
FINANCIAL SECTOR ASSESSMENT

RUSSIAN FEDERATION

OCTOBER 2003

EUROPE & CENTRAL ASIA REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM¹

A. INTRODUCTION

1. **This Financial Sector Assessment (FSA) is a summary of some of the findings of the Financial Sector Assessment Program (FSAP) report for the Russian Federation which was prepared jointly by the IMF and the World Bank in close cooperation with the Russian authorities.** The FSAP mission visited the Russian Federation in April and September 2002, and the report was prepared in 2002 and submitted to the Russian authorities in October 2002. Therefore, the FSA refers to the data that were available to the team during the preparation of the report. However, the conclusions indicated in the report are still valid and the Central Bank of Russia has provided its clearance of the FSA.

2. **Given the small size of the financial sector, the effects of a potential financial sector distress on the macroeconomy would be relatively small.** However, there are serious weaknesses in the environment and in the financial sector per se impeding the development of the sector and its ability to efficiently allocate resources in Russian economy. A few interlinked issues cut across the banking, capital markets and the insurance sectors. In spite of recent improvements, a lack of transparency in the ownership structures and poor corporate governance, including banks, slow down the development of the sector and impede financial decisions and prudential supervision. As development of a sound, robust Russian banking system will be crucial to the development of the broader financial system, the authorities are advised to place first priority on the implementation of the recommendations pertaining to the banking sector.

¹ The FSAP team, jointly led by Arne B. Petersen (IMF) and Tunc Uyanik (WB), included Angana Banerji, Margaret Cotter, Rupa Duttagupta, Jennifer Elliott, Julia Majaha-Jartby, Obert Nyawata, David O. Robinson, Gabriel Sensenbrenner, Svetlana Malysheva (Administrative Assistant, Moscow Office), and Joanna Meza-Cuadra (Staff Assistant) (all IMF); Noritaka Akamatsu, Irina Astrakhan, Thorsten Beck, Michael Fuchs, Gordon Johnson, Zeynep Kantur, Donald McIsaac, Zubaidur Rahman, Susan Rutledge, Sergei Shatalov, Marius Vismantas, and Cari Votava (all World Bank); Billy Clarke, (Financial Supervision Authority, South Africa); Stefan Niessner (Bundesbank); Risto Määttänen (Bank of Finland); Zoltán Dencs (Hungarian Financial Supervisory Authority); and David Sheppard (Bank of England).

3. **Development of the Russian financial system was severely jolted by the crisis of August 1998.** Growth since then has rebounded to its pre-crisis level. The total deposit base (M2) of the country's banking system amounts to 24 percent of gross domestic product (GDP) and claims on the private sector to 17 percent of GDP. The markets for longer-term financial instruments, such as bonds and equity, are small by international comparison although the value of equity exceeds that of bank claims (see the table).

Table. Financial Market Depth (2001)

Country	M2 (Money and Quasi-Money)		Claims on Private Sector		Total Bonds Outstanding		Equity Market Capitalization	
	US\$ billions	% of GDP	US\$ billions	% of GDP	US\$ billions	% of GDP	US\$ billions	% of GDP
Russia	74	24	54	17	11	3	78	27
Czech Republic	40	71	25	45	8	15	9	16
Hungary	22	43	18	35	13	26	10	20
Slovak Republic	14	66	5	25	2	13	1	3
Poland	75	43	46	26	35	20	26	15
France	656*	51*	1,232	95	661	51	1,844	142
Germany	1336	71	2,442	130	1,048	56	1,072	57
Italy	559*	56*	871	80	995	91	672	62
Netherlands	326*	89*	668	178	321	86	1,844	492
United Kingdom	1593	113	968	69	607	43	2,150	153
Japan	5221	123	4,084	96	4,534	107	3,910	92
United States	6509	64	7,741	76	11,672	115	13,984	137

*end of 2000

Sources: *World Development Indicators 2002*, *BIS Quarterly Financial Statistics* for data on bonds.

B. MACROECONOMIC BACKGROUND

4. **Macroeconomic environment in Russia in the year 2002 was characterized by GDP growth of about 4.3 percent, similar to 2001, and gradually declining inflation rates (15.1 in 2002).** GDP growth continues to be driven by higher energy exports and consumption. As in 2002, the balance of payments surplus is expected to remain large in 2003. Foreign exchange reserves are high; the 2003 debt servicing spike appears to have been smoothed, and external financing needs are minimal. A strong balance of payments position due to high oil prices and lower net private capital outflows has generated pressures for the exchange rate to appreciate. The Central Bank of Russia (CBR) continues to resist these pressures through large-scale interventions in the foreign exchange market to limit inflationary consequences.

5. **There has been progress in implementing structural reforms in key areas—e.g., the agricultural land market, pension funds, small business taxation—but other reforms (including in the financial sector) have lagged.** Reflecting pressures in global financial markets, asset markets remain volatile; nevertheless, the stock market has risen substantially, and Eurobond spreads have declined considerably from the level of end-2001.

C. BANKING SECTOR

6. **Banks in Russia appear to be well capitalized, but the quality of capital is questionable even under the Russian Accounting Standards (RAS), and loan provisioning does not fully reflect the banks' credit risks.** Highly concentrated assets around a few large borrowers and related lending are common areas of concern observed for the major banks in Russia. Given the small size of the sector, the mission's expectations are that even a quite large shock to the banking system, on the order of the 1998 financial crisis, would have an impact equivalent to 3–5 percent of GDP, which is relatively modest by international comparison. However, the capital of the system would be significantly impaired which, combined with a possible further loss of confidence in the system, would have serious negative implications for the financing of key sectors as well as for the monetary policy transmission, and, therefore, could have significant implications for both macro-stability and the country's economic growth prospects.

7. **Banking sector reform is a matter of the highest priority if Russia is to achieve its growth potential in the coming years.** Reform efforts should be concentrated on strengthening the supervisory framework; enhancing the transparency of ownership, governance and financial reporting; and facilitating the consolidation of the fragmented private banks, and leveling the playing field between private and state banks partly caused by the dominance of Sberbank and by the blanket guarantee on the household deposits for state banks.

8. **Any strategy for promoting the development of the banking sector will need to carefully consider the role of Sberbank.** Given its size and privileged position, Sberbank is in a unique position to extend loans to large customers, and its loan portfolio has increased rapidly; although more recently the rate of growth has been in line with that of other banks. This increase in its portfolio, coupled with breach of loan concentration limit and its heavy exposure to the raw materials sector which would make it vulnerable to a significant downturn in commodities prices, could be counted among the causes for concern. Sberbank is also the dominant investor in the government securities market, which could further endanger the capitalization of the bank since, due to recent ample liquidity, real yields have been negative. Measures would be needed to address potential risk factors in the short term, including: (a) a full review of the quality of Sberbank's loan portfolio and risk-management practices so that measures can be taken to limit undue risk taking on the part of Sberbank; and (b) introduction of safeguards to strengthen the governance of Sberbank and to ensure that Sberbank is run on commercial principles, subject to a hard budget constraint.

D. BANKING SUPERVISION

9. **The legal infrastructure for the banking sector is generally well developed, but supporting legislation and regulation for banking supervision and implementation practices need to be improved by:** (i) proactive and aggressive assessment of the operating condition and integrity of banks; (ii) focus on facilitating the exit of problem banks; (iii) strengthening guidelines for "fit and proper tests" and

enhancing the transparency of bank ownership; (iv) strengthening the definitions of capital and prompt enforcement of capital and capital insolvency²; and (v) enforcement of consolidated supervision.

10. **Unreliable financial reporting erodes investor confidence.** Russian banks will be required to prepare financial statements in accordance with IAS starting January 1, 2004. Provided the reform is implemented with sufficient due diligence, this will be a very welcome development that should promote more transparency and disclosure regarding bank financials and structure. However, the application of IAS in form rather than in substance could mislead rather than inform the users of financial statements. Therefore, it is crucial to put in place an enabling institutional framework (e.g. regulations, training, etc.) for proper implementation of IAS in the very short time remaining.

11. **Some improvements in the legal foundation would also complement the further strengthening of the banking supervision in the areas of:** transparency of bank ownership and suitability of shareholders; qualified immunity for directors, officers and employees of the CBR; strengthening of criminal statutes to define what constitutes misappropriation of funds, personal benefit and other illegal actions in the financial sector.

12. **The lack of consolidated supervision of the Russian banking system potentially poses a systemic risk where the banks hold ownership positions in other non-bank financial institutions.** Usually the quality of the financial data and reports generated by the affiliates of banks are poor and misleading due to deficiencies in the applied accounting procedures and controls. These circumstances can lead to understatement of the banks' reported large exposures and exposures to related parties.

E. DEPOSIT INSURANCE

13. **Deficiencies in the bank failure resolution system have resulted in a large number of phantom banks and has undermined depositors' confidence in the banking system.** While the CBR has the power to revoke a banking license, until 2002 an arbitration court had to find the bank to be bankrupt before the bank could be liquidated. In many cases, this did not happen, which led to the phenomenon of phantom banks and delicensed banks that are still awaiting liquidation (around 60³ according to the CBR). The bank liquidation process has proven to be highly ineffective, costly, with currently more than 600⁴ banks in the pipeline. While the legislation clearly establishes a priority for household depositors in liquidations, these rights have been watered down by settlements in banks outside the scope of the Agency for the Reconstruction of Credit Organizations (ARCO).

² After the completion of the FSAP report CBR has issued regulations aiming in enhancing the quality of banks' capital

³ This number has come down to 9 as of September 1, 2003.

⁴ This number is 365 as of September 1, 2003.

14. **The planned introduction of a deposit insurance scheme aims at leveling the playing field, as well as a mechanism to withdraw licenses from unsound and imprudently managed banks.** Ideally a deposit insurance scheme should be introduced only after the banking system is fundamentally sound and a strong supervisory framework is in place. Therefore, the mission suggested that the authorities proceed with the proposed scheme only if they are fully committed to take the necessary difficult decisions. The entry criteria proposed by the CBR were found to be broadly appropriate but need to be fleshed out further.

15. **In the context of the transition period, a number of banks will lose their licenses to take household deposits and many may need to be liquidated.** Shifting the bank failure resolution process into an administrative rather than judicial context is expected to contribute to making the process more expedient and effective. Appointing a specialized agency as liquidator (as envisaged by the CBR) could increase the efficiency of the process substantially. A balance should, however, be attained by ensuring the banks, subject to administrative decisions, access to an appropriate judicial review.

F. ANTI-MONEY LAUNDERING (AML)

16. **Since the AML Law became official in February 2002, Russia has made significant progress in a short time frame in developing and implementing an AML regime.** The major foundational elements of an anti-money laundering framework have been put in place, but issues relating to legal framework and implementation remain:

- As long as laws require credit institutions to accept all customers, banks cannot protect themselves from abuse by money launderers and will incur the risks associated with the use of their institutions for money laundering.
- The AML Law does not yet apply to important non-bank financial institutions. However, amendments to extend the reach of the AML Law are currently under consideration.
- Many important elements of an effective AML program are found in non-binding recommendations with reliance placed on an uncertain and understaffed system of prudential supervision.
- Sanctions and penalties for AML are weak. The criminal anti-money laundering provisions apply only if funds being laundered exceed a significant monetary threshold inviting structuring of transactions to avoid liability. The basic money laundering offense does not appear to permit confiscation and may result in only a fine. For other violations, there is an inconsistent and often unclear approach to sanctions with reliance on unspecified criminal and civil laws and administrative fines in other legislation. This substantially weakens capacity for deterrence and enforcement.
- Expanding customer identification requirements to cover the entire customer base of a financial institution (including accounts which predate the AML Law), strengthening client and beneficial owner identification requirements, and the

establishment of effective central authority responsible for mutual legal assistance in criminal cases was recommended to support a more effective AML system.

G. PAYMENT SYSTEMS

17. **The payments system in Russia has improved substantially and is not a major source of systemic risk.** Nevertheless, a single unified system is still not in place and there are major shortcomings in efficiency. Recommendations for improvements included: drafting of a concept paper defining the current and likely future needs of the sector including the introduction of RTGS and the separation of the payment system oversight responsibilities of CBR from its operational payment system responsibilities.

18. **The securities clearing and settlement infrastructure is similarly fragmented and diverse.** The main organized securities exchanges and the over-the-counter market are served by two central securities depositories (CSDs) and a host of custodians and registrars, with the CSDs supporting settlement of cross-exchange trades in certain stocks. Delivery-versus-payment (DVP) in securities settlement is partial, and there are no plans to introduce a central counter party (CCP) clearing house for the securities markets. Introduction by the CBR of an RTGS funds transfer system would enable full DVP to be developed and support the development of a CCP. A single national central securities depository was also recommended to address these discrepancies.

H. PUBLIC DEBT MANAGEMENT

19. **Russia's debt management practices need improvement in several areas.** The system is fragmented and there is no clear-cut legal demarcation of authority over public debt management among branches of the government. Vneshekonombank plays a central role as the agent of the federal government in external debt management while the Ministry of Finance (MoF) focuses on domestic debt. Within the MoF there are several units working on various aspects of debt, but often without coordination. Coordination among objectives of debt management, fiscal, and monetary policies is also weak. Equally weak and fragmented are the databases and analytical capacity of debt management. The system lacks overall risk management guidelines and practices.

20. **The authorities are aware of the weaknesses in their current practices and have adopted a conceptual framework involving:** an improvement of the legal basis for debt management, creation of a unified organizational structure, a public debt accounting system and a public debt accounting database, a unified system of analysis of risks, and an integrated system of strategic planning for the public debt management system, cash management and budget management. If fully implemented, the proposed debt management system will go a long way in meeting best international practices in debt management. However, key elements such as the structure and degree of independence of the debt management agency still need to be clarified. The authorities should move urgently to implement the new system; currently it looks as if the planned phases of implementation may take a significantly longer time than initially envisaged.

I. CAPITAL MARKETS AND NON-BANK FINANCIAL INSTITUTIONS

21. **The Russian capital markets remain small and underdeveloped, and its role in intermediating between savings and investments is very limited.** Successful implementation of reforms to accounting standards and issuer transparency and disclosure is essential to promote investor confidence in the equity and corporate debt markets. Further rationalization of market infrastructure including clearing and depository functions, share registration, and trading would reduce costs and promote efficiency. The Federal Commission for the Securities Market (FCSM) needs to build expertise in market surveillance and regulation, and expand its powers to apply (in particular non-pecuniary) sanctions to fulfill its mandate. The functioning of the FCSM is impeded by unresolved jurisdictional issues concerning, among others, derivatives regulation, and regulation of related-party transactions and takeover bids. Better coordination between the FCSM and the CBR is suggested to help improve the oversight of the financial sector as a whole.

22. **The insurance sector is small and characterized by a large number of mostly small companies.** An estimated 10 percent of all licensed companies do not possess the minimum capital required by current legislation, and more will not be able to meet the newly proposed US\$1 million target. Owing to resource limitations and the outdated legislative framework, the system of regulation and supervision fails to conform with international best practices in areas such as corporate governance, internal controls, and dealing with controls over reinsurance.

J. CORPORATE SECTOR ISSUES

23. **Insufficient access to finance is one of the major constraints for SME development.** Key measures to increase lending to SMEs include establishment of a credit information service and a movable property registry (pledge registry). While the leasing sector is developing at a healthy pace, there is a need to strengthen the regulation of the leasing sector.

24. **In the area of corporate governance, the primary weakness was found to be the lack of transparency of ownership and control structures.** The problem plagues both the corporate and the banking sector. Although the corporate governance framework in Russia has improved over the last two years, the mission recommended additional strengthening in the areas of: (i) increased transparency of ultimate ownership and control structures; (ii) adopting legislation requiring disclosure of related party transactions; and (iii) developing regulations on insider dealing.

25. **The legal framework supporting credit and creditor rights in Russia is considered to be deficient in important areas, specifically with respect to the taking of security over movable property and enforcement procedures.** Despite the improvements following the adoption of a new bankruptcy law in 1998 and the legal framework for corporate insolvency law, there is a need to strengthen legitimate creditor rights and promote rehabilitation. The bankruptcy process in Russia also suffers from

weak and improper implementation. The continuing lack of regulation and the potential for arbitrage in the system have continued to foster distrust of the process.