold lower levels of liquidity and the gap between them and the other Russian banks has been increasing since 2005. In general, high liquidity ratios can be interpreted as having a positive influence on stability at certain levels of liquidity.

In the case of emerging economies, liquidity ratios may also be higher if the government does not actively intervene to meet funding gaps, financial institutions are risk-averse or if there are not enough opportunities for hedging (Moreno, 2006). In that case excessive liquidity could indicate structural problems. A bank may be highly liquid simply because: i) it cannot rely on well functioning interbank markets or other secondary markets such as those for securities; ii) it prefers to distance itself from "traditional" banking operations such as lending in favour of trading in, e.g., government securities; or iii) both.

Despite sufficient liquidity in general, there has been a lack of efficient mechanisms for interbank intermediation of liquidity. The Russian interbank market is relatively small even in comparison to other emerging markets (Moreno, 2006). This is especially the

result of high segmentation and low trust on the interbank market (Barisitz, 2008), even among the big state-controlled banks. Russian banks are highly liquid but the banking system as a whole is not. Due to the lack of trust, the banking system is vulnerable to occasional liquidity shocks as experienced in summer 2004 and autumn 2007. This clearly complicates banks' liquidity management as well as the conduct of monetary policy in Russia.

Table- 4.3, Liquidity Ratio by bank ownership, location, size and participation in the deposit insurance scheme

LIQUIDITY RATIO		1999	2000	2001	2002	2003	2004	2005	2006	2007
TOTAL SAMPLE	obs.	1469	1326	1311	1238	1331	1326	1238	856	1015
	med	0.236	0.301	0.291	0.283	0.284	0.281	0.256	0.222	0.220
OWNERSHIP GROUPS										
Private	obs.	1420	1275	1257	1183	1269	1261	1170	795	946
	med	0.231	0.299	0.287	0.279	0.276	0.278	0.255	0.221	0.220
State-controlled	obs.	30	30	32	30	33	32	32	29	32
	med	0.334	0.328	0.315	0.325	0.296	0.269	0.224	0.195	0.180
Foreign	obs.	19	21	22	25	29	33	36	32	37
	med	0.420	0.590	0.521	0.518	0.429	0.405	0.334	0.230	0.260
medians significantly different		yes	yes	yes	yes	yes	yes	yes	no	no
REGION										
Moscow-based banks	obs.	567	571	586	615	646	663	620	357	469
	med	0.279	0.344	0.338	0.321	0.334	0.335	0.322	0.278	0.280
Regional banks	obs.	588	593	595	598	685	663	618	499	546
	med	0.259	0.296	0.271	0.258	0.247	0.240	0.201	0.187	0.180
medians significantly different		no	yes	yes	yes	yes	yes	yes	yes	yes
SIZE CATEGORIES										
Small	obs.	489	442	437	412	443	442	412	285	338
	med	0.184	0.249	0.253	0.274	0.281	0.277	0.253	0.234	0.290
Medium-sized	obs.	490	442	437	413	444	442	413	285	338
	med	0.218	0.295	0.289	0.284	0.277	0.291	0.263	0.230	0.220
Large	obs.	487	439	434	410	441	439	410	283	336
	med	0.298	0.370	0.323	0.288	0.288	0.279	0.254	0.200	0.180
The Big 3	obs.	3	3	3	3	3	3	3	3	3
	med	0.406	0.283	0.304	0.261	0.354	0.273	0.265	0.230	0.230
medians significantly different		yes	yes	yes	no	no	no	no	no	yes
DEPOSIT INSURANCE (DI)										
Included in DI	obs.					801	802	802	649	632
	med					0.265	0.268	0.226	0.199	0.185
Not included in DI	obs.					419	434	436	206	172
	med					0.316	0.329	0.336	0.315	0.290
medians significantly different						yes	yes	yes	yes	yes

Note: all the indicators are calculated at the end of the first quarter of each year.

Source : Risk taking by Russian banks: Do location, ownership and size matter? Bofit discussion papers, 21 • 2008, Zuzana fungáčová and laura solanko
http://www.bof.fi/bofit

4.5 Market Risk in Russian banking sector

The net interest margin[1] as a percentage of loans is often used as a proxy for the efficiency of financial intermediation, thus uncovering the health of the banking sector. Higher margins indicate lower efficiency and lower competition within the sector and thereby possibly also higher risk whereas foreign banks have significantly lower net interest margins than private banks, even though recent developments suggest that the net, interest margins of foreign banks have increased to the level of state-controlled ones (see Table- 4.4). In this respect, lower margins most probably reflect the greater efficiency of foreign banks which is connected to the support and know-how from their parent companies. Zuzana Fungáčová and Laura Solanko, in their findings, say that their indicators are in line with Karas et al. (2008), who find that Russian state banks are more efficient than domestic private banks. The net interest margin decreases with the bank's size and therefore it is the lowest for the group of the three largest banks. Regional banks used to have significantly higher net interest margins. However, the situation has changed recently and consequently Moscow-based banks have slightly higher margins, which suggests increasing efficiency and/or competition. After the implementation of the DIS, the net interest margins of the banks included in it decreased and became significantly lower than the margins of the other banks. This development indicates a positive impact of the DIS introduction on the banking sector's competition and efficiency.

[1] The net interest margin is calculated as the difference between the interest income from loans to customers and the interest expense paid on customer deposits.

Table- 4.4, Net interest margin to total loans by bank ownership, location, size and participation in the deposit insurance scheme

NET INTEREST MARGIN		1999	2000	2001	2002	2003	2004	2005	2006	2007
TOTAL SAMPLE	obs.	1423	1277	1262	1181	1280	1277	1229	761	942
	med	0.023	0.035	0.029	0.036	0.033	0.029	0.028	0.025	0.024
OWNERSHIP GROUPS										
Private	obs.	1374	1229	1211	1129	1221	1214	1161	709	878
	med	0.023	0.036	0.030	0.036	0.033	0.029	0.028	0.025	0.024
State-controlled	obs.	30	29	31	30	33	32	33	25	32
	med	0.042	0.046	0.034	0.041	0.030	0.024	0.023	0.018	0.020
Foreign	obs.	19	19	20	22	26	31	36	27	32
	med	0.016	0.015	0.016	0.013	0.014	0.012	0.013	0.017	0.020
medians significantly different		yes	yes	yes	yes	yes	yes	yes	yes	yes
REGION										
Moscow-based banks	obs.	537	544	560	575	612	630	611	311	434
	med	0.014	0.020	0.018	0.028	0.026	0.025	0.028	0.025	0.026
Regional banks	obs.	575	574	578	583	668	647	618	450	508
	med	0.046	0.053	0.040	0.044	0.038	0.032	0.027	0.024	0.023
medians significantly different		yes	yes	yes	yes	yes	yes	no	no	yes
SIZE CATEGORIES										
Small	obs.	454	411	405	368	406	406	406	346	286
	med	0.040	0.053	0.040	0.048	0.047	0.039	0.036	0.032	0.032
Medium-sized	obs.	482	431	425	403	436	433	410	263	327
	med	0.030	0.039	0.031	0.036	0.032	0.029	0.028	0.023	0.024
Large	obs.	484	433	429	407	435	435	410	249	326
	med	0.016	0.024	0.024	0.029	0.027	0.024	0.023	0.021	0.019
The Big 3	obs.	3	2	3	3	3	3	3	3	3
	med	0.006	0.006	0.008	0.021	0.015	0.014	0.017	0.018	0.014
medians significantly different		yes	yes	yes	yes	yes	yes	yes	yes	yes
DEPOSIT INSURANCE SCHEME										
Included in DIS	obs.	777	778	785	733	797	799	802	587	694
	med	0.033	0.040	0.035	0.038	0.033	0.029	0.026	0.024	0.022
Not included in DIS	obs.	349	347	356	355	403	418	424	173	217
	med	0.023	0.028	0.024	0.033	0.031	0.029	0.031	0.028	0.029
medians significantly different		yes	yes	yes	yes	yes	no	yes	yes	yes

Note: all the indicators are calculated at the end of the first quarter of each year.
Source : Risk taking by Russian banks: Do location, ownership and size matter? Bofit discussion papers, 21 • 2008, Zuzana fungáčová and laura solanko http://www.bof.fi/bofit

4.6 RISK MANAGEMENT

Risk management in banking sector is the practice of creating economic value by using financial instrument to mitigate or control unfavorable risks particularly credit risk, liquidity risk and market risk.

In the banking sector, the Basel Accords are generally adopted for tracking, reporting and exposing credit, liquidity and market risks.

Credit Risk Management

Desipte innovation in the financial services sector, credit risk is still the major cause of bank failures. Because of the potential dire effects of credit risk, it is important to perform a comprehensive evaluation of a bank's capacity to assess, administer, supervise, enforce, and recover loans, advances, guarantees, and other credit instruments (Greuning, Bratanovic 2008).

The credit risk management reviews the following themes:

- Credit portfolio management
- Lending function and operations
- Credit portfolio quality review
- Nonperforming loan portfolio
- Credit risk management policies
- Policies to limit or reduce credit risk
- Asset classification
- Loan loss provisioning policy

Credit Portfolio Management

A lending policy should contain an outline of the scope and allocation of a bank's credit facilities and the manner in which a credit portfolio is managed, i.e., how loans are originated, appraised, supervised, and collected. Flexibility must exist to allow for fast

reaction and early adaptation to changing conditions in a bank's earning assets mix and market environment.

Considerations that form the basis for sound lending policies include the following:

- Limit on total outstanding loans. A limit on the total loan portfolio is expressed to deposits, capital, or total assets. In setting such a limit, factors such as credit demand, the volatility of deposits, and credit risks should be taken into account.
- Geographic limits are usually a dilemma. If a bank lacks understanding of its diverse markets and/or does not have quality management, geographic diversification may become a reason for bad loan problems. On the other hand, the imposition of strict geographical limit can also create problems, particularly in the case of regions with narrow economies. In any case, a bank's business market should be clearly delineated and commensurate with its market knowledge and managerial and staff experience. Bank officers should be fully aware of specific geographical limitations for lending purposes, an aspect that is particularly relevant for new banks.
- Credit concentrations. A lending policy should stimulate portfolio diversification and strike a balance between maximum yield and minimum risk and all concentrations be viewed and reported on a frequent basis.
- Distribution by category. Limitation based on aggregate percentages of total loans in commercial, real estate, consumer, or other credit categories are common. Policies related to such limitations should allow for deviations that are approved by the board.
- Type of loans. Types of credit that have resulted in an abnormal loss should be controlled by senior management or avoided completely. A lending policy should specify the types of loans and other credit instruments and should provide guidelines for specific loans.
- Maturities. A lending policy should establish the maximum maturity for each type of credit, and loans should be granted with a realistic repayment schedule.
- Loan pricing. Rates on various loan types must be sufficient to cover the costs of funds, loan supervision, administration (including general overhead), and probable losses. At the same time they should provide a reasonable margin of

profit. Rates should be periodically reviewed and adjusted to reflect changes in costs or competitive factors.

- Lending authority is often determined by the size of a bank. In smaller banks, it is typically centralized. In order to avoid delays in lending process, larger banks tend to decentralize according to geographical area, lending products, and/or types of customers. A lending policy should establish limits for all lending officers.
- Appraisal process. A lending policy should outline acceptable types and limits on the amount of appraisals should be outlined for each type of credit facility.
- Maximum ratio of loan amount to the market value of pledged securities. A lending policy should set forth margin requirements for all types of marketability of securities that are accepted as collateral. A lending policy should also assign responsibility and establish a timetable for periodic pricing of collateral.
- Financial statement disclosure. A should recognize a loan, whether original or purchased, in its balance sheet.
- Impairment. A bank should identify and recognize the impairment of a loan or a collectively assessed group of loans. Impairment can be recognized by reducing the carrying amount of the loan to its estimated realizable value through an existing allowance or by charging the income statement during the period in which the impairment occurs.
- Collections. A lending policy should define delinquent obligations of all types and specify the appropriate reports to be submitted to the board. These reports should include sufficient detail to allow for the determination of the risk factor, loss potential, and alternative course of action. The policy should require a follow- up collection procedure that is systematic and becomes progressively stronger. Guidelines should be established to ensure that all major problem loans are presented to and reviewed by the board.
- Financial information. The safe extension of credit depends on complete and accurate information regarding every detail of the borrower's credit standing. A lending policy should define the financial statement requirements for businesses and individuals at various borrowing levels and should include appropriate guidelines for audited, non-audited, interim, cash flow, and other statements. It

should include external credits checks required at the time of periodic updates. If the loan maturity is longer than one year, the policy should require that the bank's officers prepare financial projections with the horizon equivalent to the loan maturity, to ensure that the loan can be repaid from cash flow. All requirements should be defined in such a manner that any negative credit data would clearly indicate a violation of the bank's lending policy.

Lending function and operations

When Carrying out its duties on behalf of both depositors and shareholders, a board of directors must ensure that a bank's lending functions fulfills three fundamental objectives:

- Loans should be granted on a sound and collectibles basis;
- Funds should be invested profitably for the benefit of shareholders and the protection of depositors;
- The legitimate credit needs of economic agents and/or households should be satisfied.

Human resources analysis, information flow etc. help lending policy, monitoring in credit management.

Credit Portfolio Quality Review

A loan portfolio reflects a bank's market position and demand, its business and risk strategy, and its credit extension capability. A detailed credit portfolio review should include the following:

- All loans to borrowers with aggregate exposure larger than 5 percent of the bank's capital;
- All loans to shareholders and connected parties;
- All loans for which the interest or repayment terms have been rescheduled or otherwise altered since the granting of the loan;
- All loans for which cash payment of interest and/or principal is more than 30 days past due, including those for which interest has been capitalized or rolled over;
- All loans classified as substandards, doubtful, or loss.

In each of these cases, a loan review should consider documentation in the borrower's file and involve a discussion of the borrower's business, near-term prospects, and credit history with the responsible credit officer. The specific objective of these reviews is to assess the likelihood that the credit will be paid.

Beyond loans, interbank deposits are the most important category of assets for which a bank carries the credit risk. A review of interbank lending typically focuses on the following aspects:

- The establishment and observation of counterparty credit limits, including a description of existing credit limit policy;
- Any interbank credits for which specific provisions should be made;
- The method and accuracy of reconciliation of nostro and vostro accounts;
- Any interbank credits with terms of pricing that are not the market norm;
- The concentration of interbank exposure with a detailed listing of banks and amounts outstanding as well as lending limits.

All off-balance-sheet commitments that incur credit exposure should also be reviewed. The key objective of a review of individual off-balance-sheet items is to assess the ability of the client to meet particular financial commitments in a timely manner (Greuning, Bratanovic 2008).

Nonperforming loan portfolio

An analysis of the aggregate loan portfolio provides a good picture of a bank's business profile and business priorities, as well as the type of credit risk that the bank is expected and willing to take. Among these loans, nonperforming loans are often considered to be nonperforming when principal or interest on them is due and left unpaid for 90 days or more (this period may vary by jurisdiction). The analysis of a nonperforming loan portfolio should cover a number of aspects, as follows :

- A list of nonperforming loans, including all relevant details, should be assessed, on a case-by-case basis to determine if the situation is reversible .
- Provision levels should be considered to determine the bank's capacity to withstand loan default.

Credit Risk management policies

Specific credit risk management measures typically include three kinds of policies. One set of policies includes those aimed to limit or reduce credit risk, such as policies on concentration and large exposures, adequate diversification, lending to connected parties, or over-exposure. The second set includes policies of asset classification. These mandate periodic evaluation of the collectability of the portfolio of loans and other credit instruments, including any accrued and unpaid interest, which expose a bank to credit risk. The third set includes policies of loss provisioning, or the making of allowance at a level adequate to absorb anticipated loss- not only on the loan portfolio but also on all other assets that are subject to losses.

Workout procedure. Workout procedures are an important aspect of credit risk management. If timely action is not taken to address problem loans, opportunities to strengthen or collect on these poor- quality assets may be missed and losses may accumulate to a point where they threaten a bank's solvency.

Public-disclosure requirements. It is important that banks make adequate disclosures to allow supervisions and other interested third parties to properly evaluate the financial condition of a bank. Disclosure principles related to sound credit risk should be mandated by regulatory authorities, as recommended by the Basel Committee on Bank Supervision.

Policies to Limit or Reduce Credit Risk

Large exposures. Modern prudential regulations usually stipulate that a bank not to make investments, grant large loans, or extend other credit facilities to any individual entity or related group of entities in excess of an amount that represents a prescribed percentage of the bank's capital and reserves. Within this framework, bank supervisors are in a unique position to monitor both the banking sector and an individual bank's credit exposure in order to protect depositors' interests and to be able to prevent situations that may put a banking system at risk. The Basel Committee on banking

Supervision has recommended a maximum of 25 percent, with the intention of reducing it to 10 percent as soon as this is practical (Greuning, Bratanovic 2008).

Related-party lending. Lending to connected parties is a particularly dangerous form of credit risk exposures, subsidiaries, affiliate companies, directors, and executive officers. This relationship includes the ability to exert control over or influence a bank's policies and decision-making, especially concerning credit decisions. A bank's ability to systematically identify and track extensions of credit to insiders is crucial.

Over exposure to geographical areas or economic sectors. Another dimension of risk concentration is the exposure of a bank to a single sector of the economy or a narrow geographical region. This makes a bank vulnerable to a weakness in a particular industry region and poses a risk that it will suffer from simultaneous failures among several clients for similar reasons.

Renegotiated debt refers to loans that have been restructured to provide a reduction of either interest or principal payments because of the borrower's deteriorated financial position. A loan that is extended or renewed, with terms that are equal to those applied to new debt with similar risk, should not be considered as renegotiated debt.

Asset Classification

Asset classification is a key risk management tool. Assets are classified at the time of origination and then reviewed and reclassified as necessary (according to the degree of credit risk) a few times per year. The review should consider loan service performance and the borrower's financial condition.

Overdue interest. In order to avoid overstatement of income and ensure timely recognition of nonperforming assets, bank policies should require appropriate action on uncollected interest. A debt is considered to well-secured if it is backed by collateral in the form of liens on or pledges of real or personal property.

Loans Loss Provision Policy

Asset classification provides a basis for determining an adequate level of provisions for possible loan losses. Such provisions, together with general loss reserves that are normally counted as tier two capitals and are not assigned to specific assets, from the basis for establishing a bank's capacity to absorb losses. Two approaches exist for dealing with loss assets. One is to retain loss assets on the books until all remedies for collection have been exhausted. In such a case, the level of loss reserve may appear unusually large. The second approach requires that all loss assets be promptly written off against the reserve, i.e., remove from the books. By immediately writing off loss assets, the level of the reserve will appear smaller in relation to the outstanding loan portfolio.

4.7 Liquidity Risk Management

Liquidity is necessary for banks to compensate for expected and unexpected balance sheet fluctuations and to provide funds for growth. It represents a bank's ability to efficiently accommodate the redemption of deposits and other liabilities and to cover funding increases in the loan andinvestment portfolio. A bank has adequate liquidity potential when it can obtain needed funds (by increasing liabilities, securitizing, or selling assets) promptly and at a reasonable cost. The price of liquidity is a function of market conditions and the market's perception of the inherent riskiness of the borrowing institution. Liquidity risk management lies at the heart of confidence in the banking system, Liquidity risk management-therefore addresses market liquidity rather than statutory liquidity. The implication of liquidity risk is that a bank may have insufficient funds on hand to meet its obligations. Liquidity risks are normally managed by a bank's asset-liability management committee, which must there fore have a thorough understanding of the interrelationship between liquidity and other market and credit risk exposures on the balance sheet.

Liquidity Management Policies

The liquidity management policies of a bank normally comprise a decision-making structure, an approach to funding and liquidity operations, a set of limits to liquidity risk exposure, and a set of procedures for liquidity planning under alternative scenarios, including crisis situations. The bank's strategy for funding and liquidity operations,

which should be approved by the board, sets specific policies on particular aspects of risk management, such as the target liabilities structure, the use of certain financial instruments, or the pricing of deposits.Liquidity needs usually are determined by the construction of a maturity ladder that comprises expected cash inflows and outflows over a series of specified time bands. Once its liquidity needs have been determined, a bank must decide how to fulfill them. Liquidity management is related to a net funding requirement; in principle, a bank may increase its liquidity through asset management, liability management, or a combination of both. In practice, a bank may meet its liquidity needs by disposing of highly liquid trading portfolio assets or assets that are nearly liquid; or by selling less-liquid assets such as excess property or other investments. On the liabilities side, this can be achieved by increasing short-term borrowings and/or short-term deposit liabilities, by increasing the maturity of liabilities, and ultimately by increasing capital. Asset liquidity, or how "salable" the bank's assets are in terms of both time and cost, is central to asset-liability management. To maximize profitability, bank management must weigh the full return on liquid assets (yield plus insurance value) against the higher return associated with less-liquid assets.

The number of banks that rely solely on manipulation of the asset-structure to meet liquidity, needs is declining rapidly in Russia, Seasonal, cyclical, or other factors often can cause aggregate outstanding loans and deposits to move in opposite directions, resulting in a loan demand that exceeds available deposit funds. Another challenge for liquidity management is contingent liabilities, such as letters of credit or financial guarantees. These represent potentially significant cash outflows that are not dependent on a bank's financial condition. While outflows in normal circumstances typically may be low, a general macroeconomic or market crisis can trigger a substantial increase in cash outflows because of the increase in defaults and bankruptcies in the enterprise sector that normally accompanies such events. These crises are normally characterized by diminished levels of market liquidity, which can further exacerbate funding shortfalls.

Foreign currencies aspects. The existence of multiple currencies also increases the complexity of liquidity management, particularly when the domestic currency is not freely

convertible. A bank may have difficulty raising funds or selling assets in foreign currencies in the event of market disturbances or changes in domestic monetary or foreign exchange policies. In principle, a bank should have a management (i.e., measurement, monitoring, and control) system for its liquidity positions in all major currencies in which it is active. In addition to assessing its aggregate liquidity needs, it should also perform a separate analysis its liquidity strategy for each currency. The liquidity strategy for each currency, or exactly flow its foreign currency funding needs will be met, should be a central concern of the bank. The bank must also develop a back-up liquidity strategy for circumstances in which its usual approach to liquidity funding is disrupted.

4.8 The Regulatory Environment

The most significant development in prudential liquidity regulation has been the assessment of liquidity needs by calculating expected cash flows based on the maturity structure of a bank's assets and liabilities. However, even regulators that have adopted the cash-flow methodology believe that the stock (of liquid assets) approach has an .important, if supplementary, role to play and should not be neglected. This stance is based on the perception that the increasingly. Important role of liquidity management, in addition to being an asset-liability management tool, has significant implications for the stability of the banking system as a whole. Banking legislation normally contains specific liquidity requirements that banks must meet. These prudential requirements should not be viewed as the primary method for the management of liquidity risk. Given the importance of liquidity, a bank with prudent management should establish certain policy guidelines for risk management in addition to determining responsibility for planning and day-to-day fund management. Typical liquidity regulations as illustrated below:

4.8a Typical Liquidity Regulations or Internal Liquidity Guidelines

A limit on the loan-to-deposit ratio, A limit on the loan-to-capital ratio, Guidelines on sources and uses of funds, Liquidity parameters; A percentage limit on the relationship between anticipated funding needs and available resources to meet these needs a

percentage limit on reliance on a particular liability category, Limits on the minimum/maximum average maturity of different categories of liabilities;

The approach to supervision is therefore increasingly focused on the independent evaluation of a bank's strategies, policies, and procedures and its practices related to the measurement, monitoring, and control of liquidity risk.

4.8b **The Structure of Funding**: Deposits and Market Borrowing Deposits. Funding structure is a key aspect of liquidity management. A bank with a stable, large, and diverse deposit base is likely to have fewer liquidity problems than a bank lacking such a deposit base. The assessment of the structure and type of deposit base and evaluation of the condition (i.e., the stability and quality) of the deposits thus is necessary for liquidity risk assessment. In addition to deposit growth, management also must look at the quality of the deposit structure to determine what percentage of the overall deposit structure is based on stable or hard-core deposits, fluctuating or seasonal deposits, and volatile deposits. This step is necessary if funds are to be invested with a proper understanding of anticipated and potential! withdrawals.

4.8c Financial market borrowings. For a bank that operates frequently in short-term money markets, the crucial determinant of the ability to borrow new funds is its standing in the market.

The obvious difficulty of estimating the ability to borrow is that until a bank enters a market, the availability of funds at a price that will give a positive yield spread cannot be determined with certainty. Changes in money market conditions may cause a bank's capacity to borrow at a profitable rate to decline rapidly. In times of uncertainty, large investors and depositors tend to be reluctant to trade with small banks because they are regarded as risky. The same pattern may also apply to larger banks if their solvency comes into question.

4.8d Maturity Structure and Funding Mismatches

Maturity mismatches are an intrinsic feature of banking, including the short-term liability financing of medium-term and long-term lending. Given its current maturity structure, a bank could survive if it met with a funding crisis, and what amount of time would be available to take action before the bank became unable to meet its commitments. These questions should be asked by banks, regulators, and, ultimately, policymakers. This aspect of liquidity risk management also implies that access to the central bank, as the lender of last resort, should be available only to solvent banks that have temporary liquidity problems. An increased mismatch could be due to problems in obtaining long-term funding for the bank or could reflect a deliberate decision based on the bank's view of future interest rate movements. For example, banks tend to increase their short-term mismatches if they expect interest rates to fall. When reviewing the short-term mismatch as a percentage of total liabilities, bank expert will need to determine the proportion of the total funding that has to be renewed on a short-term basis.

The contractual maturity-term structure of deposits over time can be used to ascertain if a funding structure is changing. If it is, the bank expert should j determine whether the bank is experiencing funding shortages or is deliberately changing its funding structure Once the contractual mismatch has been calculated, it is important to determine the expected cash flow that is produced by the bank's asset-liability management model. An additional aspect that impact of credit risk on liquidity should also be assessed. The type of credit risk exposure, especially sector concentration, should be considered and specifically evaluated.

4.8e Deposit Concentration and Volatility of Funding

The increasing volatility of funding is indicative of the changes in the structure and sources of funding that the banking sector is undergoing. To assess the general volatility of funding, a bank usually classifies its liabilities as those that are likely to stay with the bank under any circumstances and those that can be expected to pull out if problems arise. The key issues to be determined for the latter are their price sensitivity, the rate at which they would pull out, and which liabilities could be expected to pull out at the first sign of trouble.

4.9 Liquidity Risk Management Techniques

The framework for liquidity risk management has three aspects: measuring and managing net funding requirements, market access, and contingency planning. Forecasting possible future events is an essential part of liquidity, planning and risk management. The analysis of net funding requirements involves the construction of a maturity ladder and the calculation of the cumulative net excess or deficit of funds on selected dates. Banks should regularly estimate their expected cash flows instead of focusing only on the contractual periods during which cash may flow in or out. An evaluation of whether or not a bank is sufficiently liquid depends on the behavior of cash flows under different conditions. Liquidity risk management must therefore involve various scenarios. The "going-concern" scenario has established a benchmark for balance sheet-related cash flows during the normal course of business. This scenario is ordinarily applied to the management of a bank's use of deposits.

A second scenario relates to a bank's liquidity in a crisis situation when a significant part of its liabilities cannot be rolled over or replaced implying contraction of e bank's balance sheet. A third scenario refers to general market crises, wherein liquidity is affected in the entire banking system, or at least in a significant part of it. Liquidity management under this scenario is predicated on credit quality, with significant differences in funding access existing among banks. From the perspective of liquidity management, an implicit assumption can be made that the central bank will ensure access to funding in some form, The central bank in fact" Has a vested interest in studying this scenario because of the need it would create for a total liquidity buffer for the banking sector, and for a workable means of spreading the burden of liquidity problems among the major banks. Diversified liabilities and funding sources usually indicate that a bank has well-developed liquidity management.

In practice, however, it may be difficult to obtain funding when a dire need for it exists. Certain unusual situations also may have an impact on liquidity risk, including internal or external political upheavals (which can cause large withdrawals), seasonal effects, increased market activity, sectoral problems, and economic cycles. Management must evaluate the

likely effect of these trends and events on funding requirements. All banks are influenced by economic changes, but sound financial management can buffer the negative changes and accentuate the positive ones. Management must also have contingency plans in case its projections prove to be wrong. Effective planning involves the identification of minimum and maximum liquidity needs and the weighing of alternative courses of action to meet those needs.

There are following risks associated with the practice of market funding-based liquidity management:

Purchased funds may not always be available when needed. If the market loses confidence in a bank, the bank's liquidity may be threatened. Over-reliance on liability management may cause a tendency to minimize the holding of short-term securities and to relax asset liquidity standards, and may result in a large concentration of short-term liabilities that support assets with longer maturities. During times of tight money, this tendency could squeeze earnings and give rise to illiquid conditions.

Due to rate competition in the money market, a bank may incur relatively high costs when obtaining funds, and may be tempted to lower its credit standards to invest in high-yield loans and securities. If a bank purchases liabilities to support assets that are already on its books, the high cost of purchased funds may result in a negative yield spread.

When national monetary tightness occurs, interest rate discrimination may develop, making the cost of purchased funds prohibitive to all but a limited number of large banks. Small banks with restricted funding should therefore avoid taking excessive loans from money market sources. Preoccupation with obtaining funds at the lowest possible cost and with insufficient regard to maturity distribution can greatly intensify a bank's exposure to the risk of interest rate fluctuations (Greuning, Bratanovic 2008).

4.10 Market Risk Management

Market risk is the risk that a bank may experience loss due to unfavorable movements in market prices. Exposure to such risk may arise as a result of the bank taking deliberate speculative positions (proprietary trading) or may ensue (rum the bank's market-making (dealer) activities.

4.10a Sources Of Market Risk. Market risk results from changes in the (prices of equity instruments, commodities, money, and currencies.

Volatility. Institutional investors adjust then-large-scale stable liquidity investment and trading portfolios through large-scale trades, and in markets with rising prices, large-scale purchases tend to push prices up. Conversely, markets with downward trends become more skittish when large, institutional-size blocks are sold. Ultimately, this leads to a widening of the amplitude of price variances and therefore to increased market risk.

Proprietary trading versus stable liquidity investment portfolio management. Proprietary trading is aimed at exploiting market opportunities with leveraged funding (for example, through the use of repurchase agreements), whereas the stable liquidity investment portfolio is held and traded as a buffer/stable liquidity portfolio. As stated earlier, both proprietary trading and stable liquidity investment portfolios are subject to market risk.

Value at risk. VAR is a modeling technique that typically measures a bank's aggregate market risk exposure and, given a probability level, estimates the amount a bank would lose if it were to hold specific assets for a certain period of time.

According to the Basel Committee on Banking Supervision, the disclosure requirements for each portfolio should include:

- Value at risk (VAR), broken down by type of risk or asset class and in the aggregate, estimated for one-day and two-week holding periods, and reported

in terms of high, median, and low values over the reporting interval and at period end.

- Information about risk and return in the aggregate, including a comparison of risk estimates with actual outcomes, such as a histogram of daily profit/loss (P/L) divided by daily VAR, or some other representation of the relationship between daily P/L and daily VAR.
- Qualitative discussion to help in comparison of P/L and VAR, including a description of differences between the basis of the P/L and the basis of VAR estimates.
- Quantitative measure of firm-wide exposure to market risk, broken down by type of risk, that in the bank's judgment best expresses exposure to risk, reported in terms of medium and low values over the reporting period and at period end

Risk capital.: In recognition of the increasing exposure of banks to market risk, and to benefit from the discipline that capital requirements normally impose, the Basel Committee amended the 1988 Capital Accord in January 1996 by adding specific capital charges for market risk Part of the 1996 amendment is a set of strict qualitative standards for the risk management process that apply to banks basing their capital requirements on the results of internal models.

Portfolio Risk Management Policies: Prudent managers should be aware of exactly how a bank's market risk exposure relates to its capital. Market risk management policies should specifically state a bank's objectives and the related policy guidelines that have been established to protect capital from the negative impact of unfavorable market price movements.

Marking to market. : This refers to the (re)pricing of a bank's portfolios to reflect changes in asset prices due to market price movements. This policy requires that the asset be (re)priced at the market value of the asset in compliance with International Accounting Standard 39. The volume and nature of the activities in

which a bank engages generally determine the prudent frequency of pricing. It is considered prudent for a bank to evaluate and (re)price positions related to its stable liquidity investment/ portfolio on at least a monthly basis.

Risk management policy should stipulate that prices be determined and the marking to market be executed by officers who are independent of the respective dealer or trader and his or her managers. A bank should routinely acquire the latest price and performance information available from external sources on assets held in its portfolios.

Position limits. : A market risk management policy should provide for limits on positions (long, short, or net positions), bearing in mind the liquidity risk that could arise on execution of unrealized transactions such as pen contracts or commitments to purchase and sell securities (e.g., option contracts or repurchase agreements). Such position limit's should be related to the capital available to cover market risk.

Stop-Loss Provisions: The stop loss exposure limit should be determined with regard to a bank's capital structure and earning trends, as well as to its overall risk profile. When losses on a bank's positions reach unacceptable levels, the positions should either be automatically closed or consultations with risk management officers or the A ICO (asset and liability committee) initiated in order to establish or reconfirm the stop-loss strategy.

Limits to New Market Presence: In a highly competitive market environment, innovation also places pressure on competitors to engage in new business to make profits or to not lose a market presence. A prudent bank should have risk management policies that proscribe its presence in new markets and its trading in new financial instruments. Limits related to a new market presence should be frequently reviewed and adjusted.

Trading Book and Management of Trading Activities: Technology has improved the quality of and access to information and this in turn has increased the efficiency and liquidity of related secondary markets. It is this technological capacity that has enabled banks to engage in trading-i.e., to take positions in financial instruments, including positions in derivative products and off-balance-sheet instruments. The bank takes these positions with the intention of benefiting in the short term from actual or expected differences between buying and selling prices, or from other price or interest rate variations.

The management process for the bank's trading activities comprises elements similar to those of investment management. This includes decisions regarding the total volume of the trading book, the portfolio selection, and the security selection - i.e., the specific types of financial instruments and the shares that they constitute of the bank's trading book. Trading activities require highly skilled analytical support. Traders must use some form of technical analysis to gauge market movements and market opportunities.

Market Risk Measurement: Market risk factors include interest rates, exchange rates, equity prices, and commodity prices. Interest rate risk relates to positions in fixed-income securities and their derivatives (e.g., exchange traded; futures, forward rate agreements, swaps, and options). Risk factors related to interest rate risk are estimated in each currency in which a bank has interest-rate-sensitive on- and off-balance-sheet positions. The capacity to systematically assess and measure risk and to effectively manage the net open position is crucial. Risk is based on probabilistic events, and it is apparent that no single measurement tool can capture the multifaceted nature of market risk. At an absolute minimum, marking to market is a fundamental measure that should be taken to protect a bank's capital. Both the stable liquidity investment portfolio and the trading book should be marked to market on a daily basis to ensure that the real value of positions is maintained.

Value at Risk

The Basel Committee market risk capital standard requires that the VAR be computed daily and the market risk-related capital requirements met on a daily basis. The capital requirement is expressed as the higher of the previous day's VAR and the average of the daily VAR measures for each of the last 60 business days. This is then multiplied by an additional multiplication factor k (which has a minimum value of 3.0), designated by national supervisory authorities and related to the quality of a bank's risk management system. The Basel Committee recommendation also includes a requirement that banks establish and regularly use a "routine and rigorous program" of stress tests to identify events or influences that can negatively impact a bank's capital position

Stress Testing: The purpose of stress testing is to identity events or influences that may result in a loss- i.e., that have a negative impact on a bank's capital position. Stress tests should be both qualitative and quantitative in nature. Quantitative criteria should identify plausible stress scenarios that could occur in a bank's specific market environment. Qualitative criteria should locus on two key aspects of stress testing: evaluation of the bank's capacity to absorb potentially large losses, and identification of measures that the bank can take to reduce risk and conserve capital.

The results of stress tests should be reviewed periodically by senior management and the board and should be reflected, as necessary, in changes in specific risk management policies and exposure limits. If the stress tests reveal a particular vulnerability, the bank should promptly address the situations and risks that give rise to that vulnerability. The stress test scenarios and the testing results normally are subject to supervisory attention (Greuning, Bratanovic 2008).

CHAPTER- 5

CONCLUSION

The banking system that emerged after the October Revolution and, more specifically, after the credit reforms of 1930-1932 was unique in many respects. The uniqueness of the Soviet banking system lies in the complete integration of monetary processes within the system of central planning, and in the credit and foreign exchange monopoly of the State Bank, which had broad powers of control over the performance of the entire state-owned segment of the economy. After the disintegration of USSR, the banking sector developed from the centralized system of the Soviet period into a two- tier system including a central bank and commercial banks in the market-based economy.

Before and after the 1998 financial crisis in Russia, number of banks are more than the actually required number of banks for lending and other banking activities. Although, number of banks has shrunk but banks are healthier today especially till mid 2008 at least as compared with 1998. Between the financial crisis which struck Russia in August 1998 and the global crisis which broke out in September 2008, the country had the strongest decade of growth in its history, with real GDP nearly doubling. A wide range of other economic and social indicators also saw dramatic improvements during this decade. Total factor productivity grew strongly, real wages soared, and unemployment and poverty rates fell sharply. Strong current account surpluses, combined with a swing in the private capital account from large net outflows to even larger net inflows, pushed international reserves to nearly USD 600 billion.

Improvement in lending organisations' assets and restructuring measures are responsible for this growth. Besides, foreign banks were also encouraged to expand their operations. Stronger macroeconomic policies and structural reforms both contributed importantly to the good economic performance through mid-2008, a good deal of the impetus to growth came from transitory factors. Initially, there was the 50% real depreciation of the Ruble at the time of the 1998 crisis, which sparked a recovery driven by import substitution and facilitated by substantial underutilization of capital, allowing rapid growth to occur

without high rates of investment. Then, both during 1999-2000 and to an even greater extent from 2003 to mid-2008, the terms of trade improved sharply. The loosening of conditions in international capital markets, with declining spreads for emerging market borrowers and rising net inflows combined with low interest rates in advanced countries, gave a further impulse to the strong increase in domestic demand in Russia.

The contribution of transitory factors to growth in recent years increasingly raised questions about the sustainability of the expansion, particularly as some of the favourable factors (such as the compression of borrowing spreads for emerging markets) exceeded or approached record levels. Although investment grew robustly, it remained low in relation to GDP compared with other rapidly catching-up economies. Real GDP growth was increasingly driven by booming domestic demand. After defaulting on part of its debt in 1998, the federal government ran a string of surpluses and almost extinguished public debt while building up foreign assets amounting to 13% of GDP by end-2008. The picture for inflation was more mixed, but for most of the past decade inflation was on a trend decline, falling from 85% in late-1998 to single digits by mid-2007. At that time, very rapid money supply growth in Russia pushed inflation back up to 15%, before it began to fall again in late-2008 as energy and commodity prices collapsed and money supply growth came to a sudden halt.

Russia's financial system, despite its recent rapid expansion, is still relatively underdeveloped, leaving considerable scope for financial deepening to contribute to long-term growth. A number of reforms would contribute to such deepening. First, although Russia has many banks, competition overall is weak, especially at the regional level. Consolidation of the sector would help, as this would lift more banks above a minimum efficient scale, which is necessary to contribute to effective competition. Over the long term, competition and efficiency would be improved by streamlining the state's involvement in the sector. Beyond being boosted by competition, banking efficiency would benefit from improvements in the rule of law, faster convergence to international financial reporting standards, and measures to lengthen the effective duration of bank liabilities.

There remains scope for the Russian financial sector to contribute more to long-run growth, and that the system remains too prone to crises. Russia's banking sector has suffered repeated crises since the start of transition. Policy makers face two broad regulatory challenges in seeking to improve the stability of the banking system: to converge on existing best practice as regards the implementation of prudential supervision and to address defects in bank regulation which amplifies economic cycles and give insufficient weight to liquidity considerations.

In the cyclical upswing Russian banks on average maintained but did not increase capital cushions above the minimum standard, and many therefore risk falling below the minimum as loan losses rise as a result of the recession, unless new capital can be found. There is a need for a more macro-prudential approach to financial supervision, which takes more account of systemic risks, in addition to focusing on bank-specific ones. Capital requirements and/or provisioning rules should be made counter-cyclical and capital requirements should be allowed to vary across banks to reflect each bank's contribution to systemic risk. In addition, stress tests should include assessments of shocks which hit across the banking system.

Apart from this, despite substantial improvements in the quality and efficiency of banking regulation, two major challenges in this area still face policy makers. First, there remains a significant gap between prudential supervision in Russia and international best practice. Second, the current crisis has shown that even the current state of the art is deficient in important respects. Russia therefore needs to continue to reinforce its existing approach to (micro) prudential Supervision. Russia can ill afford further systemic banking crises.

Another major issue to be addressed in the long term is the role of state-owned banks. Such banks already accounted for about 40% of banking system assets before the September 2008 crisis. Already, some failing banks have been taken over by state-owned entities, and mergers and acquisitions are occurring as loan losses rise. Meanwhile, new state-owned institutions have been created in recent years, and the government has

injected substantial capital into a number of the banks it controls. The role of the state banks, along with the issue of the number of banks in Russia, is connected to the challenge of increasing bank competition. Accordingly, the long tail of small banks adds little if anything to competitive pressure, while taxing the supervisory resources of the central bank and adding to Russian banks' reputation as pocket banks and/or vehicles for money laundering, which has a negative effect on public confidence in banks in general. Many of the small banks are below any plausible minimum efficient scale, and their smaller size also tends to make them more concentrated both on the deposit and lending sides. Thus, more rapid consolidation of the sector would be beneficial to the stability and efficiency of the banking system.

Over the past decade, monetary policy has pursued two goals: to reduce inflation and limit the real appreciation of the Ruble. The Central Bank of Russia (CBR) has had annual targets for the speed of disinflation since 1999, but traditionally also set an explicit ceiling for real appreciation of the Ruble. In terms of monetary policy instruments, intervention in the foreign exchange market has been the CBR's main tool for achieving those objectives. Therefore, Russia's monetary and exchange rate policy framework has often been referred to as a *de facto* nominal exchange rate peg. Given the strength of Russia's balance of payments during the ten years through mid-2008, the tight management of the nominal exchange rate has involved large interventions which have been only partially sterilized.

As a result of rapid money supply growth, headline inflation, while on a downward trend since 1999, was persistent and the CBR's inflation targets were frequently overshot. While accelerating price pressures during mid-2007 to late 2008 were to some extent due to the global rise in food prices, second round effects also started to materialize as the degree of underlying inflation had remained high. Past money supply growth has empirically been a robust determinant of consumer price inflation in Russia. However, rapid money supply growth did not fully translate into rising inflation as demand for Rubles increased within a broader process of de-dollarisation. More elaborated tools of monetary analysis take into account changes in the equilibrium stock of money and

compute "excess liquidity measures" as the difference between the actual money stock and an estimate of the equilibrium stock. The CBR has started to compute such measures for the Russian economy and according to its measure of the "money gap", rapid money supply growth in Russia has often resulted in excess liquidity, particularly in 2001, 2004-05 and between 2007 and the first half of 2008.

By *de facto* importing the monetary policy stance of the Federal Reserve and since 2005, a linear combination of the stance of the Federal Reserve and the CBR's monetary policy was generally too accommodative between 2002 and late 2008, with domestic real interest rates remaining negative throughout this period. Moreover, conditions were increasingly favourable for foreign borrowing as well. The CBR's exchange rate policy resulted in a controlled nominal appreciation of the Ruble against the US dollar. Thus Russian corporates increasingly borrowed abroad, which boosted domestic demand and added to inflationary pressures.

As a result of cheap access to credit, monetary and exchange rate policy contributed to a credit boom. While rapid credit growth has been to some extent a reflection of desired financial deepening, and while the levels of credit were not yet such as to suggest an imminent need for deleveraging, the pace of credit expansion in the period leading up to the onset of the global financial crisis was nonetheless clearly unsustainable.

Over the past few years, and in particular during the first half of 2008, the CBR intensified its efforts to allow for somewhat greater exchange rate flexibility and to counter inflationary pressures by using interest rate policy and reserve requirements. During conditions of excess liquidity in the banking system, the CBR's deposit rate had some impact on interbank money market rates, but its overnight credit rate remained largely irrelevant. However, increases in the CBR's deposit rate were too small to actually tighten credit conditions as large interventions until mid-2008 continued to fuel money supply growth and most real interest rates remained negative. In view of the risk of further accelerating capital flows, excessively low interest rates are a natural implication of the CBR's exchange rate target and the "impossible trinity".

Intervention to support the Ruble in the months following the onset of the crisis meant sharply falling reserves, and this was accompanied by a large fall in M2 since September 2008. Real interest rates are becoming positive for the first time in years just as aggregate demand is collapsing due to adverse external shocks. The stepwise widening of the exchange rate band allowed some breathing space for firms with heavy foreign currency liabilities and possibly prevented a sharper weakening of confidence in the Ruble and, thus, a run on deposits. But the costs were heavy, as expectations of further depreciation encouraged capital flight.

Liquidity shortages did trigger turmoil in the Russian financial sector in 2008. This led to the threat to credit growth and there was also problem of the declining capacity of borrowers to repay bank loans and banks risk breaching regulatory capital requirements because of nonperforming loans. Banks are unwilling to lend as credit risks on new lending rise in an environment of negative real GDP growth both domestically and abroad.

There is wide agreement, including within the government, that a shift to a new more self-sustaining growth model is needed. The government's Russia 2020 growth strategy, which aims for innovation driven growth and reduced reliance on the production of raw materials, was developed in 2008 but the crisis struck before that strategy could even begin to be translated into concrete policy actions. It is therefore important to return to the structural reform agenda both within the context of anti-crisis measures and beyond. The strategy for Russia in tackling such a big economic crisis needs to be broad-based, including a range of monetary policy measures to support aggregate demand and maintain the functioning of the banking system. Policymakers in Russia should seek measures that maximize the immediate demand effect; minimize distortions; protect macroeconomic stability and fiscal sustainability *via* a clear exit strategy from stimulus measures; and, where possible, yield longer-term efficiency gains while achieving short-term demand management goals. It is, therefore, a dire need to design a best trade-offs between them to have an efficient banking sector in Russia.

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APPENDICES

Part 1. The move to International Financial Reporting Standards for Russian banks

IFRS was first used in Russia by large banks issuing Eurobonds or seeking ratings during the 1990s. The CBR required annual IFRS audits and financial statements as from 2004, in addition to the normal Russian Accounting Standards (RAS) accounts for tax purposes. In September 2002 the CBR created a special committee to introduce IFRS, which included representatives of CBR departments, the Ministry of Finance, and parliament. The CBR began training specialists in its supervisory divisions to regulate banks based on IFRS. The number of banks preparing financial reports to international accounting standards in 2000 was 125, and this grew to 130 in 2001 and 185 in 2002. Most banks published IFRS financials unwillingly and with several restrictions in 2000, but by 2002 reports were readily available on bank web sites. In order to develop the new accounting methods, train specialists, and select an auditor, many banks in Moscow and the regions began publishing
IFRS reports without waiting for it to become mandatory.
From 1 January 2004 Russian banks were required to begin compiling IFRS financial reports once a year and to undergo an audit to international standards.
There are several differences between RAS and IFRS for banks, including the treatment of provisioning, consolidation, disclosure, and valuation of assets. IFRS brings together in a single document a wide range of information necessary to make a credit or investment decision. To achieve similar information using RAS a large number of documents must be prepared that are more cumbersome to use. The typical balance sheet for second-tier accounts to RAS includes 400-500 entries, the income statement includes 150-200 entries, and most other forms are less bulky but are riddled with unclear symbols, codes, and so on. Analyzing such a mountain of information, especially for a period of several years, requires proper software and highly trained specialists. It is no wonder that for most creditors RAS are extremely difficult to use. Moreover, this information is often inaccessible to the outside creditor and collecting other information requires consulting various sources.
On the other hand, financial reports prepared to RAS are often useful in analysing a Russian bank, especially because they are available at higher frequency. The most important purpose for examining Russian financial reports is to determine how a bank looks at various periods during the year, not just at the end of the year. For example, banks' liquidity usually increases noticeably at the end of the year, and auditors rarely mention discrepancies between end-year indicators and the typical level of liquidity during the year.

Part 2. Deposit insurance in Russia

The Central Bank of Russia began accepting applications to join the deposit insurance system from 27 March –27 June 2004, when 1 137 banks indicated they would like to join. A list of the first group of banks to join the deposit insurance system was published on 21 October 2004 and by end-March 2005 the Central Bank banking regulation

committee had completed consideration of applications by all 1 137 banks under all criteria.

The committee approved 819 banks to join the deposit insurance system (including repeat applications). It also granted deposit licenses to seven banks that had not previously operated on the retail market. As a result the deposit insurance system included 824 banks at the close of the first quarter of 2005. These banks held 98% of deposits by individuals in Russian banks and accounted for 90% of the assets in the banking system.

Eighteen banks that filed applications to join were rejected and lost their banking licenses, while another 51 banks that had previously accepted deposits from individuals opted against participating in the deposit insurance system. Household deposits are of no interest for the business of some banks (*e.g.* investment banks, and certain subsidiaries of foreign banks). Other banks that for one reason or another have yet to join the deposit insurance system may still do so.

The deposit insurance agency regularly conducts public opinion surveys about depositor behaviour and deposit insurance awareness. The *2008 Survey* revealed that only 38% of the population is aware of existence of deposit insurance in Russia.

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