

## Financial Sector Reform in Russia: Recent Experience, Priorities, and Impact on Economic Growth and Stability

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- *Financial sector reforms belong to the set of reforms that must be given priority in order to reduce the dependence on primary commodities and sustain adequate rates of economic growth against a possible backdrop of lower oil prices.*
- *Compared to other important reforms, financial sector reforms are likely to be more technical, less controversial, and less reliant on legislative amendments, and so might be easier to advance in the run-up to the elections.*
- *The authorities' strategy for financial sector reforms is fundamentally focused on stimulating private banks, assuming that they will gradually crowd out the still dominant state banks. There is no comparably concrete plan for restructuring and reform of state banks. As to private banks, the main focus is on widening deposit insurance to include all banks, not only state banks, and to use this to leverage a much needed strengthening of banking supervision.*
- *The authorities' strategy for the financial sector is appropriately focused. A strengthening of banking supervision, in combination with a number of other planned measures, should go far in overcoming the fundamental lack of trust in counterparties that is the root cause of the low financial intermediation. Giving priority to the stimulation of private banks is also appropriate.*
- *The main risk is with regard to the implementation of the strategy. The most important risk is that the CBR does not have the political backing to fundamentally strengthen banking supervision and withdraw licenses from unfit banks. In that case, the deposit insurance scheme will in effect be open to all banks, making the financial system less stable and increasing the potential fiscal cost of a crisis. Another risk, given that state banks will continue to represent a large part of the system for at least the next few years, is political pressures to provide lending on non-commercial criteria.*

The paper begins by discussing the importance of financial sector reforms, relative to other reforms. Following a brief review of the prevailing situation in the financial sector

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<sup>1</sup> The authors are IMF Resident Representatives in Moscow. The views expressed are the authors' own and do not necessarily reflect those of the IMF. This paper was prepared as background for the presentation by one of the authors to a conference on the Russian Banking Sector organized by the Adam Smith Institute, which took place December 3-4, 2002 in London.

and how it has changed in recent years, the paper focuses on what should be the priority for financial sector reforms, how these priorities compare to the authorities' program for this sector, and the potential problems facing the authorities in implementing their program.

## **I. How Important Are Financial Sector Reforms Compared to Other Reforms?**

Russia is in the fourth year of a strong economic recovery. The recovery was initially spurred mainly by the large real depreciation of the ruble in the wake of the 1998 crisis and subsequently by the impact of high oil prices on Russia's oil-export-dependent economy. But the sustained recovery has also been a reflection of good macroeconomic policy management. In particular, the decision to save much of the oil tax windfall and run large fiscal surpluses has been instrumental in significantly slowing the real appreciation of the ruble—i.e., in slowing the unwinding of the post-crisis real depreciation—in face of what have been huge balance of payments surpluses since late-1999.

Against this backdrop, how important are financial sector reforms for macroeconomic stability and economic growth in the coming years? Considering the still low monetization of the economy, it would be difficult to argue that failure to accelerate financial sector reforms pose a potentially serious threat to macroeconomic stability. Instead, the importance of financial sector reforms comes from the fact that the basis for economic growth is fragile, particularly vulnerable to a drop in oil prices, and that such reforms will be important in order to place growth on a stronger foundation.

Economic growth has slowed notably and become more narrowly based. While showing much volatility, the trends in the main components of demand have been relatively stable in the last two years: the impetus to growth has come mainly from consumption and to a limited extent from energy sector investments, with the non-energy sector investments and the foreign balance contributing negatively:

- The negative contribution of the foreign balance from 2000 onwards reflects the large real ruble appreciation since early 1999, as well as slower growth in key trading partners. Import volumes have doubled in the last three years, reversing the import substitution that spurred growth in 1999, after the sharp real ruble depreciation in the wake of the crisis. Quite strikingly, exports excluding oil and metals, have not only remained very low, but have declined.
- Growth in investments has become heavily dependent on the oil and metals sectors. These and related sectors account for more than half of industrial investments. Investments in other sectors have generally been either stagnant or declining.
- Consumption growth has accounted for about two-thirds of GDP growth since 2000. It reflected initially a drawn-out rebound in real wages from the compression following the crisis. Real wages have continued to increase fast, and are now above their pre-crisis level. However, the productivity growth since the crisis—enterprises have been able to expand output without a corresponding increase in employment—means that unit labor cost remains below the pre-crisis level. But the gap between real wages and labor productivity is closing. This fundamentally unsustainable trend points back to the need for stronger investments outside the oil sector if the recovery is to be sustained, especially against a backdrop of less favorable energy prices.<sup>2</sup>

The narrowness of economic growth mirrors the fact that the economy remains highly dependent on the oil and metal sectors. A recent investment bank analysis of the ownership of the 64 largest Russian companies (with total sales of \$109 billion in 2000, when GDP was \$260 billion) shows this dependence.<sup>3</sup> Government-controlled enterprises (mainly Gazprom and RAO UES) accounted for 43 percent of total sales, and 85 percent

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<sup>2</sup> Recent macroeconomic developments are discussed in more detail in the note “Russia: Trends in Macroeconomic Developments and Policies”, posted on the IMF Moscow Office website at [www.imf.org/moscow](http://www.imf.org/moscow).

<sup>3</sup> P. Boone and D. Rodionov, “Rent Seeking in Russia and the CIS”, presented at EBRD tenth anniversary conference, December 2001.

of the private sales were by enterprises controlled by only eight conglomerates, all based in the primary commodities sector. Particularly disturbing is the fact that this concentration has increased in recent years.

The failure to lessen the dependence on primary commodities is also reflected in the modest share of small and medium-sized enterprises (SME) in GDP. Some Goskomstat data indicate that the share may be as low as 10-15 percent—compared to about 50 percent in advanced transition economies—and that it is not growing. Other measures suggest a somewhat larger share, and there are reasons to believe that the part of the economy not captured by such statistics is particularly large in Russia. However, few observers of Russia's economy would dispute that, contrary to the more advanced transition economies, the SME sector is underdeveloped and has so far lacked the dynamism to become the engine of strong growth.

The dominance of conglomerates based in the natural resource sector and the lack of a dynamic SME sector may reflect in part a “Dutch disease” effect of high commodity prices (especially the price of oil) and the attendant real ruble appreciation. But there is little doubt that the pronounced and increasing narrowness of economic growth is also a reflection of what is still—broadly speaking—a relatively poor investment climate outside the primary commodities sectors. The bold price liberalization and the large-scale privatization during the early stages of the transition process placed key economic decisions in the hands of an emerging private sector. But the failure since then to fundamentally improve the investment climate means that the economy has remained dominated by large conglomerates that are often focused on using monopolistic market position to gain excessively high profits, protected from competition and pressures to develop new products. Except for the primary commodities sector, concentrated in a few hands and flush with cash due to high prices, investments and restructuring have been lackluster and the transformation of Soviet-era economic structures has been slow, although by no means absent.

The fact that the investment climate is still unfavorable is not to say that the significant acceleration of reforms that we have seen under the current government and the more reform-oriented Duma after December 1999 has not been important. But except for the far-reaching tax reforms, these reforms are likely to have had only a limited impact on the investment climate. In some instances this is because of relatively long implementation periods (judicial and pension reforms). In others, the reforms involve to some extent a formalization of ad hoc arrangements already in place, and the clarification of the legal status is likely to benefit the investment climate mainly in the long run (the new Land Code). And in still others, the full benefit depends on important synergies with the aforementioned reforms that still lie ahead (the deregulation measures and the new Land Code).

Thus, the economic system is still one that fundamentally biases the resource allocation in favor of large incumbent enterprises and stacks the cards against SMEs. A recent survey by the World Bank of the obstacles to investments is sobering reading.<sup>4</sup> Three problem areas stand out:

- The biggest obstacle to new enterprises and to restructuring of old ones is the still intrusive role of the government, especially at regional and local levels. A pervasive system of licensing, inspections, and authorization requirements are a source of wide-spread corruption and a substantial obstacle for those wishing to set up a new business. Big conglomerates often know how to overcome such obstacles, and might in some instances even benefit, as the system encourages crony capitalism.
- Large-scale energy and transportation subsidies to favored companies distort the resource allocation in favor of large incumbent enterprises, reducing the pressures on loss-making enterprises to restructure, and providing insurmountable barriers for outsiders.

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<sup>4</sup> World Bank Russia Office, "Russian Economic Report, October 2002", on website <http://www.worldbank.org.ru>

- An inefficient banking system means that financial intermediation is extremely low—a meager 4 percent of fixed investments were financed by bank credits in the first half of 2002, according to Goskomstat—and that a large share of extended credits go to incumbent enterprises.

This points to what should be the three main priority areas for reforms: the civil service and public administration; natural monopolies; and the banking system and domestic capital market.

Two of the three priority areas for reforms—civil service and administrative reforms, and reforms of natural monopolies—will be technically complex and fiercely opposed by particularly strong entrenched vested interests. These reforms will therefore be inherently slow and particularly difficult to advance in the run-up to the elections. There are already signs of a notable slowdown of reforms this year. Banking reforms, however, are generally of a technical nature and therefore less controversial, and changes in the legislative framework in recent years mean that at least some can be advanced without requiring Duma approval. Thus, while banking reforms might not be the single most important reform facing the authorities, this is one area where one could expect considerable progress even as the elections draw closer.

## **II. The Prevailing Situation in the Banking System and Improvements to Date**

As already mentioned, the banking system and, more generally, the financial sector, is still far from playing the role that it should in intermediating savings and investment.<sup>5</sup> Apart from the tiny share of fixed investment financed by bank borrowing, monetization and bank lending are small in relation to GDP, about half of the average of the Czech Republic, Hungary, the Slovak Republic, and Poland (Table 1). The importance of the financial market as measured by bond issuance is even smaller. The equity market is

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<sup>5</sup> The terms ‘banking sector’ and ‘financing sector’ are used somewhat interchangeably in what follows. Most of the measures contemplated by the CBR and the government are focused on the reform of the banking system, but many of them will have implications for the financial sector at large.

relatively more important in Russia, but this is a reflection not of market depth or financial intermediation through this channel, but rather of the privatization in the 1990s of a small number of large commodity producers, mainly in the oil and gas sector.

Table 1. 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	1,336	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	1,593	113	968	69	607	43	2,150	153
Japan	5,221	123	4,084	96	4,534	107	3,910	92
United States	6,509	64	7,741	76	11,672	115	13,984	137

\*end of 2000.

Sources: World Development Indicators, IFC Emerging Markets Bonds Electronic Database, IMF International Financial Statistics, BIS Quarterly Review March 2002, Deutsche Bundesbank Monthly Report April 2002, World Bank book "Building Trust: Developing the Russian Financial Sector".

The importance of the financial markets is even less than suggested by these indicators because much of the limited depositing and lending that is done is between connected parties. Many banks are part of financial-industrial groups, where the bank is used primarily as a corporate treasury as well as, in many cases, an instrument for directing assets abroad. A striking feature of the tendency towards related party dealings is that banks are still largely unwilling to deal with each other: the interbank market remains small and segmented.

Apart from the preponderance of connected party transactions, another weakness of banks' operations is their primarily short-term nature. Only about a quarter of corporate bank loans are for more than one year. This in turn reflects banks' inability to attract long-term liabilities: all household deposits are legally required to be available on demand, regardless of contractual maturity, and other sources of longer term funding such as loans from foreign banks or bond issues have been very limited.

The failings of the financial system are also one of the main factors sustaining the appetite for foreign assets. According to CBR estimates of foreign currency holdings of Russian residents, about half of household savings is still held in dollar cash. As to the corporate sector, balance of payments data on cumulative net private capital outflows suggest that a large proportion of corporate assets has been placed abroad.

Moreover, although borrowing-lending spreads are wide, and although it is doubtful whether loan loss provisions, made in accordance with Russian accounting standards, are adequate, banks' average return on assets has until this year been low. This is especially so given the high historical variability of bank profits in Russia, which should mean that risk-averse bank owners would require average returns to be higher than in places where risks are lower. Together with evidence that operating costs in many banks are high in relation to income, this suggests that on average, Russian banks are relatively inefficient. The same conclusion is suggested by the very small average level of capital of banks in the system (about \$10 million, excluding Sberbank), which prevents most from exploiting economies of scale.

The shortcomings of the financial sector are therefore legion, and they are also widely recognized. On the other hand, the extent to which the situation has improved since the immediate aftermath of the 1998 financial crisis is sometimes overlooked. In that time, total bank assets, bank credit to the economy, and household deposits all more than doubled and banking system capital quadrupled in real terms. Many key indicators for the banking system now exceed their pre-crisis levels in percent of GDP, and in some cases they do so even in dollar terms. Recently banks have begun to tap the new domestic corporate bond market, and some Russian banks are again accessing international capital markets. Domestic capital markets have also revived, posting high returns and seeing rapid growth of issuance. But these are improvements from a very low level.

### **III. A Problem of Trust**



The current situation has thus two salient characteristics: the financial sector is weak and underdeveloped, but has become less so. It is generally recognized that the continued underdevelopment of the banking system reflects above all a fundamental remaining problem of lack of trust: of the population in banks, of banks in borrowers, of foreign counterparties in Russian banks, of banks in each other. The improvement to date indicates that the absence of trust is not absolute, and is lessening, but the still stunted size of the banking sector and financial markets shows that a great deal of room for further building of trust remains.

As to the lack of trust in banks, the underlying reasons are many. They include poor transparency and corporate governance in the banking sector, the scanty capital of most of the more than thirteen hundred existing banks, the form-over-substance nature of prudential supervision, past episodes of devaluation, and repeated banking crises, with high-profile bank failures and, with a flawed bank bankruptcy process, asset stripping, and lost deposits. Also, there are doubts about the extent to which domestic private banks can compete with Sberbank, which benefits from its size, reach, and government deposit guarantee. (The guarantee applies only to deposits with state banks.) Sberbank also enjoys a near-monopoly on pension payments, which delivers a large pool of small but stable deposits, making Sberbank uniquely able to make large long-term loans. Meanwhile, large foreign banks, which would be at less of a disadvantage in terms of size vis-à-vis Sberbank and which have the international reputation advantage to offset the lack of access to deposit insurance, have so far been unwilling to expand aggressively in Russia, in part because of **their** lack of trust in Russian borrowers.

This lack of trust by banks in borrowers, which restrains the activity of domestic banks as well as foreign-owned ones, also has several causes. These include poor corporate governance and transparency in the enterprise sector, uncertainty over legal enforcement of contracts, and a history of low profitability and susceptibility to crises among Russian corporates.

Successful development of the banking system therefore requires addressing the sources of these two main aspects of the lack of trust plaguing the system. The authorities' action program for banking reform recognizes this.

#### **IV. The CBR and Government's Program for Financial Sector Reforms**

Following mounting criticism of the policies for financial sector reforms, the CBR and the government jointly formulated a comprehensive medium-term action program for such reforms, which was adopted at the end of 2001. During the immediate aftermath of the 1998 crisis, the criticism had focused on what was seen as an ad hoc and nontransparent policy vis-à-vis distressed banks, with the CBR being accused of in effect facilitating asset stripping by not stepping in and taking control away from managers in a number of ailing banks. In the years that followed, the criticism focused on what was seen as a largely hands-off, passive role on part of the authorities and on their lack of a comprehensive program for financial sector reforms.

This is not to say that there have been no policy actions of significance. Notably, between 1999 and 2001, much was done to improve the legal framework for banking and bank restructuring. Laws on bank bankruptcy and bank restructuring were passed, and a package of amendments to the banking laws in mid-2001 represented a welcome step towards best international practice in the area of transparency and fit and proper ownership and management of banks. Bank reporting was improved, and criteria for prospective bank owners and managers strengthened. Also, in August 2001 a new anti-money laundering law was adopted, and since then many follow-up steps have been taken to implement it, permitting Russia's removal, in October of this year, from the FATF list of countries not cooperating in the fight against international money laundering. In addition, the tax burden on banks was eased and a significant distortion removed when the corporate profit tax was reduced in 2002, at which time the rate for banks, which had previously been higher than for other enterprises, was harmonized at the new lower level of 24 percent.

The reforms to date, however, have not yet had much impact on the trust-deficit problem. Some of them are very recent, while others, such as the improvements in the legal framework on bank bankruptcy, remain largely untested because of the favorable macroeconomic conditions prevailing since 1999. More fundamentally, the achievements to date represent only a small part of what is needed to yield a decisive improvement in trust and thereby lay the basis for rapid and sustained growth in financial intermediation. Thus, the limited improvement in the strength and depth of the banking system that was achieved in the past 3½ years—described above—was mainly seen as a “spontaneous” or passive function of the improved macroeconomic environment, rather than a response to policy actions.

The new CBR management has endorsed the action program and gone further in fleshing out a vision for the modernization of the banking sector. Fundamentally, the current strategy for financial sector reforms aims at spurring the growth of private banks, with the expectation that such growth will gradually reduce the importance of the still dominant state-owned banks. In accordance with this, the action plan contains a large number of measures aimed at improving the environment facing private banks, but is largely silent on what should be done to reform and restructure state-owned banks in the coming years and on what should be the role of such banks in the medium term.

#### **A. Promoting privately owned banks**

The action plan for promoting private banks is based on a realistic diagnosis of the obstacles facing such banks, and the proposed measures should go far in tackling the aforementioned fundamental problem of lack of trust, if adopted and implemented as envisaged. The two main measures in this regard are the introduction of deposit insurance and the strengthening of bank supervision:

- **Deposit insurance.** The government is in the final stages of drafting a law on the introduction of deposit insurance. By eliminating one of the main advantages

enjoyed by state banks, notably Sberbank, this measure will mean that depositors will no longer have reason to demand a higher risk premium from private banks. This will be an important leveling of the playing field for private banks that could contribute significantly to development of the banking system.<sup>6</sup>

- **Bank supervision.** Due to the potential moral hazard problems involved in deposit insurance, the CBR believes that the introduction of such a scheme will provide it with important leverage for a major improvement in banking supervision. In this regard, the new CBR management realizes that the current system of supervision suffers from considerable form-over-substance problems. It is looking to fundamentally change it from a backward-looking control of compliance with formal requirements to an essentially forward-looking assessment of the quality and procedures for risk management and control, in line with international best practice.

While the introduction of deposit insurance and the simultaneous strengthening of banking supervision are the main features of the authorities' financial sector reform program, a number of other important measures with a direct bearing on the trust problem are also being planned:

- **IAS for banks.** Banks are to adopt international accounting standards by 2004. This reform, while by no means a cure-all for problems of bank transparency, would nonetheless be a significant step forward, if properly implemented. Apart from benefits of higher quality financial information for potential customers, creditors, and portfolio investors, it would also facilitate more effective banking supervision, and make Russian banks more attractive for acquisition by larger domestic or foreign banks.

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<sup>6</sup> The draft law on deposit insurance proposes that banks would pay a premium of 0.15 percent of eligible deposits per quarter. Household deposits of up to Rub20,000 (about \$630) would be fully covered, with 75 percent coverage beyond that up to Rub 120,000 (about \$3,800), so that the maximum pay-out per depositor would be Rub 95,000 (about \$3,000). The government would be required to meet any claims beyond the resources of the fund.

- **IAS for enterprises.** The government has repeatedly declared its intention to move towards adoption of IAS for enterprises, which among other things would improve the breadth and quality of information available to lenders. Ideally, this would be done at least for publicly quoted companies and large enterprises at the same time as the introduction of IAS for banks, but the strategy is not fully specified and is likely to be more gradual.
- **Strengthening secured creditor rights.** One priority measure in the joint strategy is to secure passage of legislative amendments to enhance the priority of secured creditors in bankruptcies, in order to encourage collateralized lending.
- **Combating money laundering.** Additional anti-money laundering measures include an amendment to the Civil Code to allow banks to refuse retail accounts and to close accounts on the grounds of suspicious activity. The absence of such a provision has been a factor in the decision of some foreign banks not to expand their operations in Russia.
- **Improving the quality of bank capital.** In line with the new CBR management's stress on the quality of bank capital, the CBR has announced a tightening of its regulations to counter capital inflation by banks. One new measure to this end—preventing loans from a bank from being used to finance capital injections into the same bank—offers at least a welcome recognition of the problem of over-reported capital, and probably a partial remedy.
- **Improved bank bankruptcy procedures.** The government has submitted to the Duma amendments to the law on bank bankruptcy, to permit the bank restructuring agency (ARCO) to act as a corporate liquidator for all banks taking household deposits. This should make bank bankruptcies speedier and more professional.

- **Establishing credit bureaus.** The joint strategy called for the drafting of a law on credit bureaus, to allow for the provision of information on borrowers' credit history, and the new CBR management has confirmed this as a priority measure. This would address part of the problem of banks' lack of trust towards borrowers.

Apart from these measures, there are other significant changes in prospect, less related to the trust deficit. These include planned amendments to the Civil Code so that term deposits of households would no longer have to be available on demand—this would lengthen the effective maturity of banks' liabilities, and permit a much-needed increase in long-term lending. Also, the CBR's recent expansion of its monetary policy instruments, with new short-term repo operations and foreign currency swaps as well as 2-week deposit auctions, will facilitate banks' liquidity management, reducing their need to maintain high correspondent account balances at the CBR. This in turn should result in greater efficiency, lower spreads, and increased intermediation.

Thus, if the Russian authorities follow through on all the actions to which they have committed themselves, and if growth continues and inflation remains on its shallow downtrend, there is every reason to believe that confidence in the system will continue to gather and Russian banks will increasingly play a normal intermediating role, while the dominance of Sberbank will be whittled away by both foreign and domestic private banks. These developments would facilitate the growth of SMEs and the broadening of the economy, although it must be acknowledged that even if the reforms are successful, the low base of intermediation means that SME development and investment growth will be limited by the state of development of the financial sector for years to come.

## **B. State banks**

State banks taken together are a key part of the financial system and are macroeconomically significant in terms of both their operations and the risks they represent. This, however, is true above all because the state banks include Sberbank, the one systemically important bank in Russia. Primarily on account of Sberbank, state banks

account for about a third of banking system assets and roughly three quarters of household deposits.

The basic strategy of focusing on fostering private banks and gradually allowing the role of state banks to shrink is in our view appropriate. And there are already some signs that this strategy is working: for example, despite strong growth in Sberbank's balance sheet, its share in household deposits is already back below its immediate pre-crisis level, and its share in corporate lending has fallen back somewhat from its peak in late-2000.

Some observers have expressed concern about the sharp increase in Sberbank's credits to the corporate sector since the 1998 crisis. Since Sberbank previously was mostly engaged in lending to the government, there have been concerns that this rapid expansion of corporate lending could overtax its ability to assess the credit risk, bringing about a potential deterioration in its loan portfolio. But there are no indications of such a deterioration, and Sberbank has begun to slow the growth in its corporate lending. The systemic importance of Sberbank obviously means that regulators must keep it under particularly close scrutiny, continually assessing the quality of the loan portfolio, including the issue of how loan losses would be impacted by a much less favorable macroeconomic environment than what we have seen in recent years. While it must be acknowledged that Sberbank is already, by the standards of Russian banks, relatively transparent, we agree with those who see it as important for the CBR to exercise maximum oversight of Sberbank, both as owner and supervisor, and to increase the bank's transparency. As the one systemically important bank, as a far-flung and complex entity, and as a publicly owned institution, it is appropriate to hold it to the highest standard.

We also agree with the decisions not to begin privatization of Sberbank and to keep it intact for the time being. There is an understandable concern about creating any doubts about state backing for the one domestic bank that has enjoyed a reasonable degree of public trust, and about putting into private hands a bank still wielding considerable monopoly power. The view of the CBR that the status of Sberbank should not be changed

before it has become a much less dominating entity in the banking system is understandable. But with the deposit insurance scheme moving forward and Sberbank's share of household deposits already declining, there is no reason why it should still be taboo to begin to discuss the various strategic options for what to do with Sberbank. The discussion should, among other issues, consider whether the bank's asset menu should be restricted (the "narrow bank" model) and whether, when and how the state should exit from ownership of the bank.

As to other state banks, ownership of Vneshtorgbank (VTB) has recently been transferred to the government, and VTB is being merged with parts of Vneshekonombank (VEB) under the leadership of the management of VEB. It is likely that VEB's banking operations will be transferred to VTB, leaving a rump VEB as a government debt agency. Given the conflict of interest inherent in the CBR's owning banking subsidiaries, it could be argued that it made sense to transfer ownership of VTB to the government. But this would amount to little unless it were merely a first step in a speedy privatization process. If there is no such early privatization, the transfer of ownership could even prove to be a step backwards if it made the bank susceptible to political pressure for commercially unsound lending. The government should move quickly to privatize the enlarged VTB, while in the meantime holding it to the highest standards for transparency and governance. In order not to develop yet another state bank, the rump VEB should not be allowed to retain or develop any banking operations.

Another area of concern is the fact that the authorities have not followed through on their commitment to refrain from granting privileges to state banks. In January of this year both Sberbank and VTB were given waivers on the prudential norm on single large credit exposures, in order to allow for the provision of large loans to state-controlled Gazprom, although the CBR has now instructed both banks to get back in line with this norm within six months. If the authorities are to respect their own objectives with regard to reform of the state banks, then the CBR needs to be more hands-on as a regulator, and the government needs to be more hands-off as a solicitor of loans.



## **V. Potential Problems in Implementing Reforms**

What are the potential problems ahead? In our view, they mainly stem from potential implementation failures, reflecting our basic agreement with the priorities and focus of the authorities' program. Whether such failures arise is a question not only of the resolve and the capacity of the CBR, as the primary agency responsible for this area, but also of the political support provided by the government and the Duma.

One of the main implementation risks arises with the adoption of deposit insurance, which involves inherent dangers, especially when the starting position of the banking system is weak. The introduction of such a scheme would be a major mistake if not carefully implemented. The key test facing the authorities in this regard will be their willingness to deny entry to unsound banks. Such entry could happen if political pressures were to prevent regulators from barring banks that do not meet the entry criteria, or if these criteria are in effect lax because the shift away from form-over-substance supervision that the introduction of deposit insurance is supposed to catalyze does not occur.

The issue is the ability and willingness of the authorities to stand up to vested interests. Many banks are closely affiliated with powerful conglomerates or politically influential businessmen, and pressures will undoubtedly be brought to bear on the CBR not to withdraw licenses from such banks. The CBR's resisting such pressures, with the full support from the highest political level, will be essential if the ambitious refocusing of banking supervision is to succeed. Since this refocusing will entail legislative changes to give the CBR more discretionary powers, much will depend on the Duma. The Duma might be reluctant to give its support, as shown by the fact that during its consideration of amendments to the CBR Law this summer it succeeded in pushing in the other direction by sharply limiting the number of allowable CBR bank inspections. More generally, the

CBR faces an as yet untested challenge to its independence from the fact that the amendments to the CBR Law have given a much strengthened oversight role to the previously dormant National Banking Council, half of whose members will be Kremlin- or Duma-appointed. While there undoubtedly is a need to ensure that the CBR is accountable, transparent, and well-governed, it is crucial that the Council refrains from interfering in the day-to-day management of the CBR, including in its banking supervisory functions.

Aside from the potential outside interference, it must also be recognized that the CBR has only limited experience and expertise in conducting more ambitious forward-looking bank supervision. Even in the best of circumstances, it will take time to develop the expertise and the procedures, and if much of the CBR's huge bureaucracy resists the changes, which is a possibility, there could be additional delays.

A failure to strengthen banking supervision would not only hinder the restoration of trust and waste what is set to be the main effort in the area of banking reform in the coming years, but could further distort resource allocation by keeping alive bad banks, with potentially serious future fiscal costs. The chance to achieve a leap forward in fostering trust in banks would be missed and the probability of further debilitating financial crises raised.

As to other parts of the envisaged reform program, timely implementation is far from assured. An important example is the adoption of IAS by banks. This will require a large-scale overhaul of CBR regulations as well as extensive training of auditors and regulators, and the timetable to meet the 2004 target is now very tight. Delayed implementation of IAS would hinder the emergence of a properly functioning banking system as well as denting the authorities' credibility, while a botched implementation would also have substantial costs in terms of confusion and damage to the CBR's reputation. Hold-ups in other areas such as the Civil Code amendments to allow for true term deposits and permit banks to close or refuse to open accounts over suspicions of

illegal activities would also hinder the growth of financial intermediation via the banking system.

More broadly, there are important synergies between banking reforms and other parts of the government's reform program, not least judicial reforms and strengthening of corporate governance. Many of the measures required in the financial sphere are essentially technical, and it must not be overlooked that they depend importantly on other measures that are inherently much more difficult because of stronger resistance from vested interests.

In conclusion, we agree with the basic thrust of the authorities' program for financial sector reforms, notably the focus on leveling the playing field between state and private banks by introducing deposit insurance and significantly strengthening banking supervision, as well as the decision not to seek major changes in state banks at this stage. Failure to implement any of the main elements of the program would leave the financial sector still exerting a drag on growth in investments and GDP, and would leave such growth vulnerable to fluctuations in oil prices. In addition, if deposit insurance in effect becomes available to any bank because the authorities fail to set and enforce strict access criteria, the stability of the system will be threatened. Likewise, if political pressure is exerted on the state-owned banks to extend loans on a noncommercial basis, the dangers of a banking crisis will increase. The still low monetization of the Russian economy means that the macroeconomic impact of even large bank failures would not be acute in the near term. The scale of the risks will increase as remonetization continues, however, and even in the near term, these sorts of failures would detract from the restoration of trust in banks that is key to the system's beginning to play its proper financial intermediation role.